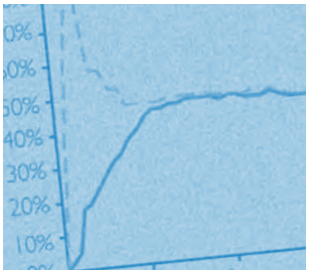
Breakthrough
Britain

Dynamic Benefits

Towards welfare that works



A Policy Report from the Economic Dependency Working Group

Chaired by Dr Stephen Brien

Economic Dependency Series Editor: Rt. Hon Iain Duncan Smith MP

September 2009

THE CENTRE FOR SOCIAL JUSTICE

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About the Centre for Social Justice

The Centre for Social Justice aims to put social justice at the heart of British politics.

Our policy development is rooted in the wisdom of those working to tackle Britain's deepest social problems and the experience of those whose lives have been affected by poverty. Our working groups are non-partisan, comprising prominent academics, practitioners and policy makers who have expertise in the relevant fields. We consult nationally and internationally, especially with charities and social enterprises, the champions of the welfare society.

In addition to policy development, the CSJ has built an alliance of poverty fighting organisations that reverse social breakdown and transform communities.

We believe that the surest way the Government can reverse social breakdown and poverty is to enable such individuals, communities and voluntary groups to help themselves.

The CSJ was founded by Iain Duncan Smith in 2004, as the fulfilment of a promise made to Janice Dobbie, whose son had recently died from a drug overdose just after he was released from prison.

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Preface: Breaking the Dependency Spiral

Iain Duncan Smith

The Centre for Social Justice (CSJ) was established to find and promote solutions to deep-rooted poverty in Britain. As leader of the Conservative Party I frequently encountered significant social breakdown and dysfunctionality across the country. I met people trapped by dependency and left behind by society.

This emerging underclass lives in communities consistently defined by five characteristics, which become the pathways to poverty: family breakdown; educational failure; drug and alcohol addiction; severe personal indebtedness; and economic dependency – caused by intergenerational worklessness.

The CSJ has published more than 350 policy solutions to reverse this breakdown – breakdown which costs society more than £100 billion a year – and move people out of poverty. At the heart of these solutions is recognition that the nature of the life you lead and the choices you make have a significant bearing on whether you live in poverty. Policy-makers regularly fail to understand this, instead viewing poverty through a financial lens only.

Benefit Reform

I asked Dr Stephen Brien to conduct this work when it became obvious during our review of intergenerational worklessness in *Breakthrough Britain* that although we had produced some excellent recommendations to make the process of returning to work easier and more sustainable (many now adopted by Government and Opposition alike), the biggest barrier to those entering work for the first time was the benefit system itself. Dr Brien and his team, fully supported by us at the CSJ, then undertook this root and branch review of the benefits system. All engaged on this report were seized with the importance of finding a better system which would support social reform and have committed themselves to this project for over two years.

More of the Same, Not an Option

Routinely, incoming Governments commit to reducing the cost of welfare at the start of their administrations, by creating new rules to govern access to existing

benefits, and by creating new benefits. All this is accompanied by claims that they will improve the system's efficiency. Yet, too often their grand claims that savings will be made turn out to be wildly optimistic. A simple look back over the last thirty years will show that the cost of welfare has risen above the rate of inflation. This is particularly true of the last ten years where the Government has had an almost uninterrupted period of economic growth. Despite such benign conditions, prior to the present recession, the number of people of working age on out-of-work benefits remained stubbornly high at approximately 5.4 million.

Cutting the bill of social failure, in particular welfare expenditure for those of working age is a laudable aim. Indeed, the present Government set it as one of its highest priorities on coming to office in 1997. It didn't take us at the CSJ to highlight that now in 2009, by its own rhetorical measure the Government has failed to achieve what was hoped for. After all, recent statements by a succession of Secretaries of State for Work and Pensions have made that judgement very public indeed. For at the heart of this analysis are some simple facts.

The cost of welfare has increased inexorably. By way of illustration, more than £74 billion was paid directly to working-age adults and children last year (amounting to 40% of the social security budget). Such expenditure has risen above inflation every year since 1997, when the cost was approximately £57 billion (at today's prices).

Our pre-recession youth unemployment rate, despite the huge investment of £2 billion from the New Deal for Young People, has remained pretty well static, despite a period of unprecedented economic growth. Even worse are the figures for the percentage of young people aged 16-18 years old, not in employment, education or training (NEET): this has actually increased since 1997.

Furthermore, the number of lone parents claiming Income Support (IS) – to which £9.2 billion was allocated last year – remains high at 736,000 (over a third of total IS claimants). As well as being a notable investment area for the Government through tailored programmes such as the £225 million New Deal for Lone Parents (NDLP), lone parents also receive a significant proportion of the £21 billion spent on tax credits, and automatically qualify for Housing Benefit through IS.

Yet this targeted investment has failed to meet the challenge of employment sustainability. Present figures for the NDLP demonstrate that a very high proportion of lone parents who move into work actually enters what is classified as 'unsustainable or unknown' employment – approximately 52% in 2008. As one would expect during the first few years of the scheme, the proportion in sustainable work was higher (as the parents who were easiest to place found employment), but it then plateaued for several years prior to falling back significantly, even before the latest recession. (We note with interest that the series recording NDLP exit rates has recently been withdrawn).

Time and again our review received anecdotal evidence from lone parents about the trap of the 16 hour working week. In dramatically reducing financial incentives to work less than 16 hours (through non-qualification for the Working Tax Credit), or more than 16 hours a week (through very high benefit withdrawal rates), the Government ensures lone parents face only one

sensible work option – 16 hours. Those who find themselves in circumstances where working less than 16 hours per week would be the right option, find that the financial reward is negligible; and those who want to work more find that it is not worth their extra effort to progress towards full-time work. Such an inflexible and complicated scenario creates system churn as lone parents must fit their lives around the two viable options – not working, or working 16 hours. This disrupts the lives of claimants through the loss of self-confidence and delays in receiving key entitlements such as Housing Benefit, when they change their circumstances. Crucially, it also fuels a highly influential word of mouth message that progression into work simply isn't worth the hassle. In its recent report on child welfare, *Doing Better for Children*, the OECD also recognises this, concluding in relation to single parent benefits that "There is little or no evidence that these benefits positively influence child well-being, while they discourage single-parent employment."

Such targeting and tweaking has created further losers, most notably couples with children who as a consequence have to work many more hours to reach the same level of income as lone parents.

Income Source v Income Level

The problem is that this piecemeal system has now become so complicated and cumbersome that it is almost impossible to predict how it will respond. Today, there are 51 separate benefits which create a myriad of tax traps and special rates for different groups. Positive life choices are penalised – such as couple formation, buying a home or saving money.

These issues are often caused by one of three problems arising from the present system:

1. It creates a series of disincentives to work;
2. It imposes penalties on constructive behaviour apart from work (such as marriage and cohabitation, saving, and home ownership);
3. It is very complex – making it costly to administer and reinforcing dependency.

It is fully accepted that being in work is good for us all, beyond the importance of the income it delivers. Government research has found income source to be more important than income level in determining levels of social exclusion. Earning money through gainful employment has many life changing advantages - people in work have better health; they develop strong social networks; and they become living proof to themselves and others around them of a link between effort and reward.

However, whilst recognising there are life changing benefits for someone who is employed, we must also recognise that few of those out of work would look upon work as a moral choice, rather a practical one. For them, employment and career progression above all has to pay and if we understand

that this is part of what motivates those already in work, why do we seem to expect something altogether different of benefit claimants? Under the present system, entering work or progressing toward full-time work simply doesn't pay. In real terms it often leaves claimants no better off, or even disadvantaged, for much more effort.

Participation and Marginal Tax Rates

For claimants in part-time employment who are seeking to work more, the marginal tax rate (MTR) – a measurement of what proportion of a small rise in earnings would be lost to taxation and benefits withdrawal – can be as high as 80% or 90% for every additional pound earned. Fuelling such high MTRs are some of Europe's highest benefit withdrawal rates – up to 100% for every additional pound earned in some cases.

For out-of-work claimants we measure the participation tax rate (PTR). This identifies the relative financial incentive to commence paid employment at a given earnings level, in comparison to remaining on benefits. Too often PTRs are extremely high, meaning tangible income will hardly increase if they work, and therefore the rational option is to stay on benefits.

Why should we expect people out of work to behave differently to those in work? We know that those already employed respond to the effect taxation has on their earnings. If they perceive that working longer hours brings no tangible benefits, then they don't commit to the extra hours. Both Government and businesses set their work conditions to incentivise productive behaviour. However, when it comes to the unemployed, Government lazily assumes people will take work out of a sense of obligation - enforced or voluntary. That is why Government has, over a number of years, produced a complex system which, rather than moving people to financial independence, instead entrenches economic dependency and ensures claimants remain net receivers in society rather than contributors.

Crucially, however, the proposals contained in this review will ensure benefit claimants gain from entering work, or from working more hours. We recognise that incentives, not values alone, shape human decisions. Our reforms will remove the financial roadblocks to entering and sustaining work. They will also steadily move benefit recipients towards their full employment potential.

The review is presented in the context of other recommended support for those seeking work, or more work, as outlined in *Breakthrough Britain* – such as tailored support, training and personal mentoring.

Dynamic Modelling

Central to our vision for the benefits system is dynamic modelling – a method used extensively in the private sector. The unique Dynamic Benefits Model we have devised will bring our static and outdated welfare system into the 21st

century. It will tell policy-makers how any given change to the structure of the benefits system will affect different households according to specific measures outlined in the review.

The establishment and utilisation of this Model is foundational to delivering the other essential, and costed, recommendations the review makes. These include more generous earnings disregards (the amount of income kept before beginning benefit withdrawal) for household categories; streamlined benefits to simplify the system; and a move away from penalising positive behaviour such as couple formation, saving money and home ownership.

These landmark reforms emerge after two years of challenging and complex endeavour. Throughout, the Working Group consulted with a number of expert academics and professionals who helped to shape its methodology. Here I am particularly grateful to Mike Brewer, Director of the Direct Tax and Welfare programme at the Institute for Fiscal Studies, for his valuable contribution as an adviser to the group, and for reviewing and helping us refine the methodology used to create the Dynamic Benefits Model. The team also engaged several focus groups of benefit claimants to test the logic and practicality of the recommendations – my thanks to these groups.

My thanks also go to Working Group members, supported by researchers at the CSJ: Nicholas Boys Smith, of Lloyds Banking Group; David Godfrey, Chief of Staff to Greg Clark MP; James Greenbury, who has 20 years experience running private equity-backed businesses; Nick Hillman, Chief of Staff to David Willetts MP; Sara McKee, of the Anchor Trust; Dr Peter King, of De Montfort University; Lee Rowley, Westminster City Cabinet Member of Customer Services and Communities; Debbie Scott, Chief Executive of Tomorrow's People; and Corin Taylor, Senior Policy Adviser at the Institute of Directors and formerly with the TaxPayers' Alliance.

My particular thanks and gratitude is reserved for the review's Chairman Dr Stephen Brien, who with great dedication has brought his insight to bear on this complex problem. The excellence and simplicity of these proposals are down in large part to Stephen's dedication and innovation. My thanks also to Oliver Wyman for supporting this work.

Conclusion

This review marks a watershed for Britain's benefits system. Although quite technical, the recommendations hold to the simple principle that work is the most sustainable route out of poverty. We believe the group's success in devising a system which smoothes out the participation and marginal tax rates so that there is no financial disincentive to work, should be taken seriously by members of every political party.

I hope these recommendations are accepted by politicians and civil servants alike. There are those who say this is not a priority because we are mired in a recession and the jobs aren't there. We disagree, for unless we put the system right now, we run the risk of increasing the number of residually unemployed,

only this time it will manifest itself as large numbers of younger people permanently excluded from gainful employment. That is why we simply cannot go on talking about the importance of getting people into work while we persist in creating disincentives for the very people we say should be in work. Our existing complex and inefficient benefits system should finally be laid to rest; otherwise all the talk about improving the number of people going back to work will be just another form of empty rhetoric.

Iain Duncan Smith
Chairman, Centre for Social Justice

The Economic Dependency Working Group Members

Dr Stephen Brien, *Chairman*
Stephen Brien is a partner and former head of the London office of Oliver Wyman. He is a member of the board of directors of the Centre for Social Justice. He contributed to *Breakdown Britain*, and was co-chairman of the Economic Dependency Working Group for *Breakthrough Britain*.

Nicholas Boys Smith
Nicholas Boys Smith is a former parliamentary candidate and has served an advisor on welfare policy to the then Secretary of State for Social Security, Peter Lilley and as secretary to the Tax Reform Commission set up by the Shadow Chancellor of the Exchequer, George Osborne MP. Nicholas was author of the report *Reforming Welfare,* published in 2006 by the think tank Reform. Nicholas is currently Wealth Director in the International Private Banking division of Lloyds Banking Group.

David Godfrey
David Godfrey is Chief of Staff to Greg Clark MP and was previously Head of Public Policy at Kent County Council where he worked closely with Lord Sandy Bruce-Lockhart to establish Kent's pioneering Supporting Independence Programme. A member of the CSJ's Economic Dependency Working Group which produced *Breakthrough Britain*, David continues to promote local solutions to national welfare challenges.

James Greenbury
James Greenbury has spent the last 20 years running a number of private equity backed support services business, all of which had a majority of the work force for whom staying on benefits was, and remains, a real alternative. Earlier in his career James was a partner of Bain & Company, strategy consultants.

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Nick Hillman is Chief of Staff to David Willetts, Shadow Minister for Universities and Skills, with special responsibility for family policy. He was appointed as an Associate Fellow of Policy Exchange in 2003 and in 2008 he authored their report *Quelling the Pensions Storm*.

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Sara McKee is Group Services Director of Anchor Trust. Before joining Anchor Trust, Sara was Group Commercial Director at A4e, an organisation that works with governments in the UK and overseas helping people in marginalised areas achieve greater inclusion in society through employment and training. Sara has over 20-years experience in commercial consumer-facing businesses, across a range of sectors including technology, retail, travel, training and employment internationally.

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Peter King is Reader in Social Thought at De Montfort University. He has over 25 years experience in housing as a housing manager, case worker and academic. His main teaching and research interests are in housing finance and political economy. He is the author of *Choice and the End of Social Housing* (IEA, 2006) as well as 10 other books and numerous articles and papers.

Lee Rowley

Lee Rowley has been a Westminster City Councillor since 2006, representing Maida Vale in north-west London. He presently serves as Cabinet Member for Customer Services and Communities. Lee also contributed to *Breakdown Britain*, *Breakthrough Britain* and *Housing Poverty reports*.

Debbie Scott

Debbie Scott is Chief Executive of Tomorrow's People, a national employment charity founded in 1984. Debbie is a founder member of the Employment Related Services Association (ERSA) and was its first Chair, until April 2007. Debbie is a member of the Association of Chief Executives of National Voluntary Organisations (ACEVO). Debbie is a member of the Employment Advisory Group of the CBI and its Public Service Industry Forum (PSIF). Debbie was a member of CBI Employment Advisory Group from 2006 to

2009. In January 2008, Debbie was awarded an OBE in the Queen's New Year's Honours for servicesto the unemployed. She was named Charity Principal of the Year at the UKCharity Awards 2005.

Corin Taylor
Corin Taylor is a Senior Policy Adviser at the Institute of Directors covering economic policy, taxation and public service reform issues. In 2006, he was Political Secretary to the Tax Reform Commission and wrote several sections of the Commission's report. Prior to that he worked for the think tank Reform for two years as Economics Research Officer, where he authored a number of papers on tax and economic reform, including drawing up Reform's "growth rule" for sustainable public spending and co-authoring a pensions reform plan with Tony Blair's former economic adviser, Derek Scott.

Adviser

Mike Brewer
Mike Brewer is director of the direct tax and welfare research programme at the Institute for Fiscal Studies. Within this broad area, Mike has analysed the generosity of the tax and benefit system for families with children, and the impact of the same on work incentives, in both the UK and the US. He took part in a major evaluation of working families' tax credit, examining its impact on labour supply and takeup, and he is currently evaluating the labour market impact of the New Deal for Lone Parents Plus. He has closely followed the development of tax credits in the UK, particularly the introduction of the child tax credit and working tax credit in 2003. He has also looked at general trends in the current Labour government's approach to social security benefits and tax credits, and its ambition to abolish child poverty.

Researchers

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Victor Burnett, *Researcher*
Victor Burnett is a former economics researcher at the Centre for Social Justice.

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Ed Bond, *Researcher*
Ed Bond graduated from Cambridge University with a First in History. He has had a range of jobs since leaving university, and is currently a football coach for Charlton Athletic Football Club.

The Working Group members were acting in a personal capacity. The report represents the views of the Working Group as a whole and does not reflect at every point the individual opinion of each and every Working Group member.

Executive Summary

Our benefits system is broken. Although it alleviates financial hardship, it does so at a price. High benefit withdrawal rates trap millions in worklessness and dependency, often over several generations.

To address Britain's unacceptable levels of poverty and social exclusion, we need to redesign the benefits system to boost employment and earnings over the long term. This will require a new approach: one that recognises how claimants respond to withdrawal rates.

The current economic downturn has merely served to expose further the already deep flaws in the system. A clear lesson from past downturns is that without reform of the benefits system, future economic recovery will bring only a slight reduction in worklessness.

Worklessness and poverty have both been rising over the last year. However, they are not solely – or even mainly – cyclical problems, but long-term structural ones. They are attributable in no small measure to the benefits system, which in alleviating the experience of poverty has also entrenched and perpetuated its causes: the lack of employment and earnings.

There is no doubt that work is a good thing. Earning money through gainful employment has many advantages, besides simply providing a source of income – for example better health, the development of social networks, and demonstrating the link between effort and reward. These are advantages that income from benefits does not provide.

With the likelihood that more than 2.5 million Britons will soon be officially unemployed, the need to reform the benefits system is more pressing than ever. To ensure that the number of workless people reduces as quickly as possible after the recession, it is imperative that we do not repeat the mistakes of previous downturns. Large numbers of claimants cannot be consigned to long-term worklessness by making it pointless for them to return to work. They must be given every incentive to participate in, and contribute to, future economic growth.

SUCCESSIVE GOVERNMENTS HAVE ATTEMPTED TO REFORM THE SYSTEM

Successive governments have attempted to address many of the problems of the welfare system. The current Government has also had high ambitions.

