

Taxing Times for the Poor: The Implications of Increasing Indebtedness for Poverty in the U.K

Damon Gibbons

Introduction

Concerns about the growth of household debt in the UK have led the Bank of England to commission an annual representative survey on the state of British household finances through NMG in each of the past four years. The results of these have been cited within the Government's over-indebtedness monitoring reports published by the Department of Trade & Industry (DTI) and in articles published by the Bank itself¹. These official reports have focused on the macro-economic implications of over-indebtedness, assessing the average level of indebtedness against a background of increasing house prices and concluding that net wealth ratios are improving despite a rise in the overall debt burden. However, the official assessment masks a significant increase in the debt burden for lower income households, which have no mortgages and little savings. This paper revisits the data from the NMG survey to assess the level of indebtedness amongst this group and looks at the implications of the debt burden on the Government's stated aim to end child poverty by 2020.

Summary of Findings

The Bank of England has previously reported on the findings from the NMG survey, and noted that the debt burden is increasing amongst lower income groups, and particularly amongst those households renting their homes. However, an analysis of raw survey data that cross referenced the amount of monthly debt repayments with household incomes was not published as part of that report and neither does such an analysis form part of the DTI's half yearly over-indebtedness monitoring reports.

As a result, we have undertaken a re-assessment of the NMG survey data. We find that the poorest households spend over three times as much as the richest on repaying unsecured debts. This is despite the fact that, in absolute terms, the richest households have greater levels of credit commitments. Households in the poorest 40% of the income distribution are spending an average of 10% of their total incomes paying off unsecured debts – compared to just over 3% for the richest 20% of households.

We found that some of the poorest debtor households in the survey, with average incomes of only £7,600 per year, are spending over £660 per annum on debt repayments, leaving them with only £6900 or £132 per week to live on. This would move a single person household from just above the Government's poverty target of 60% of median income to just below it².

For those households with children, increased debt burdens are significantly reducing the headline income growth that they have experienced since 1994/95. In our view, the concentration of the debt burden on the poorest households acts as a form of

¹ The state of British household finances: Results from the 2006 NMG survey, Waldron & Young, Bank of England 2006

² The equivalised income net disposable income at 60% of median incomes for a single person household is currently £145 per week or £7600 per annum.

retrogressive taxation, and poses a live threat to the Government's policy intention of eliminating child poverty.

Our Recommendations

Examination of the debt burden amongst British households should include analysis by income group, age, and household composition as a matter of course. We call on the Bank of England and the DTI to work together to commission much needed further research on this topic.

Debt repayments amongst the poorest households represent a tax on future income which is out of proportion to the level of income received. We recommend that the Government introduce an accessible form of debt relief for households to assist over-committed households.

However, the Government must do much more to ensure responsibility in lending, and to provide access to affordable credit. Common standards of financial assessment should be introduced for lenders, and failure to take account of a customers' ability to pay when making a loan should result in an agreement being unenforceable until the debtors circumstances have improved.

Initiatives to ensure access to affordable credit must be scaled up. Over the past 5 year over £350 million has been made in excess profits by home credit lenders as a result of a lack of competition in that industry. The Government should introduce a windfall levy on the industry and invest the proceeds in credit union development.

Banks and mainstream financial institutions must play their part in bringing affordable and responsible products back to low income communities. A common standard must be agreed by which they disclose the degree to which they are serving people on low incomes, and targets must be set for the industry to improve their performance.

Local authorities should be tasked with bringing together local financial inclusion partnerships to establish the extent of debt and financial exclusion in their communities and to draw up a resourced action plan to address these problems. Assistance should be given to this process by central Government, and seed-corn funding established to resource this.

A national strategy for financial inclusion and debt advice provision should be drawn up as a matter of urgency with sustainable funding solutions found to support the provision of free independent debt advice services.

Debt in the U.K

Total debt in the UK currently stands at £1.3 trillion. Of this, the vast majority, £1.09 trillion, is secured on properties. The remainder of £221 billion consists of unsecured credit borrowed through a myriad of possible vehicles including credit cards, personal loans, hire purchase agreements, doorstep lenders, pawnbrokers, and payday lenders. Access to credit varies across the income distribution, and people on lower incomes commonly have to turn to higher cost lending in order to pay for essential items and to fund normal household consumption.