The Government recognised that "there is a wider gap between rich and poor

than [there has been] for generations";[1] and declared their "historic aim will be for ours to be the first generation to end child poverty, and it will take a generation."[2] They were determined "not to continue down the road of a permanent have-not class, unemployed and disaffected from society."[3] Yet, Britain's benefit system has failed to address poverty in a *sustainable* way.

The failures of the old way of thinking: Poverty and dependency

- Child poverty and severe poverty have both been on the increase in recent years.[4]
- Income inequality is higher now than at any time in the previous 30 years.[5]
- While many lone parents have been lifted out of poverty, due to increases in benefit income, one of the unforeseen consequences of the system has been a growing number of couples with children living in poverty.[6]
- Approximately one in seven of all working-age households are dependent on benefits for more than half their income.[7]
- More than half of all lone parents depend on the state for at least half of their income.[8]

The Government also pledged to "get 250,000 young unemployed off benefit and into work";[9] and they despaired that "one million single mothers are trapped on benefits".[10] Tony Blair vowed "that we will have reduced the proportion we spend on the welfare bills of social failure."[11]

The failures of the old way of thinking: Worklessness

- Today, there are 10.4 million working-age people not working in the UK. Of these, 5.9 million are claiming out-of-work benefits.[12]
- Throughout the last ten years, prior to the recession, the number claiming out-of-work benefits has been at around 5.4 million.[13]
- At the end of many years of economic growth, there are 1.6 million children living with a lone parent who is not working.[14]
- The Government has spent well over £2 billion on the New Deal for Young People,[15] and yet the number of 16 to 24-year-olds not in education, employment or training (NEET) has hardly changed – 18.8% of young people were NEET in 1997, and 18.9% in 2006.[16] The number of young people who are NEET is now approaching the one million mark.[17]

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1 The Labour Party, 'New Labour: because Britain deserves better' (Labour Party, 1997).
2 Tony Blair, Beveridge Lecture, Toynbee Hall, 18 March 1999.
3 The Labour Party, 'New Labour: because Britain deserves better' (Labour Party, 1997).
4 DWP press release, 'Government Response to Households Below Average Income Figures' (7 May 2009); Mike Brewer, Alastair Muriel et. al., *Poverty and Inequality in the UK: 2009* (IFS, 2009), p. 34. .
5 http://www.poverty.org.uk/09/index.shtml.
6 Mike Brewer and Alastair Muriel, *Poverty and Inequality in the UK: 2009* (IFS, 2009), p.42.
7 Department for Work and Pensions, *Family Resources Survey United Kingdom, 2007-08,* (DWP, 2009), Table 3.8.
8 Ibid.
9 The Labour Party, 'New Labour: because Britain deserves better' (Labour Party, 1997)
10 Ibid.
11 *The Observer* (2 October 1996)
12 ONS, *Labour Market Statistics August 2009* (ONS, 2009), Table 1; Department for Work and Pensions, 'Benefit Expenditure Tables', Table C1. Available at: http://research.dwp.gov.uk/asd/asd4/medium_term.asp [Accessed 21 August 2009]. Combines income and contribution-based JSA, IS, IB, ESA. A very small number of these claimants will be working a small number of hours per week.
13 Ibid.
14 Departmnent for Work and Pensions, *Households Below Average Income 2007/8* , Table 4.1.
15 Frank Field and Patrick White, *Welfare Isn't Working: The New Deal for Young People* (Reform, 2007), p.11; Department for Work and Pensions, Departmental Report 2009 (DWP, 2009), pp.110-111.
16 Adapted from Frank Field and Patrick White, *Welfare Isn't Working: The New Deal for Young People* (Reform, 2007), p.28-29.
17 Department for Children, Schools and Families, 'NEET Statistics: Quarterly Brief: August 2009' (DCSF, 2009), p. 10.

KEY CONCEPTS:

Earnings, income and poverty

The terms **earnings** and **income** are used here with a particular meaning.

Earnings is the total amount that an individual (or household) earns from work, before Income Tax and National Insurance are taken.

Income is the resulting income after combining post-tax earnings and benefit income (including tax credits).

For example, if a single person has gross weekly wages of £165, these will be his *earnings*. £18.95 of Income Tax and National Insurance will be withheld, and he will receive £32.28 in Working Tax Credit (he will not receive the full amount because it has been partially withdrawn). His resulting net *income* will be £178.33 per week.

The poverty threshold, below which income a household is considered to be living in poverty, is defined as 60% of the *median household income*, adjusted for household size: £158 per week for a single person and £361 for a couple with two children.[21]

Most recently, under the banner of "Ending the Something for Nothing Society," James Purnell, the former Secretary of State for Work and Pensions, issued reviews of individual benefits, and increased the conditions attendant on major benefits. Although these reforms represent modest steps in the right direction, they do not get to the heart of the matter; it remains financially pointless in many circumstances to take up employment, due to the cost in lost benefits.

The failure to look anew at the structure of the benefits system has, sadly, meant that this Government has not differed from its predecessors, and has failed to achieve many of its objectives. Not only are worklessness and poverty rising, but as a result, the costs of 'social failure' have not been reduced: last year £74.4 billion[18] was paid directly to working-age adults and children, about 40% of the total social security budget. It has outstripped inflation nearly every year since Beveridge's post-war reforms.

A NEW WAY OF THINKING IS REQUIRED

For many, the answer to unsustainable welfare bills is to introduce ever tighter rules for receipt of benefits, and to cut generosity for some claimants. However, this approach has never worked. It is not the particular levels and conditions that are at fault, but the structure of the system itself.

Government research has found that the *source* of income is more important than the *level* of income in determining levels of social exclusion.[19] A system that penalises work, and focuses on how much income people have, without distinguishing between earnings from work and income from benefits, merely considers the *symptoms* of dependency and poverty. It is counterproductive and must be reformed.[20]

To address the underlying causes of dependency, and make a real difference, the structure of the system itself needs to change. Work must be supported as the primary sustainable route out of poverty. Hence, this report focuses on how to reduce dramatically the existing barriers to entering work and earning more – in an affordable way.

Part I. The Benefits System

The benefits system is not just a passive money dispenser; it is also an active player in determining whether people work. This is not because of how benefits are

18 £30.3 billion worth of Child Benefit, Child Trust Fund endowments and tax credits administered by HMRC; £3.86 billion expenditure directed at children by DWP; £40.26 billion expenditure directed at adults of working age by DWP. See: Department for Work and Pensions, 'Benefit Expenditure Tables', Table 6, available at: http://research.dwp.gov.uk/asd/asd4/medium_term.asp; and HM Revenue & Customs, *Departmental Report 2008* (HMRC, 2008), p. 8.

19 Richard Berthoud, Mark Bryan and Elena Bardasi, *The dynamics of deprivation: the relationship between income and material deprivation over time* (DWP, 2004), Table 6.6.

20 Ibid.

21 Department for Work and Pensions, *Households Below Average Income 2007/8* (DWP, 2009), Table 2.3, p. 18.

awarded, but because of how they are withdrawn when a person starts earning. High average (or 'participation') tax rates are the main disincentive to work – and this can mean that the Exchequer loses more in tax receipts than it saves by withdrawing benefits more aggressively.[22]

The benefits system in brief

The current benefits system is very complex. The following is a simplified description of the 1784 page *Benefits Handbook*:[22]

- The three main **benefits for people who are out of work** are Jobseekers' Allowance (JSA), Employment and Support Allowance (ESA) and Income Support (IS).
  - JSA is available to everyone who is looking for a job; it pays at £64.30 per week for over-25s.
  - ESA is available to those who are unable, because of disability, to take a job; it pays at different rates depending on severity of incapacity. (ESA can be supplemented by Disability Living Allowance (DLA)).
  - IS is the benefit for the remainder, those who are not expected to work but do not have a disability – for example, single mothers with young children; it pays at the same rate as JSA, £64.30.
- There are **benefits that support living costs**, such as Housing Benefit (HB) and Council Tax Benefit (CTB). The value of these varies according to local rents.
- There is also an **in-work benefit**, the Working Tax Credit (WTC), which acts as an income top-up for those in low-paid jobs. This pays £1,890 per year at the basic rate. WTC is for people over the age of 25 who work 30 or more hours per week; it is also available to parents or disabled people who work 16 or more hours. Under-25s are only eligible if they are parents. Its restriction to those working more than 16 or 30 hours is referred to as the 'hours rule'.
- Child Benefit and Child Tax Credit are paid to **families with children**. Child Benefit is a universal benefit available to any parent regardless of income level. Child Tax Credit is worth £2,780 per year for the first child and £2,235 for each additional child. It is withdrawn gradually from families earning more than £50,000.
- **'Passported' benefits** are in-kind benefits and are attached to other benefits. Income Support, for example, acts as a passport to free school meals and free prescriptions.

The benefits system exists to relieve the effects of unemployment, and to make life without work less difficult. It also plays a central role in the economic choices made by the poorest in society.[23] However, it has three main failings which directly contribute to the rising levels of social breakdown in the country's most disadvantaged communities:

1. **It disincentivises work:** the swift withdrawal of benefits, offsetting any earnings from work, punishes the lowest earners trying to earn more. It makes leaving welfare a risky proposition;
2. It imposes **penalties** on desirable behaviour apart from work – such as marriage and cohabitation, saving, and home ownership;
3. It is very **complex** – making it costly to administer and reinforcing dependency.

22 Child Poverty Action Group, *Welfare Benefits and Tax Credits Handbook 2009-2010* (CPAG, 2009).
23 See Social Justice Policy Group, *Breakthrough Britain: Ending the costs of social breakdown* (CSJ, 2007) for further details.

KEY CONCEPTS:
Benefit withdrawal rates

When a person who is on benefits earns more, the amount of benefit they receive, per week or per month, begins to decrease. This is known as benefit withdrawal. The **benefit withdrawal rate** shows how much benefit is lost per week for each extra £1 earned.

Normally there is also an amount of earnings, called the **earnings disregard**, below which no benefits are withdrawn.

Different benefits have different withdrawal rates, and some are on pre-tax and some on post-tax earnings. Different benefits can be withdrawn at the same time.

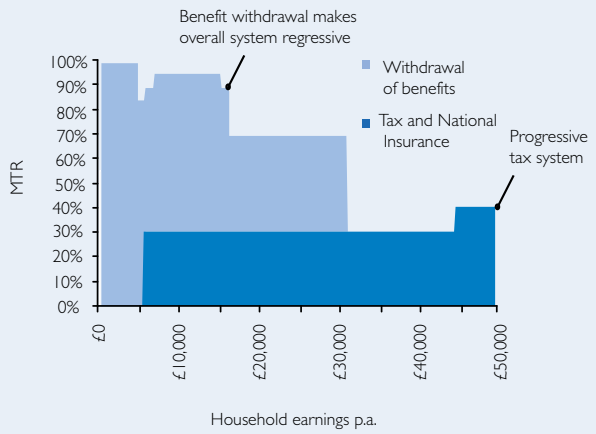
- As a person enters work, they face withdrawal rates of 100% for Jobseeker's Allowance (JSA) and Income Support (IS).
- After a claimant has made the full transition from JSA into work, Housing Benefit and Council Tax Benefit are then withdrawn at a combined rate of 85% of after-tax earnings.[26]
- For every £1 extra per week in gross earnings, 39p of tax credit is lost: its withdrawal rate is 39% of pre-tax earnings.

Both the absence of work and the presence of family breakdown have a detrimental impact on the mental and physical health of adults[24] and the future life chances of children.[25]

DISINCENTIVES TO WORK

The swift withdrawal of benefits, offsetting earnings from work, creates a deeply regressive system that punishes low earners who are trying to earn more. Today's complex benefits arrangements often result in a participation tax rate of more than 75% for low earners – which means that their increased income from working is less than 25% of their earnings. The first steps into the world of work for many in a low hours/low pay job are all but pointless.

Low earners have much higher MTR than high earners



High benefit withdrawal rates create problems for low earners who wish to earn more by working longer hours, because they face high marginal tax rates.[27] In recent years, the lowest income deciles have experienced the largest rises in marginal tax rates (MTRs).[28] Nearly two million working people currently face MTRs of more than 60% – some even of more than 90%. Compare this to the MTR experienced by the highest earners in the UK – soon to be 51%.

As a result of these benefit withdrawal rates, the participation tax rate faced by many making the transition from total benefit dependency into low paid work

24 Gordon Wadell and A Kim Burton, *Is Work Good for Your Health and Well-Being?* (2006).
25 Jenny Graham et al, *The Role of Work in Low Income Families with Children – a longitudinal qualitative study* (DWP: 2005); *Centre for Longitudinal Studies Briefing, The intergenerational transmission of disadvantage of disadvantage and advantage for various studies* (CLS, 2007).
26 14 Described in more detail in Chapter 3.
27 The only time a low earner has a low marginal tax rate is when they can cross from below to above the hours thresholds for the Working Tax Credit.
28 Stuart Adam, Mike Brewer and Andrew Shepherd, *Financial Work Incentives in Britain: comparisons over time and between family types* (IFS, 2006) p. 37.

is 75% or higher.[29] It is this participation tax rate (PTR) that has the biggest impact on decisions to enter work. For many carers, a low-hours job is all they can take on; and for others an entry-level job represents a stepping stone to higher-earning employment. Yet, virtually all initial efforts to work are penalised – and for those in low-earning jobs (60% of median wage or less) their PTR is almost always higher than the average for other European countries.[30]

Those who do move into work also face the immediate withdrawal of the attached 'passported' benefits, such as free school meals and prescriptions. For those who rely on them, the loss of these passported benefits can be more significant than the gain in income from the Working Tax Credit. The security of keeping what a claimant already has often trumps the potential gain from work.

Only 25% of benefit claimants, when polled, thought they would be better off from working. In contrast, 17% said working harder would make no difference; 19% were unsure; and disturbingly, 39% thought they would be worse off if they worked more.[31]

The group that is most trapped by some of the highest PTRs comprises those adults under 25 without children: low earners in this group are not entitled to Working Tax Credit. Yet, those making up the growing NEET population[32] are the people most in need of encouragement to work, not least because of the long-term repercussions of youth unemployment: the Prince's Trust identified a long-term wage penalty of 10-15 per cent as a result of being NEET.[33]

KEY CONCEPTS:
Marginal tax rate (MTR)

All taxpayers are familiar with the idea that higher tax rates create a disincentive to work harder. For benefit recipients, the withdrawal of benefits as earnings increase compounds the disincentive caused by taxation.

The effective **marginal tax rate (MTR)** faced by an individual in work measures the incentive to earn more. The MTR for those on higher wages, who do not receive benefits, is just their tax rate. However, for low earners it reflects not just the loss of income through taxation, but also the simultaneous, cumulative withdrawal of benefits that contributes to the MTR.

For example, if an individual is working and in receipt of Housing Benefit, then in earning an extra pound he not only loses 31p in tax, but has a further 45p of his weekly benefit income taken away. This leaves just 24p of any extra pound earned. The MTR is a huge 76%. For those also facing the withdrawal of tax credits and CTB, it reaches 95.5%. Working harder produces negligible financial gains.

PENALTIES

Economic dependency is reinforced by factors beyond work. Being part of a family, owning a home and having some savings are all protections against economic dependency. However, the current benefits system penalises these life choices, particularly for those with the lowest earnings.

There is a well-established body of evidence that two parent families with at least one working member generally produce the best overall long-term outcomes for the whole household.[34]

29 This is lower than the 100% and 85% MTRs, because it also accounts for the earnings disregards.
30 Authors' calculation, based on an analysis of OECD data. See section 3.2.2 for further details.
31 YouGov poll, commissioned by the Centre for Social Justice, May 2008.
32 Not in education, employment or training.
33 The Princes Trust, *The Cost of Exclusion: counting the cost of youth disadvantage in the UK* (The Princes Trust, 2007).
34 See Social Justice Policy Group, *Breakdown Britain: Interim report on the state of the nation, Volume 2: Family Breakdown* (CSJ, 2006) and Social Justice Policy Group, *Breakthrough Britain: Ending the costs of social breakdown* (CSJ, 2007) for further details.

KEY CONCEPTS:
Participation tax rate (PTR)

The **participation tax rate (PTR)** measures the average combined tax and benefit withdrawal rate as a result of moving from worklessness to employment. A high PTR means that a person's income after moving into work will be little different from that received when out of work. A low PTR means that person will be much better off in work.

The PTR represents the financial incentive to move from total benefit dependency into work (full- or part-time). In the case of a high PTR, the lack of a tangible difference in income, coupled with other associated costs of taking a job, such as travel and clothing, means it can be perfectly rational for a person to choose to remain on benefits.

Case study: Why take a job? The PTR effect
Jane is a single mother who, though currently dependent on benefits for her income, wants to get a job. She needs to work part-time in order to look after her children. Jane finds a part-time job paying £80 per week. However, moving into work means her benefits will start to be withdrawn. Once this is taken into account she will be better off by just £20 a week. Fully 75% of her earnings would be negated by reduced benefits. In addition, Jane will have to pay for her bus fare to and from work, reducing this additional £20 income further, and is concerned about how she will cover childcare costs in school holidays. The economic incentive to move from welfare to work is negligible and Jane therefore decides to remain on benefits.

Economies of scale mean that two single claimants will always need (and hence deserve) more than a couple. However, the Government reduces benefit payments to couples by far more than is saved through cohabiting: so, among families facing the greatest disadvantage, where strong, stable family units are needed most, they are most penalised.

Our research[35] shows that approximately 1.8 million low-earning couples are materially worse off – **each couple losing an average of £1,336 per year** – because they live together. The US, Germany, France, and Spain all have lower couple penalties than the UK.[36] In fact, only three of 26 OECD countries surveyed have larger couple penalties than the UK.

This is a strong disincentive to marriage or cohabitation, and is recognised as such by those who face it. Our polling showed that 77% of out those who are out of work or in part-time work think low-earning/unemployed people are materially better off if they live apart than if they live as a couple.[37]

Low earners are 30-50% less likely than higher earners to live as couples.[38] It is a damaging policy that forces a member of the poorest segment of society to choose between making a significant income contribution and a family life with their own children. It also encourages fraud - the Institute for Fiscal Studies has estimated that there are 200,000 more people claiming tax credits as lone parents than actually exist in the UK.[39]

Mortgage and savings penalties

The UK is one of the few countries where Housing Benefit is available only to tenants: low earners with mortgages are not supported. In contrast, support for housing costs is available to all low-income home-owners in France, Germany, Sweden and the Czech Republic to help them pay their mortgage. This 'mortgage penalty' currently affects 1.9 million low- earning working households.

The Government also gives reduced benefits to people with savings, on the basis that they should be expected to deplete them when faced with economic hardship. More than 750,000 of the lowest-earning households lose over

35 We have used the Family Resources Survey's representative set of 24,000 different couple and ingle households and aggregated them to calculate the current penalty to *all* couples in the UK. See section 4.2.3 for further details.
36 Authors' calculation, based on analysis of OECD tax and benefit tables.
37 YouGov poll, commissioned by the Centre for Social Justice, May 2008.
38 Controlling for age.
39 Mike Brewer and Alastair Muriel, *Poverty and Inequality in the UK: 2009* (IFS, 2009), Appendix D.

£1,000 per year in benefits as a result.

We agree with this principle, but it must be balanced against the need to encourage financial prudence. The amount by which benefits are reduced currently is punitively high,[40] and so creates a clear disincentive to save. Other countries (such as Australia) have recognised the corrosive effects of capital limits on benefits, and have higher thresholds and less punitive tapers.

CASE STUDY:
The couple penalty

Brenda and Brian are both workless and living separately from each other. They are each entitled to a single person's JSA of £64.30 per week and a HB/CTB award that would depend on where they lived.

If they choose to live together, then the Government recognises their joint income required to keep the same standard of living would be 75% of their combined separate incomes as singles.

However, as a couple they would be entitled to just the same HB as a single person, and between them would receive a joint JSA award of only £100.95 per week. This would typically leave them with approximately 66% of their previous income, less than the 75% required to make it equivalent for couples.

COMPLEXITY

Successive Governments have tweaked and patched the benefits system in the hope of improving it. But the unintended consequence has been a system of 51 different benefits of bewildering scope and complexity, which is extremely complex to administer. This has itself entrenched benefit dependency, as claimants are afraid to change their situation, and even advisers are unsure whether to recommend they take a job.

The difference between all these benefits is confusing.[41] The Department of Work and Pensions (DWP) issues 8,690 pages of guidance to help its decision makers to apply DWP benefits, with a further 1,200 pages covering Housing and Council Tax Benefits. Benefits pay at different rates for similar circumstances. Some are paid weekly, and others monthly. Some depend on hours, and some can only be awarded through one benefit, but not through another.

Reporting any change in circumstance is time-consuming, and can jeopardise stable payment of benefits. Any such change, for example an increase or decrease in earnings, requires multiple forms to be filled – in some cases up to ten forms and 1,200 questions.[42]

Furthermore, numerous agencies need to be informed, including JobcentrePlus, the local Tax Credit Office, the relevant local authority, and the other agencies of the DWP, such as the Pension Service and the Disability and Carers Service. A judge recently ruled, in finding for the Department for Work and Pensions, that simply because a claimant had notified a change of circumstance to one part of the DWP, the claimant could not assume that other parts of the DWP had been informed.[43] This is an absurd organisational breakdown.

Claimants who have spent hours ensuring their benefits are set up correctly are understandably anxious about changing their financial position as a result

40 Reduction in annual benefits equivalent to 20% of the total value of their savings above £6,000.
41 This is addressed in more detail in Chapter 5.
42 David Martin, Benefit Simplification: How, and why, it must be done (CPS, 2009), p.5.
43 House of Commons Work and Pensions Committee, B*enefit Simplification: Seventh Report of Session 2006-2007*, HC (2006-07) 463-I [196].

of getting into work, especially if this might not even result in an increased income, or cause delays in payments. For many, debt has been the ultimate consequence of trying to get and hold down a job. Thus, many believe they are better off staying on benefits, or are deterred by the uncertainty and risk associated with their income, upon taking up a low-earning job.

Part II. Better Benefit Design

DYNAMIC MODELLING

To redesign the benefits system so that it relieves poverty over the long term, we must understand how its shape and structure influence people's movement into and out of work. People need to be recognised as dynamic, active participants in the economy, not as static, passive recipients of cash transfers.

Existing dynamic models have not captured the full effect of benefits withdrawal on employment. We have developed our own model, drawing on recent research published by the Institute for Fiscal Studies. It enables us to understand how changes to the system would affect employment, earnings, the income distribution and the cost to the taxpayer, thus allowing us to design a system that will reduce barriers to work and reduce poverty.

Successive governments have failed to acknowledge adequately the economic incentives created by the benefits system. Clearly, tax and benefits are not the only factors influencing movement into or out of work, and may not even be the main factors for many individuals; but they are a greater influence on those with lower earnings potential. Nonetheless, there has not been any systematic scrutiny of how changing the benefits system affects the decisions made by those dependent upon it. Instead policy has been determined mostly by making static assumptions about welfare benefits: 'increase benefits and claimants will be better off'.

Dynamic modelling is a way of accounting for people's responses to changed incentives. It is a form of economic analysis that is well established in the private sector, but is not in widespread use for developing government policy.

Academic analysts have developed models to predict how high earners will vary their earnings in response to changes in taxation levels, but these have little relevance to people who are deciding whether to come off benefits and into employment. This is because they fail to differentiate between employment, earnings and income; they do not capture the fundamental value of work for a household. At the lower end of the income scale such differentiation is essential.

We have built a dynamic model[44] that incorporates the work choices made by people at all earnings levels, drawing on recent research by the IFS that identifies two distinct "elasticities" (the level of people's responsiveness to the amount of benefit received and withdrawn):

44 For more details, see Chapter 10.

1. **The employment elasticity**, related to making the transition from total benefit dependency into work, which is driven by the PTR; and
2. **The earnings elasticity**, related to taking on more work when working low hours, which is driven by the MTR.

The model can measure the impact of any welfare reform with hitherto unprecedented robustness; and we can use it to quantify the longer-term effects of reform. We can review various options for benefit reform, from flat tax to "super-benefits", and assess whether they encourage claimants to enter work or to work longer hours. By modelling a particular proposal for reform, we can predict the consequences for society: we can estimate the cost to the Exchequer, the change in GDP, the number of people in work and the reduction in poverty.

OBJECTIVES

Better benefit design also requires clear objectives distinguishing between the distribution of income and the distribution of employment and earnings; it also requires that we recognise the limits of possible reform.

At the heart of our proposal are four core objectives for the benefits system: (1) continue to relieve poverty;[45] (2) reduce worklessness and benefit dependency; (3) support positive behaviours by reducing the couple, mortgage and savings penalties; and (4) increase the affordability of the system.

A dynamic model on its own is not sufficient to design a better benefit system. We also need to define precisely what we mean by 'better': we must have clear objectives, distinguishing between the distribution of income and the distribution of employment and earnings. To date, there has been too little debate about what the benefits system is trying to achieve.

We also explore in greater detail than previous reviews the mathematical and logical constraints on benefit design. These constraints mean that no one system can satisfy all possible objectives at the same time: we believe that the necessary trade-offs must be made explicit.

Having reviewed different possible social objectives for the welfare state, and the different implied configurations of tax rates and benefits, we conclude that sustained poverty relief must be driven by boosting *earnings* – in other words, by increasing employment through low PTRs – rather than simply by the transfer of money.

Furthermore, it is *household* rather than *individual* employment that should be of greatest concern for policy makers. Increasing the number of households in which at least one person works, even if only part-time, will reduce the causes of poverty and dependency more than increasing the number of households in which a second adult works.

45 We do not propose reducing any levels of out-of-work benefits.

In addition to encouraging people to find work, we want to reward decision-making that enhances self-sufficiency, and provide a degree of security for people taking tentative steps into the workforce.

BENEFIT DESIGN

The employment decisions of low earners are particularly responsive to changes in tax and benefits. Hence, to reduce worklessness, we must reduce participation tax rates for low earners, and do so in a way that the increase in employment makes it self-financing.

Designing a benefits system that increases the rewards from work and reduces complexity, while minimising the number of losers and containing costs, raises many challenges.[46] Reducing PTRs, by increasing generosity of in-work benefits, risks increasing the cost of the system as a whole. Furthermore, reducing complexity could either create as many losers as winners – or else could be very costly.

Balancing all these considerations will require exploiting the dynamic effects to the full. This requires us to be confident that our model is robust, and to be very clear and explicit in our objectives. This will ensure that we focus spending to greatest effect, and avoid increasing the generosity of in-work benefits beyond the point of diminishing returns.

In order to make the first steps into work much more rewarding, the reduction in participation tax rate needs to be focussed on low earners. However, this needs to be structured in a way that also optimises the tax raised from higher earners: i.e. we need relatively high MTRs on their lower earnings (in contrast to lower MTRs for their higher earnings.)

Therefore a simplified benefits system that satisfies these conflicting objectives will be one that:

- Provides generous earning disregards for benefits, to reduce PTRs;
- Has higher MTRs for low earnings, to capture optimal tax take from higher earners;
- Avoids increasing generosity of in-work benefits beyond the point of diminishing returns.

In Part III we provide the details of how such a system would work.

Part III. Dynamic Benefits

UNIVERSAL CREDITS – A NEW BENEFITS SYSTEM

As well as describing a new and more rigorous way of thinking about benefits design, this report presents specific proposals to address Britain's unacceptable

46 There are many other challenges, such as the confounding 'More workers, less work' effect. See section 13.1.

levels of poverty and social exclusion, of which worklessness is a major contributory factor.

Our proposals would dramatically reduce PTRs and cut complexity. The key measures are:

- ***Reduce the rates at which benefits are withdrawn to an across-the-board rate of 55% of post-tax earnings;***
- ***Increase the 'earnings disregards' – allowing low earners to earn more, before any benefits are withdrawn;***
- ***Simplify the benefits system by moving from the current 51 possible benefits, to two streamlined payments – Universal Work Credit, and Universal Life Credit;***
- ***Reduce the penalties for couples, those with mortgages, and low-earning savers.***

We propose to replace the current system with the Universal Credits scheme[47] – a simplified system that provides greater rewards for work. It maximises the number of working-age households with at least one member in work – thereby directly tackling severe poverty and increasing the life chances of adults and children – while ensuring all households receive a fair minimum income.

A SIMPLIFIED, TWO-COMPONENT SYSTEM

The Universal Credits scheme is a single benefit with two components:

- *Universal Work Credit*, for those out of work or on very low wages. This will combine JSA, IS, IB/ESA;
- *Universal Life Credit*, to cover additional living expenses for all those on low incomes. This will combine HB, CTB, DLA, WTC, CTC.

While the assessment for each of the two components depends on different factors, they will be received as one payment and will be withdrawn at the same rate. Universal Life Credit begins being withdrawn only after Universal Work Credit has been completely withdrawn.

There will be a single application form which would need to record only household characteristics and asset levels, to calculate the sizes of the initial award and disregard. This contrasts with the numerous forms currently required to inform of a change of circumstances.

We do not propose any changes to the existing sizes of the initial benefit awards for different households – this is a decision which requires significant political debate.

47 See Chapter 16 for further details.

Standard Withdrawal Rate

We propose to end the current confusion and multiplicity of benefit withdrawal rates, and make them much more transparent and consistent. We propose a single universal benefit withdrawal rate of 55% on post-tax earnings above the earnings disregards. This will make it simpler for claimants – and benefits advisors – to project how much better off they would be if they take a job, or increase their working hours. This rate represents the best compromise between improving incentives and containing costs.

Passported benefits will continue to be available to those earning above the current hours thresholds. Higher earners who choose to receive them will be expected to pay a notional value imputed to them. In this way, low earners will not face the cliff-edge withdrawal of these benefits. Instead, their value will taper away, like other benefits.[48]

Earnings Disregards

The earnings disregards – the earnings level at which benefits begin to be withdrawn – play a key role in our proposed system. To encourage workless households into work, we propose to raise significantly the household earnings level below which all benefits are retained. It is those with low earnings potential who are most responsive to changes in the PTR, and therefore this move will provide a significant incentive to find employment.

The level of earnings disregard is different for different household types. The basic principle is that the larger the household, the more generous the disregard (noting as well that the initial award has not been affected, so households with greater need will generally also be receiving more benefit to start with). The disregard for a couple with one child is bigger than for a childless couple, therefore the first couple keeps more of their earnings before the withdrawal of benefits. This ensures larger families are better able to support themselves through working.

We use the following table[49] to calculate the earnings disregard for particular household types:

Household Earnings Disregards	**Size of Disregards**
Households	£1,500
Over 25/ Parent Addition	£3,500
Lone Parent Addition	£3,000
Each of 2nd and 3rd children	£350
Rent	-1.8 x rent supplement[50]
Council Tax	-1.3 x Council Tax supplement[51]

With a 'disregard floor' of £260 per adult + £650 per child + £1,660 for lone parents, should the formula above suggest a lower disregard.

48 See section 16.6 for further details.

49 This table is additive, each applicable component contributes to the overall disregard for a household.

50 For every £1 provided in benefits to cover housing costs, £1.80 is reduced from the benefits disregards. In this way those households with large support for housing costs have a lower disregard than those with low or no housing support included in their Universal Credit.

51 The same reduction in allowance applies to the amount of Universal Credit provided to cover Council Tax. However, this deduction in the allowances is not applicable to those under 25 who have the youth penalty. There is also a floor for these allowances.

These earnings disregards are set at a level to ensure that those working at the 16/30 WTC hours thresholds will have the same net income as they do today (when in receipt of WTC).

Those under-25s who are not currently eligible for WTC would be entitled to an earnings disregard that is lower than for older claimants, but much more generous than they receive today. Over time, this disregard would be equalised: younger people need as much of an incentive and equal reward from working as older ones. Any differences in the level of financial support for younger people should ultimately come from the benefit levels, not from differential withdrawal rates or disregards.

It is the way in which the earnings disregard changes based on family size and out-of-work award entitlement that marks our scheme out from all others. It allows us to balance fairness, control costs and limit the number of people who would lose out from our reforms. By having the variation in the disregard rather than in the withdrawal rate, the experience of the claimant with fluctuating earnings is much more stable. Changes in disregards are aligned with changes in the level of benefit entitlement, i.e. at the major events in life such as house moves or changes in family structure.

Simpler payment and withdrawal

All benefits will be paid in full by a single agency based in the Department for Work and Pensions, regardless of whether a person is in work or not. HM Revenue and Customs would no longer be involved in the payment of benefits. However, it would be involved in the *withdrawal* of benefits. Those who are employed will find the value of the benefit gradually withdrawn through the 'pay as you earn' (PAYE) mechanism, with employers withholding payments in a similar way to Income Tax and National Insurance.

This ensures continuity of income as a person moves into work, and means people will not have to manage their benefits level on an ongoing basis. It also eliminates up-front means testing for benefits, as the application for initial award and disregard has nothing to do with how much is being earned.

Reduced working-couple penalty

The proposed earnings disregards and withdrawal rate will reduce the working couple penalty by a modest amount, helping mostly low-earning childless couples. However, for out-of-work couples, whose benefit levels would remain unchanged, the material couple penalty would persist at the same level as today – an immediate reduction would be prohibitively expensive.

Reduced mortgage and savings penalties

The proposed earnings disregards for Universal Credits have been structured so that those not in receipt of support for renting have higher disregards. Hence, low-earning mortgagors will benefit more than low-earning renters. Low-earning renters would still receive higher benefits, but the gap would be narrowed by approximately £300 per year.

The increased disregards and simplification of benefits mean that low-earning savers lose less in the way of benefits. While the penalty has not been eliminated, it is concentrated more on benefit recipients who are also higher earners. Hence, the illogical and unfair elements in the current system have been significantly reduced.

We recommend that as funds become available, future budgets continue to reduce the remaining couple, mortgage and savings penalties.

ADVANTAGES

The Universal Credits scheme is a cost-effective way of greatly increasing household employment and tackling poverty and child poverty.[52]

A total of 4.9 million households with low-earning workers would see their incomes rise by an average of £1,000 per year. By careful design we can minimise the number of low earners who lose out. 600,000 previously workless households would enter employment, and the national income (GDP) would increase by £4.7 billion. Consequently, 829,000 households – including 210,000 children – would move above the poverty threshold.

Winners / Losers

The net effect of our reforms is to increase income for low-earning households: 4.9 million working households would see their incomes rise under this proposal, by an average of £1,000 per year. They are mostly those in entry-level jobs, especially working below the current 16/30 hours thresholds, including 1.8 million working couples with children, 1.6 million working single households and 750,000 working lone parents.

While the average low earner gains under this system, there are some who will lose a small amount. In particular, two categories of people are made marginally worse off by these reforms:

- The largest group comprises those higher-earning families earning above £30,000 per year currently receiving the Family Element of Child Tax Credit (£545 per year). This benefit currently starts to be withdrawn when earnings reach £50,000 per year. Under these proposals it would be subsumed into the Universal Credit, and thus tapered away at lower earnings.
- The other group comprises a subset of those working just above the hours thresholds for the Working Tax Credit, who under the new proposals would be affected by a slightly different schedule. This is especially true for home-owners and those with savings.[53]

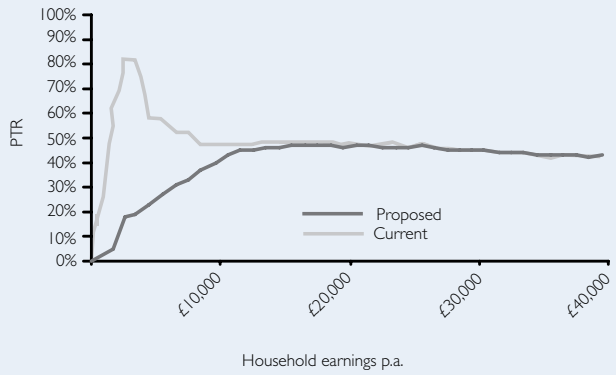
52 See Chapter 17 for further details.

53 Those with savings are currently eligible for the full value of the WTC award – yet lower earners are currently penalised. Under our proposals, savers with lower earnings are penalised less, but those working at the hours thresholds are more likely to experience a penalty.

Incentives

The graph below compares the current average PTR for all households with the PTR resulting from our proposal. It shows a dramatically lower average PTR for those households earning up to £15,000 per year, although this varies by household type and housing tenure. It is a clear contrast to the extremely high average PTR for the same group in the current system.