Whilst the overall picture of the UK's indebtedness needs to be balanced against the level of asset prices – for every mortgage there is a house – for people on low incomes there are seldom any assets to consider. A growth in the unsecured debt burden amongst this group is of particular concern as it represents a burden obtained in the present which must be offset by increased future household income. Unlike higher income groups, they have few assets to serve either as a buffer against fluctuations in income, or which are able to confer wealth. The growth in the debt burden amongst the poorest has major implications for the Government's commitment to halve the number of children living in child poverty by 2010. The Government is committed to the measurement of that target on relative terms – and an uneven increase in the level of debt repayments across the income distribution, with the poorest paying the most for their credit and the richest the least, would offset some of the increased growth in disposable incomes experienced by the poor in recent years.

Despite these concerns, there has been little published data on the levels of debt repayments across income groups, with a focus instead on the number of households that are 'over-indebted'. This term was included in the Government's action plan to tackle over-indebtedness in 2004 as:

*"... debt which has become a major burden for the borrower. Citizens Advice define problem debt as when an individual is "unable to pay their current credit repayments and other commitments without reducing other expenditure below normal minimum levels."*³

Further research commissioned by the DTI revealed that a wide range of possible subjective and objective measurements could be used to assess the degree to which debt has become a 'major burden' including the numbers of insolvencies, the length of arrears on an agreement, or number of credit commitments⁴. In the Consumer Credit White Paper (2005), the households most at risk of over-indebtedness were defined as those having four or more credit commitments; spending 25% of their gross incomes of credit repayments and/or spending 50% of their gross income on mortgage and credit commitments.

The focus on over-indebtedness, although important for example in terms of assessing the need for debt advice services, and as an indicator of possible wider social and financial exclusion issues, overlooks the importance of debt repayment levels per se as a reduction in immediate consumption power and as a drain on the future financial resources of the poorest. Put simply, the issue of whether or not households are *struggling* to maintain payments is irrelevant in a consideration of the impact of

³ Para 7, Tackling Over-indebtedness Action Plan, DTI, 2004

⁴ Oxera, 2004

making those payments on current disposable incomes. Default on payments due may indicate severe financial problems, but any repayment of debt actually made reduces current disposable income.

The NMG Survey: Reported Results

In late 2006, the Bank of England reported on the results of a commissioned survey by NMG concerning British Household Finances. The survey is based on a representative sample of approximately 2,000 households, and gathers both quantitative and qualitative responses relating to indebtedness and the degree to which households view their debt repayments as a burden or are struggling to maintain these.

The Bank of England's overall concern, as can be expected, is with the potential impact of widespread debt problems at the macroeconomic level.

"The rapid increase in household debt in recent years has raised questions about the ability of people to repay what they owe. This could have implications for monetary policy if debt problems were widespread and those affected cut their spending sharply."

As a consequence, the focus of the Bank is on those households carrying the largest proportion of total debts in the form of mortgages. Nevertheless, the Bank's report identified that the unsecured debt burden continues to rise for people renting their homes.

"While there was little change in the overall proportion of households with debt, this masks a change in the distribution of debt across types of households.⁽¹⁾ In particular, the proportion of renters with unsecured debt had continued to rise. While renters account for a very small proportion of overall outstanding debt (3%), they might be more prone to default than homeowners because they do not have housing equity to draw on if they face financial difficulties."

However, the overall focus of the Bank remained on households with mortgages because although *"a small minority (9% of renters with debts) had unsecured debts in excess of their annual pre-tax income...this is a very small proportion of households as a whole (around 1%)."*

Nevertheless, the release of the raw data from the survey provides an opportunity to bring a greater focus to the unsecured lending commitments of low income borrowers and to assess the impact of a growing debt burden not on the macro-economy or monetary policy, but on other Government priorities and in particular its commitment to end child poverty.

The Distribution of Unsecured Debt and Repayment Levels

The NMG survey data provides an indication that those on the lowest incomes are less likely than the general population to take on debt (see table 1, below) – reflecting current Government concerns in respect of financial inclusion more generally. 37% of households in the poorest income quintile compared to over 60% of households in the richest.