Impact of proposal on average Participation Tax Rates

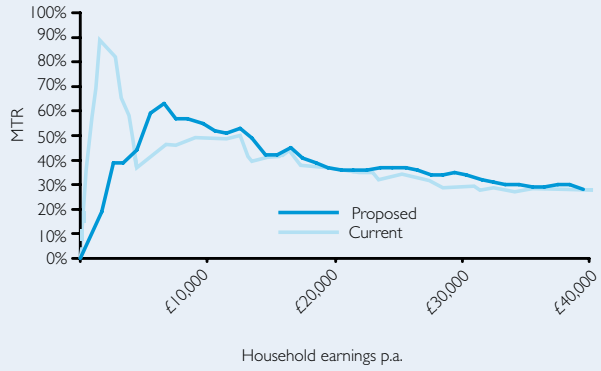


The more generous earnings disregards mean that for those taking up employment in entry-level jobs at hours levels below the current WTC thresholds, there would be minimal impact on their benefits entitlement, thus providing much greater security.

The PTR reduction may be particularly attractive to lone parents for whom working fewer than 16 hours is the right option, or for childless people whose first attainable job offers fewer than 30 hours work per week.

The more generous earnings disregards mean that benefits start to be withdrawn with higher earnings; this and a withdrawal rate capped at a lower level will result in many households receiving benefits which previously would not have done. This means they will be better off financially; however they will also experience withdrawal of these new benefits.

Impact of proposal on average Marginal Tax Rates



As the graph on the previous page shows, this results in an increase in MTR for many low-to-middle earning households. Unfortunately this group will have a reduced incentive to earn more.

Changes to employment and poverty

Our proposal would result in 600,000 households, mostly childless, entering work. National earnings would increase by more than £1.1 billion per year. The effects on earnings and employment mean that the overall increase in income would be £4.7 billion.

The combined effects of reduced benefit withdrawal and increases in employment mean that 829,000 households – including 210,000 children – would move above the poverty threshold. The main reduction in poverty would result from people entering work, rather than from income transfers, therefore bringing accompanying benefits in health and wellbeing.

Additionally, the reduced number of benefits and automatic payment of the full amount will increase the take-up, particularly among low earners, who are most likely to comprise today's working poor.

FINANCIAL IMPACT

While direct benefit costs would increase in the short-term, the tax gains from increased employment and earnings, together with reduced administration costs make these reforms self-financing over the medium-term.

The change in benefit withdrawal rates, earnings, and employment resulting from these proposals would increase the total annual benefits bill by £3.6 billion. However, this cost would be partially offset by increased tax. The increase in receipts from Income Tax and National Insurance would be small (about £80 million per year), because a lot of earnings gains would be in low earning jobs which are not taxed. On the other hand, there would be an additional £800 million per year in VAT/Duty raised from the extra income and hence expenditure.

Hence, the total short-term cost of these proposals is £2.7 billion per year, an increase of 3.6% on current annual benefits expenditure of £74.4 billion. This will be funded from the broader cost savings detailed below, so in the longer term our proposals will produce net gains to the Treasury.

The reduction in worklessness would save money as a result of fewer demands on the administration of the benefits system. The dramatic simplification would reduce the number of government departments involved in administering benefits and reduce the number of tasks involved, besides offering significant potential to cut error and fraud. Broader savings would also come from reducing the indirect cost of unemployment – reduced expenditure on health, crime, policing, and other social costs. We estimate

that the total cost savings that could be achieved by these reforms would be £3.4 billion per year, meaning they would more than cover the direct costs.[54]

Alternative proposals

The full report includes details of the alternative options that we considered, some of which are more expensive but lead to greater income equality than our proposal, and some which are less expensive but also less effective in reducing worklessness. The differences between the options are all in the earnings disregards. Our favoured option should be seen in the context of these other options having been considered. We ultimately rejected them because they are less cost-effective ways of increasing employment, or would leave many low earners worse off.

Conclusion

The more we struggle to end poverty through the provision of benefits, the more we entrench it. By focusing on income transfers rather than employment, the system makes people dependent on benefits. Habituation to dependency destroys both individuals and communities, as well as reducing the overall competitiveness of the UK. To accept a system that produces this is to despair of the idea that we could ever offer every member of society the chance to progress.

We must continually encourage the desire for a job; and we must also clearly determine that a life on benefits, no matter what their level, should not be a sensible choice for those able to work.[55] The next Government will likely make the same predictions and declarations as the last one; and it is right that they should have these aspirations to reduce worklessness and dependency.

But they also have the option to learn from the mistakes of the past, and approach the benefits system in a new way: not just to change the system, but also to change the way we think about it. In particular, policy-makers need to consider how the system can deplete the incentive to work.

The answer is not about the generosity, or about ever more precise targeting of benefits to particular groups. Such piecemeal reform can only further complicate the system and obscure the route from dependency to independence.

The key is to encourage and support the efforts of claimants to reduce their dependency on benefits. Dynamic modelling brings rigour to the analysis, and can allow us to design a coherent system that deploys the vast welfare budget

54 Details of this calculation can be found in Appendix G.

55 See Social Justice Policy Group, *Breakthrough Britain: Ending the costs of social breakdown* (CSJ, 2007).

to better help those in need. The system we have proposed is designed to create a stronger society, in which work pays and in which socially beneficial decisions do not face a financial penalty.

Whether or not those in government agree with our objectives, we urge them to embrace this new rigorous, empirically grounded way of thinking about the benefits system, so that decisions can be made on a more informed basis.

With no change in the way that governments think about benefits, the future will repeat the past: more broken promises, more expense, and more dependency.

Foreword

By Dr Stephen Brien, Chairman of the Economic Dependency Working Group

Unemployment is rising sharply and bringing with it an increase in the sheer number of benefits claimants and a decrease in tax revenues. Today, there are 5.9 million people claiming out-of-work benefis, meaning they are entirely dependent on the state for their income.[56] Of these, 2.4 million are unemployed. Unemployment and economic inactivity have increased steadily over the past year, and now more than one in four of the UK's working-age population is not in paid work.[57]

How should the State help those people, out of work and in work, who are supported by the benefits system? This question has now, in times of recession, taken on an even greater urgency. This report provides a new and transformative answer: dynamic benefits.

Background to this report

This report is the third produced by the Centre for Social Justice's Economic Dependency Working Group. The Working Group was first constituted to look at worklessness and economic dependency. Economic dependency is when people, families and even whole communities have an enduring reliance on the benefits system to keep them afloat. A key argument in the first two reports was that the benefits system was not just failing to help many vulnerable people, but actually creating or exacerbating some of the problems.

The first submission of this Working Group, in *Breakdown Britain*, was published in 2006.[58] It highlighted that worklessness and dependence on benefits were part of a set of interrelated social problems in Britain's most deprived communities. We identified worklessness and dependency, along with family breakdown, educational failure, serious personal debt, and drug and alcohol addiction, as key predictors, or Pathways to Poverty.

Benefit dependency is enormously destructive to the fabric of society. It can endure from generation to generation, depriving each new generation of its potential. It deprives many of the belief and hope that they can actually work. It can become its own culture, where the habit of dependency becomes a way of life. Winston Churchill described welfare as a safety net 'below which

56 Department for Work and Pensions, 'Benefit Expenditure Tables', Table C1. Available at: http://research.dwp.gov.uk/asd/asd4/medium_term.asp [Accessed 21 August 2009]. Combines income and contribution-based JSA, IS, IB, ESA. A very small number of these claimants will be working a small number of hours per week.

57 Office for National Statistics, *Labour Market Statistics August 2009* (ONS, 2009), Table 1. A person is defined as unemployed if he/she has tried during the previous month to get a job, and is able to start immediately. A person is defined as economically inactive if he/she is out of work but not technically unemployed. There are 37.9 million working-age people.

58 Social Justice Policy Group, *Breakdown Britain: Interim report on the state of the nation*, December 2006.

none shall fall.'[59] In *Breakdown Britain*, we made the point that, as a concept, the safety net is wholly inadequate to describe the necessary aspirations of the welfare state. [60]

The Working Group's second submission, in *Breakthrough Britain*, followed in 2007.[61] It found compelling evidence for the idea that money earned through work carries more utility than money received from benefits. Work is good for physical and mental health; it fosters independence and helps lift adults and their children out of poverty, for now and for the long term. For example, once a parent returns to work, their children will be more likely to follow them. The conclusion was that poverty reduction policy will be most successful when it encourages a return to work.

The decision to take a job, for those who are on the margin of working and not working, is not simple. The challenges of a job, and the rearrangement of one's life required to take it, can present real difficulties. Hence, this second report proposed that much greater attention should be given to supporting a claimant's move into employment. It outlined a model of more personalised, localised and extended support for those making the effort to engage in work, which was subsequently adopted by both Government and Opposition.[62]

Furthermore, the report also recognised that there were significant problems with the structure of the benefits themselves, particularly with how the benefits system itself influenced life decisions. Benefits are the *main source of income* for three in ten households in the UK,[63] and many more rely on them to keep them out of poverty. It stands to reason that people will behave in such a way as to protect their income. The points at which benefits are given to and withdrawn from different groups discourages return to work, discourages saving or investment in assets, and discourages living together, particularly for parents. This reinforces dependency and worklessness across generations.

Were this situation an unavoidable consequence of our efforts to relieve poverty, it would be merely unfortunate. However, it is not. It is an unnecessary by-product of poor benefit structures and policies. This is unacceptable, and is the subject of this report.

So, this report, the third in the series, reviews the failures of today's benefits system, and makes the case for a new set of tools with which to respond.

It analyses in detail the historical, political and economic structure of the current system (including tax credits and the interaction with the tax system), and asks 'how do the economic incentives of the current benefits system alter the employment and life decisions of claimants?'. It also examines the extent to which current benefits reinforce the belief that work does not pay. It concludes

59 Conservative Party, *This is the Road*, January 1950.
60 Social Justice Policy Group, Breakdown *Britain: Volume 1: Economic Dependency* (CSJ, December 2006).
61 Social Justice Policy Group, *Breakthrough Britain: Ending the costs of social breakdown*, Volume 2: Economic dependency and worklessness (CSJ, July 2007).
62 DWP Green Paper; Conservative Party Tax Proposals.
63 Department for Work and Pensions, *Family Resources Survey United Kingdom*, 2007-08 (DWP, 2009), Table 3.8.

by suggesting how those arrangements can be changed, in an affordable way, to make work more attractive, particularly for low earners, and ensuring that the system does not weigh against beneficial life choices.

In making choices about benefits, we should be guided by our instinct to redress misfortune and injustice, and to encourage and support people to become independent. However, when making decisions about a system as complex as the tax and benefits system, instinct is not enough.

At its core, this paper is about an evidence-based and analytical approach to the tax and benefits system. We believe such an approach should be used to overhaul policy thinking in this area.

The Dynamic Mindset

How can Government know the effects, and project the conse-quences of its reforms?

For some time, policy makers have recognised that a claimant's loss of benefits when taking up employment creates a disincentive to work. But though the problem has been noted, little has been done to address it. Until recently, academic work in the area has not emphasised tackling this problem sufficiently. Indeed, research has focused more on redistributing income than addressing worklessness, leading to a certain set of policy implications.

In support of this report, the CSJ Economic Dependency Working Group built a dynamic economic model that calculates the scale of these effects, and evaluates the effectiveness of potential reforms. The Dynamic Benefits Model allows us to understand how the welfare system 'looks' or 'feels' to the claimant and-crucially-how they are likely to alter their behaviour in response to changes in the system: it is a uniquely powerful lens through which to analyse the current system.

Dynamic modelling is the key to understanding the impact of a set of reforms, in terms of the worklessness and poverty reduction, as well as the true fiscal cost of those reforms.

This dynamic approach is well established in the world of business, where, for example, companies routinely model and predict how customers will respond to a change in the price of a product or service. In contrast, the benefits system has not been designed or justified using dynamic modelling, but rather with reference to imprecise aspirations and static costs.

Some reform proposals can have small 'static' costs – the cost of the transfer or the reform to the Exchequer – but big behavioural impacts. One example would be to increase out-of-work benefits while increasing the rate at which they are withdrawn as a person start to earn. The static cost may look small, as the increased taper offsets the increase in the initial generosity. However, in the long run people may change behaviour to take advantage of the benefit increase, dramatically increasing the cost. Only by looking at the situation dynamically can the true impact be modelled.

On the other hand, some proposals can have a big static cost, but actually

be self-funding because of the employment impact. An example would be the targeted reduction in the highest benefit withdrawal rates. It looks costly, but in the long term these costs are offset by the number of people returning to work.

Without dynamic modelling, it is easy for governments, even with the best of intentions, to create costly traps for the weakest in society, because the true impacts of proposals are not identified.

Reform Considerations

Socially just reform of the welfare system must follow some basic principles. We want work-focused reform to minimise the numbers of households in poverty, while simultaneously alleviating the financial situation for those who remain so.

In our proposals, we focus on providing the greatest affordable reward to low-earners, so as to incentivise a return to work and increase the number of households with work.

Our dynamic model is critical to unlocking the right approach. First, it allows us to evaluate the most cost effective way to reduce worklessness, by ensuring the right financial incentives are created for those most likely to respond to them.

Secondly, the dynamic model allows us to factor in the positive economic effects of people returning to work over time: the true net cost is lower than static models suggest. The dynamic approach allows us to be confident about bolder proposals which make bigger changes than would appear affordable with a static approach.

At the heart of our proposal are six core objectives for the benefits system: *continue to relieve poverty; reduce worklessness; increase fairness; support positive behaviour; reduce benefit dependency; and increase affordability of the system.*

Relieve poverty

We must support the most vulnerable members of our society, and ensure a respectable standard of living for all.

We need to continue to encourage the up-take of benefits by those entitled to them, and reduce the waste of resources in unnecessarily complex administration.

Reduce worklessness

The system must promote self-reliance, not dependence. Changes in policy, in specific benefits and taxes, must encourage people who can work to move away from permanent dependence.

For those capable of working, work should always be preferable to benefit payments as a route out of poverty. Those on low earnings, and those working part-time, should retain more of their wages. Hence, we propose increasing the earnings disregards, and reducing the highest benefit withdrawal rates.

Increase fairness

We must reduce bare unfairness in the system, especially the discrimination against couples and under-25s without children. Those with low or no earnings should be treated more equitably.

Our proposals increase the earnings disregards for couples, to reduce the current in-work penalty, while at the same time keeping the second earner connected to the job-market. We also set out proposals for reducing the under-25 penalty over time.

Support positive behaviour

We want the system to support the positive behaviours that protect against long-term poverty, especially for those struggling to save or to house themselves independently.

Our proposals reduce the existing mortgage penalty for those low earners not currently eligible for Working Tax Credit. We propose transferring the savings penalty further up the earnings scale, so that those with savings are more likely to be entitled to out-of-work benefits, and the associated support. We also propose reducing the incapacity trap by splitting the work assessment from the receipt of extra levels of benefit required to support the financial consequences of incapacity.

Reduce benefit dependency

We want the system to be simple and empowering in its interactions with benefit recipients, thereby reducing the level of benefit dependency.

Beyond removing the perverse incentives not to work, we need to make sure that it is transparently clear to all that work pays. We must also end the perception that for a claimant, work might be a bad or risky idea. Simplicity must be a fundamental goal.

To do so, we propose reducing the number of benefits within the system as a whole, and eliminating distinct in-work benefits. We propose one standard withdrawal rate. We propose simplifying the administration needed for both Whitehall and the claimant. Benefits would be paid in full and withdrawn through the PAYE system.

Increase affordability

We must ensure the benefits system is economically sustainable. To do so, we must ensure that marginal expenditure is focused on reducing dependency, rather than increasing it.

Our proposals are focused on helping low earners into work. Our modelling shows that they would reduce the number of workless households by 600,000 at a short term cost of £2.7 billion p.a. This cost would be eliminated over time as the broader social benefits of these changes reduced other government expenditure, such as on crime prevention and health.

The Dynamic Benefits Model is a powerful analytic tool, and a dynamic approach to benefits design must be embraced. But reform cannot fully succeed without also fundamentally changing the attitudes and values of those who administer the system, *as well as* those claimants who could work but who choose not to. Reform must be accompanied by administrative effort and widespread cultural change within the system, to focus more on motivating people to modify their goals and improve their own lives.

Finally, political and social leadership must be focused on inspiring people to see the value of work itself and their engagement with society. No amount of financial adjustment can obviate the need for cultural and social change.

How this report is organised

This report is divided into three parts:

- Part I begins by describing the context of poverty and worklessness in the UK. It then presents a critique of the current benefits system, drawing attention to the perverse incentives it creates and its baffling and needless complexity.
- Part II establishes the principles of better benefit design. It introduces the Dynamic Benefits Model, and describes the new empirical research which made it possible. It discusses some inherent shortcomings in several commonly adopted objectives for the benefits system. It also identifies necessary limitations on design, and trade-offs between objectives.
- Part III brings together the objectives for reform identified in Part I with the model described in Part II, to present our vision for a dynamic welfare state.

Conclusion

A benefits system designed using dynamic modelling can achieve a reduction in worklessness and benefit dependency, without significant extra cost in the medium term. It would herald a new era of social mobility among those who currently see little reason to work. It could even accelerate the reversal of the current economic contraction, and ensure that the base-level of worklessness does not climb further.

A reappraisal of the assumptions and systems that define our welfare state would give much needed impetus to the flagging bid to reduce child poverty. Furthermore, it would increase the efficiency of the rising bill for social protection. To those who say that we cannot pursue thorough reform in recessionary times, we say: consider how successive Governments over the last fifty years have failed to control welfare spending, and failed to achieve their welfare objectives. Our proposal is an alternative to more of the same.

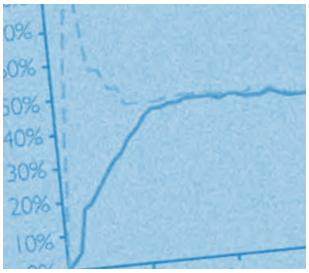
I would like to extend my thanks to the members of the Working Group whose insight, commitment, and challenge have contributed so much to the

completion of this report. I would also like to thank all the experts, from academia, business, government and charities who worked with us to produce this report. I am very grateful to Iain Duncan Smith and the CSJ for offering me the opportunity to chair this review, and to my colleagues at Oliver Wyman for their ongoing support and encouragement. I would particularly like to thank the CSJ researchers who helped prepare and edit the report – Ed Bond, Victor Burnett, Nick Cooper, Gabriel Doctor, Asheem Singh, and Cameron Watt. Special thanks go to Daniel Khoo, who took on the challenge of building the dynamic labour model that was so necessary to develop and analyse our proposals.

I hope that both the analysis and the proposals contained in this report will stimulate debate, and encourage new ways of thinking about how to tackle one of modern society's biggest problems.

Stephen Brien
September 2009

PART I:
THE BENEFITS SYSTEM



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CHAPTER ONE
Poverty, Worklessness, Dependency

National expenditure on 'Social Protection' is enormous – £188 billion in 2007-08.[1] This is the equivalent of three-quarters of all Government receipts from personal taxation on earnings (i.e. Income Tax and National Insurance Contributions) being redistributed to pensioners, and to low-income households through benefits.[2] The amount *directly paid to working-age adults and children* is £74.4 billion[3] – about 40% of the total. Another £6 billion is spent on the Department for Work and Pensions' central administration.[4]

Given the scale of this income transfer, it is important that it is done effectively.

Even before the recession, it was clear that the benefits system was not achieving the Government's objectives: child poverty had started to rise again,[5] and severe poverty was getting worse.[6] The people who will suffer most are the vulnerable members of society: those who can't work; those who won't work; and those who work, but who remain in poverty.

Recession has now struck, placing both the British economy and the benefits system it supports under severe strain. The challenge in the immediate future will be even greater. Unemployment is rising sharply, and bringing with it an increase in the number of benefits claimants and a decrease in the tax revenues. A Government already strapped for cash will have to pay for those rises in costs.

As a result, the recession has made calls to reform the welfare state louder and more urgent than ever before. However, beyond the immediate economic imperative, this report argues that reform of the benefits system is the crucial plank for any agenda that places the reduction of worklessness and poverty at its heart.

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1 HM Treasury, *Public Expenditure Statistical Analyses 2009* (TSO, 2009), Table 5.2.

2 Total raised through Income Tax and National Insurance in 2007-08 was £252 billion. See HM Treasury, *Budget 2009: Building Britain's Future* (TSO, 2009), Table C6. Throughout this report, the term 'benefits' refers to both benefits and tax credits, which are administered by HM Revenue and Customs.

3 £30.3 billion worth of Child Benefit, Child Trust Fund endowments and tax credits administered by HMRC; £3.86 billion expenditure directed at children by DWP; £40.26 billion expenditure directed at adults of working age by DWP. See: Department for Work and Pensions, 'Benefit Expenditure Tables', Table 6, available at: http://research.dwp.gov.uk/asd/asd4/medium_term.asp; and HM Revenue & Customs, *Departmental Report 2008* (HMRC, 2008), p. 8.

4 Department for Work and Pensions, *Departmental Report 2008* (DWP, May 2008), Table 1.

5 DWP press release, *Government Response to Households Below Average Income* Figures (7 May 2009) http://research.dwp.gov.uk/mediacentre/pressreleases/2009/may/127-09-070509.asp.

6 Mike Brewer, Alastair Muriel et. al., *Poverty and Inequality in the UK: 2009* (IFS, 2009), p. 34.

What is poverty? Measurements and concepts

There are a number of important terms and concepts which we will use throughout this report.

Here they are explained.

The terms '**earnings**' and **'income**' are used very specifically. By **earnings** we mean the total amount that an individual (or household) earns from work, before Income Tax and National Insurance are taken. Where necessary, we will distinguish pre-tax from post-tax earnings. **(Net) income** is resulting income after combining post-tax earnings and benefit income (including tax credits). So if a single person, Bob, has gross weekly wages of £165, these are his earnings. He will also have £14.16 of Income Tax and National Insurance withheld, and receives £35.05 in Working Tax Credit. His resulting net income will be £185.89 per week.

The poverty threshold, below which a person is considered to be living in poverty, is defined as *60% of the median household income.* (If you rank all UK households in order of income, the one in the middle is the median income, and the poverty threshold is 60% of their income).

We also refer to a **severe poverty threshold** which is defined as 40% of the median household income. Households whose income is below this are said to be in severe poverty.

Households differ in size – one adult, two adults, two adults and two children, and so on. Clearly, larger households will need a higher income to maintain an equivalent level of material comfort. The poverty threshold can be adapted to different household types, depending on size, taking into account savings from living together. This process is called **equivalisation**.

According to the standard measure of equivalisation used by the Government (the OECD scale), a childless couple needs 75% of the combined incomes of two single people to have the same material standard of living. For a couple with two children, it would be 80% of the combined income of a lone parent and a single person.[7]

Owing to the importance of housing costs, there are two different poverty thresholds: a **before housing costs (BHC)** threshold and an **after housing costs (AHC)** threshold. This means that the BHC poverty threshold is numerically higher than the AHC threshold as housing costs are still to be deducted. It also means that if the family's housing costs are low enough, it is possible to be in poverty on the BHC measure, but not on the AHC measure.

Some key poverty thresholds are shown in the table below.

Figure 1.1 Examples of annual poverty thresholds for different family types[8]

	BHC poverty threshold	AHC poverty threshold
Single	£7,567	£6,480
Couple with no children	£11,294	£9,672
Lone parent with two children	£12,085	£10,349
Couple with two children	£15,812	£13,541

Earnings poverty is when the underlying gross earnings of people is insufficient to reach the poverty threshold, without the help of benefits. (The concept can be applied both to those in work and out of work).

7 See the equivalisation table in: Department for Work and Pensions, *Households Below Average Income: An analysis of the income distribution 1994/95 - 2007/08* (DWP, 2009), Table A2.1

8 Authors' calculations based on Department for Work and Pensions, *Households Below Average Income: An analysis of the income distribution 1994/95 - 2005/06,* (DWP, 2007), using the OECD equivalisation scale and assuming that all children are under the age of 14.

The purpose of Part I is to understand how poverty and worklessness in the UK are affected by the benefits system. Our analysis begins, as it must, by looking at the nature of poverty among working-age households. Later chapters will explore how the benefits system has failed to improve the situation and in some cases worsened it.

1.1 Poverty levels remain stubbornly high

Even before the recession, Government performance on alleviating poverty had shifted into reverse. After several years of improvement, the numbers in poverty are beginning to increase again. In 2005/6, there were 700,000 more people in poverty than the previous year.[9] The latest figures (for 2007/8) show that there are 13.5 million individuals in poverty (AHC), a rise of 1.4 million since 2004/5.[10] The poverty rate for children remains higher than the poverty rate for adults, and hence reducing child poverty has been a major priority for the current Government. However, by 2006/7 there were 200,000 more children in poverty than two years previously.[11] By the end of 2007/8, the figure had risen by another 100,000 to 4 million children in poverty (AHC).[12]

Before these figures started to turn, the Government had had a good run of decreasing numbers in poverty. However, the Government's poverty fighting efforts appear to have focused on 'quick wins': pulling those just below this particular poverty line to just above it. This was helped by the fact that those whose income was just below the 60% poverty line represented a very large proportion of the total population.[13] Less has been done to help those in the deepest poverty.[14] The number of individuals in severe poverty (measured as those living in households whose income is less than 40% of the median) is significantly higher than the 1997/8 level and currently stands at 3.6 million.[15] The number of children living in severe poverty has increased by 100,000 in the decade up to 2007/8 (BHC).[16] In line with our research, a report for Save the Children in 2005 concluded that there had been little or no improvement in the percentage of children living in severe poverty in Britain.[17]

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9 Before housing costs, see: 'Numbers in low income', available at www.poverty.org.uk, [Accessed 22 July 2009].

10 Mike Brewer, Alastair Muriel et. al., *Poverty and Inequality in the UK: 2009* (IFS, 2009), p. 31.

11 This trend holds for poverty count both before and after housing costs. 'Numbers in low income', available at www.poverty.org.uk, [Accessed 22 July 2009].

12 DWP press release, 'Government Response to Households Below Average Income Figures' (7 May 2009),available at http://research.dwp.gov.uk/mediacentre/pressreleases/2009/may/127-09-070509.asp.

13 For further discussion see Social Justice Policy Group, Breakdown Britain: Volume 1: Economic Dependency (CSJ, December 2006).

14 Jennifer Moses and Mark Bell, *Working on welfare* (CentreForum 2007).

15 Mike Brewer, Alastair Muriel et. al., *Poverty and Inequality in the UK: 2009* (IFS, 2009), p. 34.

16 Mike Brewer, Alastair Muriel et. al., *Poverty and Inequality in the UK: 2009* (IFS, 2009), Accompanying spreadsheet, available at http://www.parliament.uk/commons/lib/research/briefings/snep-03870.pdf [Accessed 22 July 2009].

17 Monica Magadi and Sue Middleton, *Britain's Poorest Children Revisited: Evidence from the BHPS* (1994-2002) (Centre for Research in Social Policy, Loughborough University and Save the Children, 2005).

1.2 Earnings poverty

There are around 23.5 million working-age households in the UK,[18] which approximates to 37.9 million working-age adults.[19] Of these, 8.6 million households are in earnings poverty:[20] households, *workless and working*, whose gross earnings are insufficient (without benefit income) to escape the Government poverty threshold of 60% of median net income. These households in earnings poverty are at the heart of our benefits system: individuals and families who rely on the state to lift them out of poverty. Benefits are the *main source* of income for three in ten households in the UK,[21] and many more rely on them to keep them out of poverty.

Only 13% of workless households escape net income poverty through their benefits.[22] In total, there are some 4.7 million workless households left in income poverty by the current benefit arrangements.

However, work itself is not always a clear route out of poverty. The number of households with children in poverty whose head is working rose by 200,000 in the decade from 1997.[23] More than half of all children in poverty now live in a household in which someone is working.[24] This means that the poverty rate among working households has increased: now over one in seven working households are in poverty.

The evidence is clear that the problem of worklessness and underlying earnings poverty is severe. In 2005-6 there were approximately 23.5 million working-age households in the UK, of whom 8.6 million were in earnings poverty, including both workless and working poor. Figure 1.2 below shows the number of single and couple households in earnings poverty, as well as those which are working, but in earnings poverty, and those in which no one works. The percentages in the table show the proportion of the household type in each kind of poverty – so we see, for example, that 16% of single households are in earnings poverty despite working, while only 7% of couple households are workless.

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18 Authors' calculations, based on analysis of the Family Resources Survey (FRS). All such calculations used the FRS 2005/06, combined as is standard, with the Households Below Average Income survey (HBAI). Here and throughout this report, the 'households' or 'families' referred to in the text relate to 'benefit units' in the FRS data. A benefit unit is a "single adult or a couple living as married and any dependent children" (including same-sex partners); technically, a household is "a single person or a group living at the same address as their only or main residence; who either share a meal a day together or share the living accommodation." A household can contain more than one benefit unit. We generally use the benefit unit (or "benunit") category as it is the unit for which benefit claims are assessed.

19 Department for Work and Pensions, *Households Below Average Income: An analysis of the income distribution 1994/95 - 2007/08* (DWP, 2009), p. 102.

20 Authors' calculations, based on analysis of the FRS.

21 Department for Work and Pension, *Family Resources Survey United Kingdom, 2007-08* (DWP, 2009), Table 3.8.

22 Authors' calculations, based on an analysis of the FRS. See Appendix B.

23 Graeme Cooke and Kayte Lawton, *Working out of poverty* (Institute for Public Policy Research, 2008), p. 6.

24 Calculations based on Department for Work and Pensions, *Households Below Average Income: An analysis of the income distribution 1994/95 - 2007/08,* (DWP, 2009), p. 66.

Figure 1.2 Working age households in the UK (2005-06 data)[25]

	Single	Couple	All Households
Total number of households	12.5m *100%*	11m *100%*	23.5m *100%*
Households in earnings poverty	6.3m *50%*	2.3m *22%*	8.6m *37%*
Working household in earnings poverty	2.0m *16%*	1.6m *15%*	3.6m *15%*
Workless households	4.2m *34%*	0.8m *7%*	5.0m *21%*

A further three million workless adults live in households where another works.

The group of underlying poor accounts for 37% of all working-age households, and should be the primary concern of the benefits system. We must ask ourselves how the system balances providing supplementary income to alleviate this poverty with encouraging work. In the long-run, the only sustainable route to addressing poverty is to increase the earnings of the poorest in society. In the next two sections we review the patterns behind worklessness and earnings poverty.

1.3 Worklessness as a cause of poverty

The UK's current working-age population is 37.9 million, of whom 10.2 million were workless as of June 2009[26]: more than one in four of the UK's working-age population is currently not in paid work. Of these over two million are unemployed and around eight million are economically inactive. Apart from the inevitable rise as we have entered recession, there has been no significant deviation from this level.[27]

Nor in the last decade has there been a significant reduction in the level of long-term worklessness. Since 1997, there has been only a very small reduction in the proportion of working-age people on long-term out-of-work benefits.[28] One third of Jobseeker's Allowance (JSA) claimants have spent more time claiming out-of-work benefits than they have in work.[29]

25 Authors calculations, based on an analysis of the FRS, excluding pensioners and treating 'benefit units' as households. The FRS underestimates the number of Workless Households at any point in time, due to its annual timeframe.

26 ONS, 'Statistical Bulletin: Labour Market Statistics June 2009', available at www.statistics.gov.uk. A person is defined as unemployed if he/she is out of work and trying to get a job. A person is defined as economically inactive if he/she is out of work but not trying to get a job.

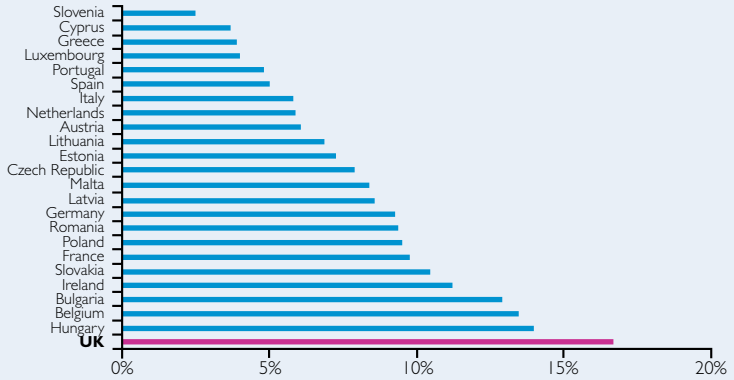
27 ONS, 'Summary of Labour Force Survey Data, Selected Labour Market Statistics', available at www.statistics.gov.uk.

28 New Policy Institute, 'Monitoring Poverty and Social Exclusion' (New Policy Institute/Joseph Rowntree Foundation, 2005), p. 42.

29 Hannah Carpenter, *Repeat Jobseeker's Allowance spells: DWP Research Report No 394* (DWP, 2006) p.31.

In contrast, many other advanced European democracies have restricted their levels of worklessness to below that of the UK. 23 European countries have a lower proportion of children living in workless households than the UK.[30] In countries such as Spain, Italy, and the Netherlands, the percentage of children living in workless households hovers at around 6%. In the UK, by contrast, it is over 16%.

Figure 1.3 Percentage of children in workless families (Eurostat, 2008)



This situation has had dire consequences for society. In Breakthrough Britain, we reported that worklessness in the UK is often concentrated geographically.[31] In the east end of Glasgow, for example, over 60% of children live in workless households and almost half the residents claim Incapacity Benefit (IB).[32] In workless hotspots the culture of not working is often transmitted, not just from generation to generation, but reinforced from household to household.[33]

Our analysis of the Family Resources Survey has shown that worklessness is most likely if a claimant household:

1. is headed by a single adult;
2. has two or more children;
3. has young children (aged seven or under);
4. lives in social housing.[34]

For example, only 7% of the 0.7 million childless couples living in private rented accommodation are workless. At the other end of the spectrum, of the two million single adults without children living in social housing, over 60% are workless.[35]

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30 Eurostat *table-Share of persons aged 0-17 who are living in households where no-one works*. Available at http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsisc080&plugin=1 [Accessed 1 December 2008].
31 Social Justice Policy Group *Breakthrough Britain* (CSJ, 2007).
32 The Centre for Social Justice Breakthrough Glasgow: Ending the costs of social breakdown, February 2008
33 Social Justice Policy Group *Breakthrough Britain*, July 2007
34 Authors' calculations based on an analysis of the FRS.
35 Authors' calculations based on an analysis of the FRS.

> "A child born to parents who are long-term recipients of benefits is more likely to be a long-term recipient of benefits. A child born into a family in which the mother failed to attain basic school-leaving qualifications is more likely to lack basic skills when entering the job market. Successive governments have failed to end this cycle. This is the real challenge. If we don't empower people to break free from this trap, we will not end child poverty by 2020 or any other date.
>
> This isn't like the problem of families just below the poverty line; it can't be solved by money alone. It is a problem of demoralised neighbourhoods, of broken families, of drug and alcohol dependency, of poor schooling, of poor housing and decrepit estates, of unemployment and unemployability, of children growing up with too little hope and too much fear."
>
> Oliver Letwin[36]

There are many issues that create and sustain worklessness and unemployment: from the state of the local labour market, and other social problems such as addictions and the other pathways to poverty. Part I will demonstrate how the benefits system itself perpethates worklessness; through poorly designed work incentives and a complexity which makes people wary about changing their circumstances. It will also ask if the level of support given to some groups is fair, and also whether the fact that some groups are supported more than others when they are out-of-work can account for the relative prevalence of that group out-of-work.

It is clear that to address poverty we must make entering work a rewarding route out. This will also mean providing the right support for those on low earnings. It is to this group we now turn.

1.4 Working poverty

Many working households do not earn enough from their wages to escape poverty. In 2005-06, 15% of working households were in earnings poverty - nearly as many as those that are workless.[37]

These working households in earning poverty are exerting themselves to work, but need help to overcome poverty. Most of these households are lifted out of poverty through benefits. But society places very different expectations on the amount different household types must earn in order to escape poverty. As we will show in Chapter 4, the net income required to put different working households above the poverty line varies considerably. On average, working

36 Oliver Letwin, 'Why We Have Signed Up to Labour's Anti-Poverty Target', *The Guardian,* 11 April 2006

37 3.6 million households. Authors' calculations, based on an analysis of the FRS. Note that not all workless households are in poverty.

households are expected to earn 73% of the amount needed to escape poverty. This amount varies considerably across household type, from 19% for a single person with children in rented accommodation, to 93% for a couple with no children in their own house. Appendix A will also show that, in some cases, a working person can be taxed back into poverty – their gross income is above the threshold, but their net income, after tax and NI, is below it.