Quintile	Mean Income £'s per annum	% households with unsecured debts
1	7650	37.09
2	13450	42.75
3	22600	56.27
4	32800	58.64
5	59200	63.63

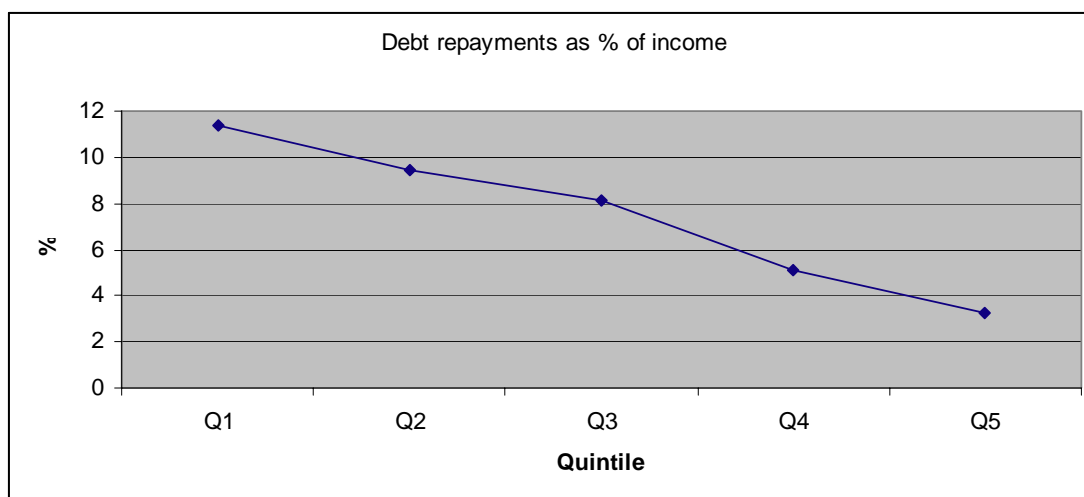
The average level of unsecured debt taken on was also likely to be significantly lower amongst poorer households (see table 2), although debt levels are higher relative to income. The debt to income ratio for the poorest households revealed in the survey was 34% compared to just over 10% for those on the highest incomes. This discrepancy in income gearing is interesting given that the financial services industry would generally regard low income as a high risk factor to be taken into account in loan decisions.

Quintile	Mean Income £'s per annum	Average Unsecured Debt (£'s)	Debt: Income %
1	7650	2669	34.88
2	13450	2783	20.71
3	22600	5738	25.37
4	32800	5570	17.04
5	59200	6296	10.63

The impact of lending higher amounts relative to income levels to the poorest households may not be felt immediately, however. A variety of loan vehicles allow significant advances to take place whilst restricting the monthly payment to affordable amounts, at least in the short term. For example, credit cards targeted at the sub-prime market can be obtained which provide 'concessionary rates' at lower APR's than their 'standard rates' which become effective in the event of a default.

Low income households taking on debt can therefore be at significantly greater risk of facing swift increases in the amount of their debt repayments, both because they are often restricted to using credit products that increase repayments on default, and because they are more likely to experience pressures on their household budget that cause them to default in the first instance.

Although this dynamic requires further exploration, what is clear from the survey data is that low income households do pay the most for their credit as a proportion of their income. As can be seen in the figure, below, the poorest households with credit debts spent an average of 11.39% of their income on debt repayments in the month prior to the survey. This compares to just 3.2% of the richest incomes paid over to credit lenders in the period.



Impact of Debt Repayments on Household Income Distribution

Repaying a growing debt burden reduces the disposable incomes of the poorest households more than it does those of their richer counterparts. This impact is not considered by Government when assessing the degree to which household incomes are distributed in the UK. The latest figures available for the household income distribution demonstrate that the poorest households have seen their incomes grow at a faster rate than those in the upper quintiles.