For many working people in earnings poverty, there may be limited opportunities to increase earnings. Moreover, there may be little incentive to do so, given that a person's income may not increase very much even if they work longer or harder. The benefits system (and its interaction with the tax system) determines to a large extent whether it is worth working more. Today, the most vulnerable members of our society face very high withdrawal rates of their benefits. This is a serious barrier to the social mobility of many people at the margin and should form the first point of enquiry for a dynamic model.

1.5 The route out

Poverty levels remain high; earnings poverty too. These households will be dependent on the benefits system to lift them out of poverty – if it does so at all. But the dependency goes beyond the size of the income – it is engendered by people's efforts to maintain a stable income from benefits. The welfare state is not adequately alleviating poverty; it is rather shifting the nature of poverty. And today's benefits system – at the heart of the welfare state – serves not to enable but to block many of the sustainable economic routes out of poverty.

The good news is there is a way to get welfare to work. It begins by recognising that welfare is not measured by income alone; the size of an income transfer is not sufficient to measure social impact. Rather, we need to take into account the entire consequences for society – and the importance to society of individuals who work – of any welfare reform.

Recognition of the incentives created by a benefits system must be at the heart of welfare reform. Yet the current (and historic) Treasury vision of benefit reform rather resembles a machine, whose function is to improve the state through the pulling of financial levers. These levers produce money, which has the inevitable effect of improving society. It sounds facile; it is facile, yet how else does one explain the following from Nicholas Macpherson, in his October 2007 submission to the Treasury Select Committee:

> *The primary reason the Treasury has led on Child Poverty is that we control the levers which are critical for meeting the 2010 target, as we set the levels of financial support for families. Employment will have an important impact on achieving our goal of halving child poverty, but financial support is the most important lever …*[38]

38 House of Commons Treasury Committee, *First Report: The 2007 Comprehensive Spending Review 3* (December 2007), Written Evidence.

This, we aptly describe as *the static world view*.

The Treasury's 'control' of static 'levers' is slipping; and its basis for control may have been in the first place unsound. In the first instance, income transfer carries none of the added value of earned income. Secondly, successive governments have not structured the economic incentives attendant upon the benefits system effectively – so we should beware Government officers pulling levers without being able to explain fully the consequences of doing so.

Others have identified and criticised this thinking in the current Government. For example:

> "In a world which only took account of static effects, Gordon Brown and the Treasury might be right to argue that tax credits are a more cost effective way of fulfilling the welfare function than lower tax rates or higher tax allowances. However that analysis takes no account of the dynamic benefits that come from cutting marginal tax rates or the damaging consequences of the very high effective tax rates that tax credits have introduced.""
>
> Rupert Darwall[39]

Thinking about the world in a static way does not allow one to think about how people can help themselves, by entering work and earning more – and hence what impact policies have on these behaviours. It also fails to account for the fact that work is not simply something you do; it also gives meaning to who you are. It fails to account for the fact that work builds capacity and community and ultimately, is one of the activities that delivers meaning to the life of the individual.

Our research demonstrates that the combined effects of the tax and benefits system serve to create a destructive financial gradient that restricts the life choices of the most vulnerable people in our society; and that reinforces dependency and worklessness across generations. Some years ago, the IFS quantified this longer-term phenomenon in terms of effective marginal tax rates (which have not changed for the better since then):

> *Effective marginal tax rates have generally increased for workers, in spite of reductions in benefit withdrawal rates, owing to the increasing numbers facing means-tested benefit withdrawal.*[40]

Were this situation an unavoidable consequence of our efforts to relieve poverty, it would be merely unfortunate. However, it is not. It is an unnecessary by-product of poor benefit structures and policies. It is unacceptable that it

39 Rupert Darwall, *A Better Way to help the Low Paid,* (CPS, 2006).
40 Mike Brewer and Tom Clark, *The Impact on Incentives of Five years of Social Security Reforms in the UK*, (IFS, 2003).

should continue to misspend vast sums of money in a time when the public purse is constrained, especially when there is a better way.

The static way of thinking about welfare is no longer good enough. It leads, inexorably, to badly structured reform and spiralling cost pressure on the public purse. From the point of view of social justice – from the point of view of a shattered economy – we can no longer afford to ignore dynamics.

Dynamic modelling, which we describe in Part II, allows hitherto unparalleled levels of foresight as to the effects of reform. It uses the very latest econometric analysis. It is a powerful tool if we ask the right questions. What does the benefits system look and feel like to those it affects? Is it invariably an instrument for good or can it be an instrument for ill? Does it have a single purpose and, if not, do those it affects benefit from its various purposes? Is the welfare state, in its current form, a good thing; a positive influence on society? If not, can we afford reform? And if we cannot, or if reform is optional, what will be the consequences of inaction? Dynamic modelling has the answers.

1.6 Part I

The remainder of Part I describes the current state of the benefits system, and what it is like to be reliant on it. From this analysis we will derive objectives for reform, which will be scrutinised and passed through our Dynamic Benefits Model in Parts II and III.

Part I is in five parts:

- *A large, cumbersome net:* the development of many discrete streams of benefit raises several questions as to the effectiveness of the system (Chapter 2).

We then review different aspects of the system, and identify objectives for reform:

- "*Why should we work?*": : high benefit withdrawal rates and levels of income tax and national insurance create an unacceptably high financial disincentive to work for those with the lowest levels of earnings (Chapter 3). This raises several issues including that of the desirable shape of the income curve across society, which we address more thoroughly in Part II.
- *Unfair and unwise:* many people rely on the benefits system for their income. Chapter 4 looks at whether the system is fair to different households and also whether it discourages prudent and socially beneficial decisions, such as whether two people should live together as a couple and whether to build up savings.
- *The burden of complexity:* the complexity of the system and its administration adds to its expense and engenders greater dependency (Chapter 5).

We require a system that is rational, simple, work- , family focused and encouraging of financially prudent behaviour. As such, we conclude with a **manifesto for reform** that incorporates these values. In Parts II and III, these objectives will be analysed and used to develop specific proposal for reform, underpinned by a dynamic model that ensures they are both affordable and effective.

CHAPTER TWO
A Large, Cumbersome Net

This chapter examines the history of state provision of benefits, and describes the development and current arrangement of benefits that can be claimed today by working age households. The description of the major available benefits – out-of-work, child-related, housing, in-kind, and in-work benefits – will act as a reference point for the rest of this work. Moreover, a picture will emerge of an increasingly complex and expensive system which has moved away from the vision of its major architect, while failing to adapt positively to changing social and labour market characteristics.

2.1 Lost opportunity

The provision of welfare by the state eventually led to the creation of the welfare state. Yet its most well-recognised architect, William Beveridge, warned early on about the growing tendency of the system to elbow out the community and voluntary sector and reduce personal incentives. Beveridge's warnings went largely unheeded and the system continued to develop in a similar manner. Reforms were reactive, attempting to control spiralling costs of particular benefits and redress unforeseen problems that the system itself seemed to create or exacerbate.

2.1.1 A ROLE FOR CIVIL SOCIETY

Social welfare did not start with Beveridge. A constituted form of welfare dates as far back as 1597, with the enactment of the Poor Law. By the eighteenth century, around 20% of the population applied for some sort of governmental assistance at least once in any given five year period.[1]

Before the 20th century, welfare provision was predominantly locally administered, at the hands of friendly societies, or charitable entities. Those who were able-bodied were obliged to work for support. It was not until 1911 that a statutory unemployment insurance scheme was established. Britain took further steps towards a nationally-run, rights-based benefits system when the Government introduced Out of Work Donations in 1919 and then means-tested Unemployment Assistance in 1931.

By the beginning of the Second World War, Britain's state-based social security system had begun to develop a complexity familiar to us today. There

1 Paul Slack, *The English Poor Law*, 1531-1782 (1990), cited by Nicholas Boys Smith, *Reforming Welfare* (Reform, 2006), p.21.

were, for instance, three types of unemployment benefit, with different rules and benefit rates for each. Moreover, there were wide variations in the service offered by the friendly societies who conducted much of the administration.

Beveridge wanted to reform these organisations but, crucially, his vision was never to erase them completely. The involvement of the voluntary sector provided many additional, yet vital benefits. The voluntary sector could be effective at targeting help on those who needed it most. They could provide a helping hand of encouragement and support. They could provide incentives and encouragement for those who could work, to seek it.

2.1.2 THE BEVERIDGE REPORTS

Beveridge wrote three reports which formed the basis of the post-war settlement. The first Beveridge Report, *Social Insurance and Allied Services,* was published in 1942. The second was *Full Employment in a Free Society,* published in 1944. Together, these made a major contribution to the post-war settlement.

From these two reports sprang the legislation that sought to bring the sprawl of previous years to order. The National Insurance Act (1944) sought to create a comprehensive insurance scheme covering sickness, unemployment and retirement. The National Assistance Act (1948) established a scheme to replace the local Poor Law system and unemployment assistance.

The role of the state in society was to *insure* against disaster. For those who could not work, the state would ensure their maintenance beyond the poverty line.[2] To those who could work, but were unemployed, the state would give a 'hand up.' Those who were insured were required to return with alacrity, where possible, to meaningful employment.

The role of voluntary action by communities and charitable organisations was key to Beveridge's vision; but equally important was individual action – the willingness to go out and work to improve one's own circumstances and that of one's family and community. Beveridge was clear from the start that a welfare state had the potential to undermine both communal and personal voluntary action. The third guiding principle of his proposal, and indeed the first which deals directly with the future shape of social insurance, is that:

> *The State in organising security should not stifle incentive, opportunity and responsibility; in establishing a national minimum, it should leave room and encouragement for voluntary*

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2 Note the poverty line as defined by Beveridge was quite different to what it is today. In the Reports, he defined poverty, or as he referred to it, 'Want', as "lack of income to obtain the means of healthy subsistence-adequate food, shelter, clothing and fuel". He continued:

> *"The Plan for Social Security is designed to secure, by a comprehensive scheme of social insurance, that every individual, on condition of working while he can and contributing from his earnings, shall have an income sufficient for the healthy subsistence of himself and his family, an income to keep him above Want, when for any reason he cannot work and earn. In addition to subsistence income during that, however large the family, no child need ever be in Want, and medical treatment of all kinds for all persons when sick, without a charge on treatment, to ensure that no person need be sick because he has not the means to pay the doctor or the hospital"*

> *action by each individual to provide more than that minimum for himself and his family.*[3]

Beveridge's vision was holistic. However, in the Attlee Government's rush to implement it, the end result became somewhat narrower than the vision.

2.1.3 THE NEED FOR A THIRD REPORT

In the Attlee Government's welfare state, the emphasis was on *income transfer*. The state provided the means, through the transfer of income, to alleviate poverty. From the state's perspective, the community and voluntary sector had no role to play in delivering the system and promoting a return to work.

Putting these measures in context, we must understand that they reflected a social climate quite different from our own. The job market was different. Family dynamics were different too. There was little available research to understand the impact of benefits, or the economic incentives that accompany benefits, on the lives of those subject to such a large state system.

There were additional pressures. The Labour Government had been elected on a mandate to institute the welfare state and as such, there was a hurry to implement the Beveridge proposals. The first Beveridge report had sold a phenomenal 500,000 copies.[4] There were stories of soldiers reading it at El-Alamein, and Beveridge received considerable personal fame as a result. With these reports, many who had a clear memory of the problems before the war felt that these hardships would be abolished. There was excitement and optimism.

As Beveridge watched the Government implement his two reports, he grew concerned that there was a lack of balance. He felt his task was incomplete. That is why he wrote a third report. Published in 1948, Voluntary Action bemoaned the Government's failure to implement what he saw as the vital tenets of the welfare state:

> *In a totalitarian society all action outside the citizen's home, and it may be much that goes on there, is directed or controlled by the State. By contrast, vigour and abundance of Voluntary Action outside one's home, individually and in association with other citizens, for bettering one's own life and that of one's fellows, are the distinguishing marks of a free society. They have been outstanding features of British life.*[5]

Most tellingly, Beveridge wanted civil society – the community and voluntary sector – to form that humanising link between the state and the home. Welfare to him was not an instrument of state but of society.

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3 William Beveridge, *Full Employment in a Free Society* (George Allen & Unwin, 1944), p.17.
4 Brian Abel-Smith, 'The Beveridge Report: Its origins and outcomes', *International Social Security Review*, 45, (1992).
5 William Beveridge, *Voluntary Action* (Allen & Unwin, 1948), p.10.

2.1.4 BEVERIDGE UNDERMINED

Beveridge's own report was founded on two principles: the right to receive assistance, and the responsibility to return to work, where possible, swiftly. During the first few years of the welfare state, this balance was lost. The tension between a right to benefits and a responsibility to work translated immediately into problems. Beveridge had wanted the majority of social security payments to be funded through National Insurance contributions.[6] This was intended to preserve individual action by requiring that a person work to build up his insurance pot. However, by 1953, it was clear that the sums raised through insurance contributions were inadequate to satisfy the increased demand.[7]

Moreover, in the 30 years after the Second World War, many policy-makers emphasised the rights-based aspects of Beveridge and underplayed his call for a responsibility to seek work. The 1960s saw the growth of a welfare rights lobby, and the concurrent expansion of means-tested and non-contributory benefits. Policy was characterised by little concern for the part that economic incentives play when a claimant makes important life decisions. As the welfare state developed it moved ever further away from Beveridge's insurance model; and expenditure on social security increased significantly.[8]

There are many additional reasons for the rise in welfare expenditure, each reason depending, in large part, on one's view of the arrow of causation. Rising expenditure, according to one view, was a natural product of changing demographic and economic conditions.[9] However, there is another view that supposes the reverse: that the welfare state, or at least those architects who followed Beveridge, implemented their own vision of the Beveridge report. As a result, society was moulded in the images of successive Governments. Following this line of argument, it is not difficult to see why Beveridge's welfare state became something of a flawed creation.

2.1.5 STEP-CHANGE: THE CONSERVATIVES AND NEW LABOUR

The Conservative administration of 1979-1997 attempted to rein in the rising social security expenditure.[10] Some benefit changes, such as the abolition of earnings-related additions to Unemployment Benefit, were made soon after the 1979 election. On the other hand, a series of sector-by-sector reforms of the welfare system had to wait until the late 1980s and early 1990s. There were still significant upward pressures on costs, triggered by recessions in the early 1980s and early 1990s. Peter Lilley, towards the end of the Conservative period of government, managed more or less to stabilise expenditure.[11]

The New Labour administration led by Tony Blair embraced the welfare critiques of the previous administration. A large social security budget was,

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6 William Beveridge, *Social Insurance and Allied Services* (1942) p.11.
7 Conservative Party, *Reshaping our social security system* (Conservative Research Department, 1995).
8 Robert Walker and Marilyn Howard, *The Making of a Welfare Class? Benefit Receipt in Britain* (The Policy Press, 2000), p. 40.
9 Ibid p. 8.
10 Office for National Statistics, *Social Trends 39: 2009 edition* (Palgrave Macmillan, 2009), p.110. Note that the graph pictured does not include expenditure on tax credits.
11 Ibid.

Blair argued, "not a sign of socialist success, but a necessary consequence of economic failure."[12] Social security had to be adapted to meet the needs of a flexible labour market. Employment, not benefits, provided the best defence against poverty.

There began a campaign to modernise welfare and make it proactive rather than passive. Welfare could be part of the solution to poverty and social exclusion.[13] This included a series of welfare-to-work schemes, the New Deals, the introduction of a National Minimum Wage, and benefit reform. New Labour sought to "make work pay" and offer "work for those who can; security for those who cannot."[14]

2.1.6 THE FLAWED WELFARE STATE

Successive Governments have tinkered with the welfare state, shifting priorities as they sought to control its growth. Over the decades, growing expenditure on benefits has led to the increase in the targeting of the payments on those who need assistance most. This has given rise to large benefits, taken away quickly as a claimant's financial situation improves, with high, means-tested withdrawal rates. Increasingly, for a claimant, once in receipt of benefits, the path to independence has become more difficult.

At the same time, because of mounting cost pressure, successive Governments have sacrificed policies that are for the good of society as a whole, in favour of more expedient ones. The growth of benefit recipients has brought about ever-tighter restrictions on access, as a way of controlling spending. In fact, each successive Government has tried to target and restrict, but has actually ended up expanding the welfare state, as society and circumstances have evolved with policy.

The benefits system has also not kept pace with changes in society. Take the case of in-work poverty. This phenomenon was not recognised in the 1940s:

> *The Beveridge Report barely discusses the problem of poverty among working households. In this, it is very much a product of the particular time at which it was written… for Beveridge it was axiomatic that anyone in employment had resources sufficient to support a wife and one child.*
>
> Dilnot, Kay and Morris [15]

Working meant working a full time job with a regular wage. Even when the problem of in-work poverty began to assert itself, the creation of the

12 Speech in Southampton, 13 July 1994.
13 Robert Walker and Marilyn Howard, *The Making of a Welfare Class? Benefit Receipt in Britain* (The Policy Press, 2000), 40.
14 The Department for Education and Employment, A new contract for welfare: The Gateway to Work, p. 8.
15 Andrew Dilnot, John Kay, and Nick Morris, *The reform of social security* (OUP, 1984) p. 23.

first in-work benefit in the 1970s maintained this assumption: it was only available to those in full-time work. There was no thought that the benefit would play a role in enticing people into work: a person was either employed or temporarily unemployed, such that he or she would be back in work at the earliest opportunity. The contemporary phenomenon of young people entering adulthood unemployed or workless and remaining so for a long time was unknown. Furthermore, for those on these in-work benefits, they provided no incentive to progress, as they had punitive withdrawal rates; but progressing was not seen as goal of policy, nor was it contemplated that people would change their behaviour in order to maintain a benefit.

As society and the economy changed, such that there were more part time jobs and a greater level of sustained, life-style unemployment, policy-makers became wise to the potential for in-work benefits to incentivise work. They became aware that there was now a need to give people a reason to come off out-of-work benefits, and to progress from part-time to full-time work. This process culminated in the Working Tax Credit. But in a sense the wrong lesson was learned: it was not that in-work benefits could incentivise work, but that all benefits affected incentives. Yet policy-makers persisted with using the vestigial and inherited structures.

These reforms and patches to the welfare state have produced a series of crude, overlapping reforms: in- and out-of-work benefits, conditional and unconditional benefits, benefits withdrawn after tax and benefits withdrawn before tax. The list goes on. As problems with new arrangements have emerged, successive Governments have reformed again on the basis of expediency, using the relatively blunt economic tools at their disposal. The result has been a series of largely unintended consequences for those who claim benefits.

One of the major contentions of this report is that a system in which income transfers are dependent on the behaviour of recipients will in turn have an impact on that behaviour. Beveridge himself recognised this; indeed it was so central that it formed his third principle: that the system had to be careful not to "stifle incentive, opportunity and responsibility."

Our analysis suggests that many of the problems of the welfare state are attributable to a failure of policymakers to understand the way that benefit reforms affect life decisions. A client state, dedicated to benefit provision, has yielded more economic dependency than the strong civil society, based upon a framework of empowerment that Beveridge envisioned; with long-term decisions often swapped for short-term ones, driven by financial incentives. In Part II we will describe recent research which has quantified the effect of these incentives on behaviour, which will allow us to be much wiser in future design.

The following sections describe the development of those benefits currently claimable by working-age people. As we shall see, each strand or type of benefit has developed independently. Each incremental change is understandable in its own terms. However, the cumulative effect has been unintended. We look first at the basic out-of-work benefits, Jobseeker's Allowance, Income Support

and Employment and Support Allowance; then at the child-related benefits, Child Benefit and Child Tax Credits; then housing-related benefits of Housing Benefit and Council Tax Benefit; then the in-kind benefits that accompany Income Support and some tax credits; and finally the in-work benefits. Section 2.7 draws out some conclusions.

2.2 The basic three benefits: Jobseeker's Allowance, Income Support, Incapacity Benefit / Employment and Support Allowance

A claimant who requires assistance will begin by being ascribed one of these three, theoretically exclusive, benefits. If unemployed but employable, the claimant will be placed on Jobseeker's Allowance. If unemployed but unwell, the claimant will move to Employment and Support Allowance (formerly Incapacity Benefit). Where the claimant has a very low household income and is not expected to work, they will be entitled to Income Support.

These three benefits were developed in parallel, but quite separately. This has led to a number of contradictions.

2.2.1 JOBSEEKER'S ALLOWANCE AND THE START OF MODERN WELFARE

In 1911, the Liberal Government introduced the world's first statutory *unemployment insurance* scheme. This was designed to replace the private and voluntary insurance schemes that had previously supported unemployed people.

Further consolidation occurred when Attlee's Government implemented the main benefit from the Beveridge Reports for unemployed people: *Contributory Unemployment Benefit*. This was an insurance-based benefit, which lasted for 12 months if the claimant had paid sufficient contributions. After this period, or if the claimant had paid insufficient contributions, the claimant received *Means-Tested Unemployment Benefit*. This structure was maintained throughout the following 30 years.

From 1979-1997, policy in this area had two drivers. The first was a static driver: to contain, and if possible reduce, government expenditure. Secondly, there was a dynamic driver: to enhance incentives to work.

- In 1980, Unemployment Benefit was made taxable and was increased by5% less than other benefits in the annual up-rating.
- In 1980, earnings-related additions to Unemployment Benefit were abolished – thus weakening the insurance principle.
- In 1988, 16-18 year-olds were awarded a lower rate of Unemployment Benefit.

Then, in 1996, the Conservatives replaced Unemployment Benefit with Jobseeker's Allowance (JSA).

The structure of JSA was closely modelled on its predecessor: it had a contribution-based component, which was paid for only six months, and an income-based component. The Major Government described JSA as a tough regime. JSA's eligibility criteria were much stricter than those of its predecessor.[16] Those out of work had to satisfy three "labour market conditions" in order to qualify for JSA:

i. They had to have a Jobseeker's Agreement with the Department of Social Security (precursor of the Department for Work and Pensions).
ii. They had to be available for work.
iii. They had to be actively seeking work.

The introduction of JSA is thought to have reduced registered unemployment by between 100,000 and 200,000 between the spring of 1996 and the summer of 1997, mainly in those areas where labour demand was high.[17] New Labour has maintained JSA in this form.

We will return to discuss two features of JSA. The first thing to note is the withdrawal rate, which is set at 100%. Once work is found, JSA is lost pound for pound with earnings.

The second is that there is a sizeable financial bias against those who would live with another claimant. This occurs because, in a household of two, the second earner has JSA withdrawn as the first person's earnings exceed the limit for their own JSA to be fully withdrawn. This provides a big disincentive to living together.

Two kinds of JSA

JSA splits into two categories.

Contribution-based JSA is paid to unemployed people who have made sufficient insurance contributions, and is not means-tested. It is paid for six months (at £64.30 per week), and is paid at a lower rate (£50.95 per week) to those under 25 years-old.[18]

Income-based JSA is paid at the same rate as contribution-based JSA, for an indefinite amount of time. It is paid to people who are ineligible for contribution-based JSA and who pass a means test. If a claimant has over £16,000 in savings or other capital, he/she is ineligible for income-based JSA. Savings or other capital of between £6,000 and £16,000 affect the level of benefit.

16 Unemployment Benefit had had some work-seeking expectations, but JSA represented a step change in the obligations.

17 Robert Walker and Marilyn Howard, *The Making of a Welfare Class? Benefit Receipt in Britain* (The Policy Press, 2000), p. 83.

18 Unless otherwise stated, the source for any quoted benefit rate or condition is Child Poverty Action Group, *Welfare Benefits and Tax Credit Handbook 20008/09* (CPAG: April 2008), widely recognised as the most useful and comprehensive guide to the benefits system. Some rates may have changed in line with inflation.

2.2.2 INCAPACITY BENEFIT / EMPLOYMENT AND SUPPORT ALLOWANCE

Benefits for incapacity have always been among the most necessary, but also the most controversial benefits in the system.

In the Beveridge scheme, Sickness Benefit was paid at a flat rate (equal in value to Unemployment Benefit) for as long as a person was incapable of work.

In 1971 Edward Heath's Conservative Government introduced *Invalidity Benefit* (IVB) for those who are long-term sick or disabled. A person was entitled to IVB after six months of incapacity for work. For the first 28 weeks of incapacity, a person continued to receive Sickness Benefit.

At the beginning of the 1970s, IVB awards were set at the same level as Unemployment Benefit. By the end of the decade, they were 20% higher.[19] At the same time, during the 1970s, and particularly during the 1980s, there was a steady increase in both the number of IVB recipients, and the cost of the benefit. In 1979, there were 880,000 IVB recipients and government expenditure on IVB was £847 million per annum.[20]

Since the high levels of unemployment of the 1980s, successive Governments have focused on unemployment as a key measure of the success of their labour market strategies. It is possible that this made it politically expedient to maintain a low unemployment count even if other workless categories are growing, and effectively encouraged the development of new workless categories and the growth in the number of people receiving benefits such as IVB. By 1993 there were over 1.5 million recipients of IVB and expenditure had increased to roughly £5.7 billion per annum,[21] a real terms increase of about 230% from 1979.

In 1995 Sickness Benefit and Invalidity Benefit were replaced by Incapacity Benefit (IB). The Government was eager to reduce expenditure on social security, to encourage people to move from welfare to work, and to ensure that benefits for incapacity went only to those genuinely incapable of work. (IB has very recently been replaced by Employment and Support Allowance [ESA], discussed below.)

IB was made taxable and had tougher eligibility criteria. However, unlike contribution-based JSA, it was not time-limited. An IB claimant can conceivably claim for their entire life.

In order to qualify for IB, claimants were required to pass a test of incapacity for work. For the first 28 weeks of incapacity, people previously in work were assessed on the "own occupation" test – the claimant's ability to do his/her own job. Otherwise incapacity was based on the "all work test" (now called a "personal capability assessment"), which assessed ability to carry out a range of work-related activities. The test applied after 28 weeks of incapacity, or from

19 Nicholas Boys Smith, Reforming Welfare (Reform, 2006), p. 55.
20 Hansard 5 February 1981 vol 998 c190W.
21 Nick Wikeley, "The Social Security (Incapacity for Work) Act 1994," *Modern Law Review 58* (July 1995), p. 525.

the start of the claim for people who did not previously have a job.

There was no absolute bar to work. *Therapeutic Work* was allowed. This meant that those on the benefit could work, on the advice of a doctor, for less than 16 hours per week for earnings up to £66 for an unlimited period. New Labour replaced this with *Permitted Work*, which was touted as a "stepping stone off benefit and into employment."[22] It allowed those on IB to test their capacity for work – and perhaps acquire new skills – while continuing to receive their benefit.

The number of IB recipients has exceeded the number of people claiming Jobseeker's Allowance by a wide margin. The number of recipients of disability-related benefits has increased in the last three decades. The average number of IB recipients in 2008, 2.6 million,[23] was approximately four times the number of people who claimed the equivalent benefits in 1979.[24]
In addition to IB, an individual may be eligible for *Disability Living Allowance* (DLA). This is in two parts – the care component and the mobility component. A claimant may be able to claim just one component or both. This is a set rate of benefit and is not usually affected by savings. In November 2008, there were 3.02 million recipients of Disability Living Allowance (DLA). This is the first time the DLA caseload has reached over 3 million.[25]

Benefits for incapacity require sensitive appraisal. The bare truth is that the difference in payment levels between IB and JSA inevitably create large economic incentives to move from JSA to IB, from a benefit which nominally requires the claimant to look for work, to one which does not. There is rising concern, across all political parties, that IB has become a place where the aspirations of some claimants are written off.

Incapacity Benefit: Facts

- IB is paid at three rates:
  - The lower rate of short-term IB (to which eligible people are entitled for the first 28 weeks) is paid at £67.75 per week.
  - The higher rate of short-term IB (to which eligible people are entitled for the second 28 weeks) is paid at £80.15 per week.
  - Long-term IB (to which eligible people are entitled after 52 weeks) is paid at £89.80 per week.
- There are also age-related additions:
  - Those under 35 are paid an additional £15.65 per week.
  - Those under 45 but over 35 are paid an additional £6.55 per week.

2.2.3 INCOME SUPPORT

The National Assistance Act (1948) established a national social assistance scheme to replace the local Poor Law system and means-tested unemployment

22 Permitted Work Procedural Information for Disability Organisations, DWP.
23 Department for Work and Pensions, *Quarterly Statistical Summary* (DWP: 2009), Table 1.1.
24 Moussa Haddad, *The Incapacity Trap*, (Social Market Foundation, 2005), p. 6.
25 Department for Work and Pensions, *Quarterly Statistical Summary* (DWP, 2009).

> "Nine out of ten people who came on to incapacity benefit expect to get back into work, yet if you have been on incapacity benefit more than two years, you are more likely to retire or die than ever get another job. That cannot be right."
>
> John Hutton, former Secretary of State for Work and Pensions.[27]

assistance. *National Assistance* was intended to be a means-tested safety net that stretched beneath Beveridge's contribution based system. Its task was to cover what Beveridge called "abnormal subsistence needs."

In the 1950s and 1960s, the failure to set contribution-based benefits at a high enough level meant that many more people than anticipated ended up supplementing contribution-based benefits with National Assistance. In 1949 the National Assistance Board had one million clients; by 1954 the number of recipients had almost doubled to 1.8 million.[26]

In 1966, Harold Wilson's Labour government replaced National Assistance with *Supplementary Benefit*, which sought to change the culture of benefit claiming. From now on, this benefit would be a legal right to be claimed rather than a charitable gift to be asked for.

As a result, the number of claimants increased by 365,000 within a year. Harold Wilson stated that "hundreds of thousands of the least well-off members of the community now claimed their rights."[28]

From the late 1960s onwards, economic and demographic pressures began to alter the population with which the Supplementary Benefit Commission dealt. Not only did unemployment begin to rise, but the number of lone parents also began to increase steadily. Initially this was mainly as a result of a rise in the number of divorces and separations, but the patterns changed over time. The number of lone parents receiving Supplementary Benefit/ Income Support had reached 213,000 in 1970/71.[29] As a result of these trends, Supplementary Benefit was made taxable in 1982.

2.2.3.1 Income Support and the Social Fund (1988)

In 1988, *Income Support* (IS) and the *Social Fund* replaced Supplementary Benefit. The Conservative Government was seeking to simplify benefits for people on low incomes.

The Social Fund was designed to assist people (mainly those on Income Support) in special circumstances when they had to meet large and unexpected expenses.

Income Support is available to people on low incomes who are not available for full-time work, by reason of being a lone parent, being either sick or disabled, or having carer responsibilities. Under the current arrangements, Income Support:

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26 Nicholas Timmins, *The Five Giants: A Biography of the Welfare State*, 2nd ed. (HarperCollins Publishers Ltd, 2001), p. 192.
27 House of Commons Debate, 24 January 2006, Column 1305.
28 Ibid, p. 228.
29 Robert Walker and Marilyn Howard, The Making of a Welfare Class? Benefit Receipt in Britain (The Policy Press, 2000), p. 4.

- Is paid to any person not working 16 or more hours a week, and whose other income is less than a prescribed level;
- Is not routinely paid to 16 and 17 year-olds – unlike its predecessor. The significant exceptions are for those who have no regular contact with parents, and if they have children.
- Includes an *earnings disregard* so that a person could earn a small amount without having any of their award withdrawn; after that the award was reduced by £1 for every £1 earned until the entitlement was zero or the person was working 16 hours, at which point any remaining entitlement was withdrawn;
- Has similar capital restrictions and withdrawal rates to JSA.

The value of Income Support

Income Support currently (in 2008/09) provides £50.95 per week for a single person aged 18-24, and a higher amount of £64.30 per week for those over 25. The earnings disregard is £20 per week for a lone parent, £10 per week for a couple, and £5 per week for a single person.

The story of Income Support is the story of the struggle of lone parents to sustain themselves. The number of lone parents receiving Supplementary Benefit/Income Support increased from 213,000 to 972,000 between 1970/71 and 1998/99.[30] It is the major alternative to Jobseeker's Allowance, with the crucial difference that there is no work requirement, and one of the major access conditions is having a dependent child. Like JSA, it is withdrawn pound for pound with any earned income, which is particularly tough for lone parents because they are the ones most likely to need a job that has short hours and concomitantly low pay.

Until recently, lone parents claiming IS did not have to attend work-focused interviews before their youngest child turned 16, though they were offered. These interviews were designed to help lone parents keep in contact with the employment market and eventually begin full-time work (though, to be clear, they are not actual job interviews). Lone parents were not required to seek work until their youngest child turned 16. This has recently been reformed, and all lone parents whose youngest child is over seven will soon be obliged to demonstrate that they are actively seeking work in order to claim IS.

2.2.4 EMPLOYMENT SUPPORT ALLOWANCE (ESA)

As of October 2008, the Government replaced IB and the IS disability claim categories with Employment and Support Allowance. A thirteen week-long

30 Ibid. Since 1999, the size of this group has decreased, reaching a low of 728,000 at the end of 2008. See DWP Statistics, 'Income Support Caseload (Thousands): Time Series by Statistical Group', , available at:
http://83.244.183.180/100pc/is/ccdate/ccstatgp/a_carate_r_ccdate_c_ccstatgp.html [Accessed 3 June 2009]

'Work Capability Assessment' replaces the 'Personal Capability Assessment'. All new and repeat claimants must now take this test, which is designed to ask what work a potential claimant can, rather than what they cannot, do. There are a number of milestones and inter-related examinations, clearly designed to enact a 'tough,' more work-focused regime. There are temporary payment rates during the assessment phase of up to £64.30 p.w. for a single person aged over 25, £50.95 for a single person under 25, and £100.95 for a couple if they are eligible for the income-related (as opposed to contributory) ESA.[31]

There are two categories of ESA:

- ***Work-related***. This is for those who are capable of some work. Recipients:
  - are paid at a flat rate of £89.80 p.w.;
  - are required to attend the Pathways to Work scheme, which includes work focused interviews;
  - face sanctions if they fail to comply.
- ***Support group.*** This is for the most severely disabled individuals and those deemed incapable of work. Estimates suggest 10-20% of those who undertake the testing regime will fall into this category.[32] Recipients:
  - are paid £95.15 p.w., with a top up of £13.40 where claimants have no other income;
  - have no obligation to take part in work-focused activity.

ESA removes age-related top-ups and also the raises over time. The payment structure is the same as that for IS: there is a basic qualifying amount and premiums depend on conditions.

2.3 Benefits to support children: Child Benefit and the Child Tax Credit

One of the key goals of the welfare state is to protect the next generation of children, and to help ensure that even the most disadvantaged children have a chance to live in a household that remains above the poverty threshold. As such, benefits to support children have developed at their own pace, with their own schema and categories.

2.3.1 FAMILY ALLOWANCE (1948)

The Family Allowance provided five shillings (25p) a week for the second and subsequent children to every family in the UK – a significant amount of

31 Department for Work and Pensions, 'Employment and Support Allowance factsheet 1', available at http://campaigns.dwp.gov.uk/esa/pdfs/overview.pdf [Accessed 23 July 2009]. All payment figures in this section are applicable from April 2009.

32 Hansard, 19 January 2009, c1023W

money at a time when the average male manual wage was £6 p.w..[33]

2.3.2 CHILD BENEFIT (1977)

Child Benefit replaced Family Allowance, and was more generous. It was paid for the eldest child as well as younger ones. It represented a significant loosening of the eligibility rules: for the first time, all parents with children received a universal benefit. Among the benefits we have described, Child Benefit is unique in not being withdrawn based on earnings. The number of families receiving financial assistance for their children doubled. It has now become something of a national institution.

Child Benefit was the first benefit to include a supplement for lone parents. This was renamed One Parent Benefit in 1981, enshrining the principle of care for this vulnerable group. However, it made a financial difference only to lone parents in paid employment.

In the 1980s, the Conservatives made changes to Child Benefit. In 1980 the first Thatcher Government froze the value. In 1988, mothers lost the right to Child Benefit for children not in full-time education.

Then, in 1997, One Parent Benefit was incorporated into Child Benefit. Lone parents effectively received this benefit in the form of a higher rate on the same benefit, compared to two-parent families. The disparity was increased when Labour increased the value of Child Benefit for the eldest child from £11.45 p.w. to £14.40 p.w. in 1999.[34]

2.3.3 INCOME SUPPORT FAMILY PREMIUM (1988)

In 1988, Income Support replaced Supplementary Benefit. Income Support included a *Family Premium* (£10.80 p.w. in 1997) for parents with children and a *Lone Parent Premium* (£15.75) for single parents.