(£pw equivalised)	Quintile group medians					Population mean
	Quintile 1	Quintile 2	Quintile 3 (median)	Quintile 4	Quintile 5	
Income Before Housing Costs						
1994/5	146	210	290	394	596	350
1995/6	148	212	290	391	599	351
1996/7	149	219	303	407	617	363
1997/8	151	223	308	415	627	373
1998/9	154	227	313	427	651	386
1999/00	159	234	322	436	661	394
2000/01	164	243	332	449	685	411
2001/02	174	258	349	464	717	429
2002/03	176	262	355	470	720	433
2003/04	178	264	355	473	714	431
2004/05	182	268	359	477	722	437
2005/06	181	269	362	482	733	443
Income growth 1994/95 to 2005/06	24%	28%	25%	22%	23%	27%

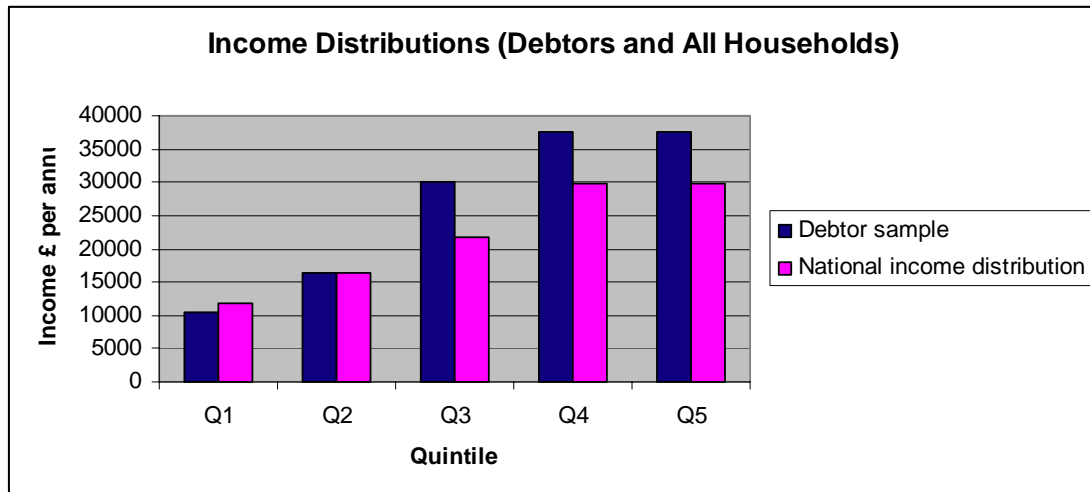
Note:
1. Figures are for United Kingdom from 2002/03 onwards. Earlier years are for Great Britain only.
2. All estimates are subject to sampling error.

Source: Households below Average Incomes, DWP 2006

However, if the results from the NMG survey were to be replicated across the population, then the picture could look very different. Consider the above data on the basis that the poorest debtors pay over 11% in debt repayments of their income in the year 2005/06. This would reduce those households income from £181 per week to just £161.09, effectively eliminating any income growth for those households since 2000/01. Debtors in the highest quintile are also affected, but because they spend on average only 3% on debt repayments the effect is to reduce their household income to

£429 per week (the level received in 2001/02). The unequal distribution of the debt burden therefore compounds existing inequalities further.

There are however, some clear methodological problems in assuming that the NMG survey data can simply be read across to the national population. Only a relatively small sample of debtor households in the NMG survey declared the level of their debt repayments (n = 343). This leads the income distribution of the debtor sample in the NMG survey to vary from the national income distribution with debtor households having a slightly higher income than nationally in the lowest quintiles and a lower level of income at the richer end of the distribution.



Nevertheless, the NMG data clearly demonstrates that once debt repayments are taken into account, there is a marked shift to the left in the available incomes of the poorest groups compared to the richer households.

The sums involved are sufficient to move households from above the Government's target of 60% of median incomes to below this. Debtor households in the NMG survey with mean incomes of £12,500 would ordinarily be above the Government's poverty line of £11,284. But debt repayments amongst this group swallow up an average of £1250, reducing disposable income to £11,250 and putting them below the poverty line. For single households, the poverty line equates to £148 per week. But we found that the 20% poorest households in the survey, with a mean income of only £7,600 per year, are spending over £660 per annum on debt repayments, leaving them with only £6900 or £132 per week to live on. For these reasons we conclude that the impact of the growing debt burden on the Government's child poverty targets now needs to be urgently researched and monitored.