In 1997 the Labour Government incorporated Income Support Lone Parent Premium into Income Support Family Premium. Lone parents now received this benefit in the form of a higher rate. In addition, between 1997 and 2003 New Labour regularly up-rated Income Support Family Premium.[35]

2.3.4 CHILD TAX CREDIT (2003)

In 2003 the Labour government introduced Child Tax Credit (CTC). This benefit brought together several parts of the benefits system that supported parents with children (e.g. the family premiums in Income Support and income-based JSA). It was considerably more generous than the benefits it

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33 Nicholas Timmins, *The Five Giants: A Biography of the Welfare State*, 2nd ed. (HarperCollins Publishers Ltd, 2001), p. 49.

34 Herwig Immervoll, Lavinia Mitton, Cathal O'Donoghue and Holly Sutherland, *Budgeting for fairness? The distributional effects of three Labour Budgets* (March 1999), p. 3.

35 There was effectively an 80% rise in real terms in the value of Income Support Family Premium between 1997 and 2001. Tess Ridge, "Benefiting Children? The Challenge of Social Security for Children" in Jane Millar (ed.), *Understanding Social Security* (The Policy Press, 2003), p. 178.

replaced. Hence, the presence of children in an out-of-work or low-earning household has a materially beneficial effect on its net income.

The Government priority of addressing child poverty has increased the value of these benefits. This has had the corollary effect of making life as a lone parent more sustainable than previously it was, and possibly more financially attractive.

Benefits for those with children: Facts

Non-means-tested benefits: Child Benefit is paid to all parents with children. £18.80 p.w. is paid for the eldest child, and £12.55 p.w. is paid for second and subsequent children.

Means-tested benefits: A family with children and an income below about £58,000 per year can claim Child Tax Credit as well as Child Benefit. CTC is paid regardless of whether the parent(s) is (are) in paid employment. For those with household earnings below £50,000 per year,[36] CTC is worth £545 per year (£1,090 if they have a baby under one year old). Those with low earnings receive an additional £2,085 per child per year. If the household is receiving Working Tax Credit (WTC),[37] CTC will not be tapered away. If the household does not receive WTC, on the other hand, CTC is tapered away at 39%.[38]

2.4 Housing–related benefits: the biggest benefits of all

Housing-related benefits account for a large proportion of total benefit spending, especially as the price of property in the UK has soared.

Between 1948 and 1966, many local authorities provided recipients of means-tested benefits with additional help to pay for rent and local taxes. In 1966, a national rebate scheme was introduced.

In 1972, Edward Heath's Conservative Government introduced *Rent Rebate* and *Rent Allowance.* Both benefits were intended to help people with low incomes and low savings pay for rented accommodation: Rent Rebate reduced rent for council tenants and Rent Allowance provided cash assistance to help with rents of private tenants.

In 1982, *Housing Benefit* (HB) replaced Rent Rebate, Rent Allowance, and housing payments included as part of Supplementary Benefit. By introducing HB, the Conservatives sought to simplify the system of support for people who struggle to afford to pay for housing.

If a claimant received IS or income-based Unemployment Benefit, he or she was usually able to get the maximum rate of HB. It was then withdrawn as income

36 This family element of CTC is tapered away at a rate of 6.67% above gross earnings of more than £50,000.

37 See section 6 of this Chapter on in-work benefits.

38 CTC is withdrawn from household earnings above the point at which entitlement to WTCs is exhausted, or from £15,575 per annum, if WTC is not claimed,. The taper rate of 39% applies to elements of CTC other than the family element.

increased beyond an earnings disregard, dependent on family circumstances.

Rent levels rocketed across the UK during the 1980s and early 1990s. Between 1988 and 1998, for example, average local authority rents more than doubled, and average private rents almost tripled.[39] The increase was even steeper in London and the South East.[40] As a result, HB expenditure became one of the fastest-growing components of the social security budget. It increased by 4% per annum in the 1980s, and by 11% per annum between 1990 and 1996. By 1997, it had reached over £14 billion per annum,[41] even though less than one-third of all households rented their homes. In recent years it has stabilised somewhat, though continues to rise. By August 2007 there were 4 million recipients of Housing Benefit, of whom 1.5 million were aged 60 and over.[42] The average weekly amount of Housing Benefit was £71,[43] thus pushing the total cost towards the £16 billion mark.[44]

2.4.1 REFORM IN THE 1990s

Rebates for local taxes were available from 1990 through *Community Charge Benefit*. This was replaced by *Council Tax Benefit* in 1993. This enables one already claiming benefits, or one who is on low income, to receive help with the council tax they already pay on the property in which they live.

The level of benefit depends on how much money the claimant has coming in, the amount of council tax to pay, the amount of money needed to live on, savings, and whether other adults share the home.[45]

In 1996, the Major Government limited the amount of HB paid to private deregulated tenants to an 'eligible rent'. This was determined to be the smaller of the actual household rent and a Local Reference (average) Rent (LRR) for the number of rooms the family was entitled to.

Single Room Rent (SRR) regulation was also introduced in 1996. SRR limited eligibility for single people under 25 to a maximum (based on the premise that they would be in shared accommodation).

This reform was intended to reduce government expenditure on social security; to discourage people from moving into housing which they would not be able to afford without help from the taxpayer; and to increase work incentives. Both LRR and SRR led to a reduction in the number of HB claimants in the private rented sector,[46] and a concomitant decline in HB expenditure.

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39 House of Commons Library *Research paper, 98/69: Rent levels, affordability, and housing benefit,* (HOC,1998), pp. 9-10.

40 These trends continued after 1999.

41 In 2008 prices.

42 Department for Work and Pensions, *Quarterly Statistical Summary* May 2009, (DWP, 2009).

43 Hansard, 6 May 2009, c316W.

44 Hansard 24 March 2009, c254W.

45 Council Tax moreover incorporates a second adult rebate. This is claimable even by someone who with a higher income if he or she shares the home with other adults who are on a low income. Here, income and savings are not taken into account. The maximum rebate is 25% of the Council Tax bill.

46 According to Steve Wilcox, *The Vexed Question of Affordability* (1999), the number of HB claimants in the private rented sector declined by 100,000 between May 1997 and May 1998.

Family Room Entitlement

Families are allowed one 'room suitable for living in' (plus kitchen, bathrooms and toilets) for each of the following groups, with each group only counted once and in the first category they fall into:

- A couple;
- A person over 16;
- Two children of the same sex;
- Two children under 10;
- A child.

Families of less than four receive an additional room, those from four to six an additional two rooms and those with seven people or more an additional three rooms.

2.4.2 REFORM SINCE 2000

In 2003, the Labour Government piloted in some areas a reformed version of HB, *Local Housing Allowance* (LHA), for some private sector tenants. LHA was based on local rent levels, rather than on claimants' actual rent levels. The policy idea was that tenants get to keep (or pay) the difference if their rent is lower (or higher) than their LHA, so they have an incentive to keep their rent to a minimum. Administrators only need to know about the claimant's income, family size and location, and not about their actual rent or the property being rented. This was intended to make the assessment of HB eligibility quicker and easier.

The Welfare Reform Act (2007) expanded the pilots so that LHA applied to all new tenants in the deregulated private sector from April 2008. However, in the 2009 budget the Government announced that it was scrapping the scheme because costs had "very significantly exceeded" the planned expenditure.[47]

Benefits for housing immediately elicit many problems that contradict the aim of fighting poverty. The table above shows a clear couple penalty. With a combined Housing Benefit and Child Tax Credit withdrawal rate of 85% on net income, there are moreover very high rates of withdrawal which contribute to the disutility of earned income. The Government's attempt to rationalise administration is welcome, but more important is for the architecture of the system to be rationalised itself.

> "The single biggest financial disincentive to work is Housing Benefit, in particular the tapers."
>
> Off the Streets and Into Work, response to the Welfare Reform Green Paper 'A New Deal for Welfare', April 2006[47]

Housing Benefit, the main means-tested programme though which the government helps people on relatively low incomes with their housing costs, has an extremely high withdrawal rate. This exacerbates the problem of

47 House of Commons Treasury Committee, *Budget 2009*, HC 2008-09 [80]

undesirably high marginal rates. It is also hard to administer and is not claimed by many working families entitled to it. Council Tax benefit, on the other hand, and rather confusingly, is withdrawn at 20% (on after tax earnings).

Housing Benefit: Facts

The levels of Housing Benefit vary by family composition and local area. The following are some illustrative Local Reference Rents for some typical families in different parts of the country. This small sample shows that some areas have ten times the LRR of others:

Figure 2.1 Local Reference Rents

	Childless couple	Lone parent with one child	Couple with two daughters	Couple with a son and daughter (i.e. not expected to share a room)
Durham	£82	£95	£106	£115
Guildford	£158	£196	£225	£265

HB has a withdrawal rate of 65% on net income post taxes and other benefits, except child benefit. If a claimant, or a claimant's partner, had over £16,000 in savings or other capital, he/she is ineligible for HB. Savings or other capital of between £6,000 and £16,000 affect the level of benefit.

2.5 Passported benefits: benefits 'in-kind'

Out-of-work benefits and Child Tax Credits currently act as a 'passport' to various in-kind benefits. Rather than providing extra cash benefits across all the out-of-work population to pay for them, the current system provides them directly to those who need them. Passported benefits have a wide impact on claimants' lives, providing many services and essential goods which materially improve the lives of low-income families. Many are well-known, such as free school meals and free prescriptions. Others, such as legal aid, are called upon in case of an emergency or dispute and are less likely to be accounted for when valuing the cost of or incentive to work. Others have a cash value, such as the Disabled Persons' Tax Credit.

These benefits are removed when people cross an hours/earnings threshold. Often the decision to work (and especially to work more hours) can precipitate the loss of passported benefits. The family that qualifies for Income Support also qualifies for free school meals, free prescriptions, dental care and sight tests and the *Surestart Maternity Grant*. These are all withdrawn as one. The effects of these withdrawals on work incentives is discussed in section 3.3.2 below.

48 Off the Streets and into Work *Welfare Reform Green Paper "A new deal for welfare: empowering people to work": A response from Off the Streets and into Work*,April 2006

A recent survey of those helping people get into work emphasised that:

> *when the financial benefits were low, these could easily be outweighed by factors including low motivation, in-work costs, the withdrawal of benefits (in particular passported benefits) and the financial risks involved in entering what could often be temporary or insecure work.*
>
> Off the Streets and into Work, December 2006[49]

Common passported benefits (with the 'passport' in brackets)

Free school meals (IS/JSA/ESA/CTC)
School clothing grant (IS/JSA)
Prescriptions, dental and hospital fares (IS/JSA)
Health costs (IS/JSA/CTC)
Home Energy Efficiency Scheme (IS/JSA/DLA/WTC/HB/CTB)
Bus pass (DLA)
Free car tax (DLA
Blue parking badge (DLA)
Railcard (DLA)
Taxi Card (DLA)
Legal Aid
Housing grants
Social Fund Payments

2.6 In-work benefits and the Working Tax Credit

The UK labour market has evolved over the last 40 years. In that time, in-work benefits have played an increasing role in supporting those in earnings poverty (see Chapter 1).[50] According to Conservative MP David Willetts, this is desirable:

> *There is a particular case for such a system [of in-work benefits] in Britain because our flexible labour market means that we have a greater range of earnings than the more heavily regulated labour markets on the Continent, where low-paid jobs have been regulated out of existence so that people are unemployed instead. If that is the alternative, it is better that people should be in work even if it is low-paid and we can then top their incomes up to ensure they are not living in poverty.*[51]

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49 *Off the Streets and Into Work,* 'The costs and benefits of formal work for homeless people', December 2006.
50 Those in work, whose earnings are below the poverty line.
51 David Willetts, 'Tax Credits and Welfare Reform', speech to Politea (24 February 2003).

Keen both to reduce in-work poverty, and more recently to improve work incentives, successive governments have sought to support the underlying working poor. This has culminated in the Working Tax Credit (WTC, explained in section 2.6.6 below).

2.6.1 FAMILY INCOME SUPPLEMENT (1971)

In 1971 the Conservatives introduced *Family Income Supplement* (FIS), the first modern, non-contributory, in-work benefit for low-income parents with children. To qualify for FIS, a low-income parent had to be in full-time paid work (defined as 30 hours p.w., or 24 hours p.w. for single parents). Low-income singles and childless couples were not eligible to receive FIS.

FIS was designed not just to reduce poverty levels among families with children, but also to improve work incentives for a small proportion of the population and tackle the unemployment traps created by non-work-contingent means-tested benefits. It had a poor record and many problems.

First, it suffered from low levels of take-up.[52] Secondly, it helped to create a significant earnings trap: some families receiving FIS could lose £1.20 for each extra £1 of earnings after tax, national insurance, and the effects on rent and rent rebates.[53]

2.6.2 ONE PARENT BENEFIT (1981)

One Parent Benefit (OPB) was designed to encourage lone parents to find a paid job. In 1996, the year before its abolition, OPB was worth £6.05 p.w., for those in work.

2.6.3 FAMILY CREDIT (1988)

In 1988, *Family Credit* (FC) replaced *Family Income Supplement*. FC was more generous and more easily accessed than its predecessor:

- It reduced the qualifying hours to 24 p.w..
- It had a higher earnings disregard (£79 p.w.).
- The earnings means-test for FC was applied to post- rather than pre-tax income.
- It had a lower withdrawal rate (70%).

No one could now increase earnings and become worse off. In 1991, 350,000 families received FC, of which 38% were lone parents.[54]

As a result, this benefit created more of an incentive to work for those eligible. However, many others without children lacked such a reward and incentive.

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52 FIS reached only about 200,000 families. Alan Marsh, 'Helping British Lone Parents Get and Keep Work', in Jane Millar and Karen Rowlingson (eds.), *Lone Parents, Employment, and Social Policy: Cross-national Comparisons* (The Policy Press, 2001), p. 12.

53 Alan Marsh and Stephen McKay, *Families, Work and Benefits* (Policy Studies Institute, 1993), p. 4.

54 Alan Marsh, 'Helping British Lone Parents Get and Keep Work', in Jane Millar and Karen Rowlingson (eds.), *Lone Parents, Employment, and Social Policy: Cross-national Comparisons* (The Policy Press, 2001), p. 12.

2.6.4 FURTHER REFORMS

In 1992 the Conservatives reduced FC's minimum eligibility requirement from 24 to 16 hours of work per week. This reform was designed to allow a greater number of low-income working families to take advantage of in-work benefits and to encourage low-income single parents to take part-time paid work.

In the same year, the Conservatives also introduced *Disability Working Allowance*, a means-tested benefit which helps people with an illness or a disability who work for 16 hours or more per week and have limited earning capacity. Disability Working Allowance was designed to encourage some disabled people to move from welfare to work.

In 1995, the Conservatives further reformed FC so that recipients who worked more than 30 hours per week would be entitled to an extra £10 per week. This reform was designed to encourage people to move from part-time to full-time work, to offset the perverse incentives created by the reduction of FC's minimum eligibility requirement from 24 to 16 hours of work per week.

As a result of the 1992 and 1995 FC reforms, the FC caseload rose markedly to 733,000 in 1997 (12% of all working families with children).[55] Expenditure on Family Credit rose from £626 million in 1991/92 to around £2.35 billion in 1997/98.[56]

In 1996 the Conservatives introduced small-scale pilots of the *Earnings Top-up*, a scheme which effectively paid Family Credit to childless couples and single people.

2.6.5 WORKING FAMILIES' TAX CREDIT (1999)

New Labour replaced FC with the *Working Families' Tax Credit (WFTC)*.[57] There were two major differences between WFTC and FC:

i. WFTC was a refundable tax credit (albeit not generally linked to tax actually paid) administered by the Inland Revenue, rather than a traditional cash benefit administered by the Benefits Agency. By making this change, Labour hoped to reduce the stigma of receiving legitimate benefit. However, this change also introduced complexities and administrative problems, resulting in persistent over- and under-payment of claimants.
ii. WFTC was substantially more generous than FC:
    - It had a higher earnings disregard (£90 p.w. vs. £79 p.w.).
    - It had a lower withdrawal rate (55%).

The means-test for WFTC was applied to post- rather than pre-tax income. The increased generosity of WFTC inevitably increased government expenditure on in-work benefits. Expenditure on employment tax credits almost doubled between 1998/99 and 2000/01, rising from £2.68 billion to £4.81 billion (constant 2002 prices).[58]

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55 Robert Walker and Marilyn Howard, *The Making of a Welfare Class? Benefit Receipt in Britain* (The Policy Press, 2000), p. 86.
56 Department for Social Security, *Social Security Departmental Report*, Cm 3913, (DSS, 1998) Table 1.
57 Disabled Person's Tax Credits also replaced Disability Working Allowance.
58 Richard Blundell, "Earned Income Tax Credit Policies: Impact and Optimality," The Adam Smith Lecture, EALE/SOLE Meeting, June 2005.

2.6.6 THE WORKING TAX CREDIT (2003)

Keen to encourage single people and childless couples, as well as parents, to move from welfare to work, the Labour government replaced WFTC with *Child Tax Credit* and *Working Tax Credit* (WTC) in 2003. WTC gave means-tested support to everyone in work with a low income who was either a parent or was over 25 and working full-time (30 hours per week). Prior to the introduction of WTC, the UK had not had a national system of in-work financial support for low-income childless people. WTC moreover differed from WFTC in that:

- It had a disregard of £100 p.w.;
- It had a withdrawal rate of 37%;
- The means-test for WTC was applied to pre- rather than post-tax income.

As a result of these changes, the marginal withdrawal rate[59] before Housing Benefit for those in receipt of WTC was broadly equivalent to that of WFTC:

In 2008 the standard rate of tax was reduced from 22 to 20% and WTC's withdrawal rate was increased from 37 to 39%. This meant that the majority of low earners saw no reduction in their marginal rate of tax. The way in which Working Tax Credit reduces the withdrawal rate of benefits is in principle an excellent idea. However, its design is cumbersome. Its *hours thresholds* – the number of hours a person has to work before he or she is eligible - are

Figure 2.2: Marginal withdrawal rates

	Family Credit (1988)	Working Families Tax Credit (1999)	Working Tax Credit (2003)[60]	Working Tax Credit (2008)[61]
Tax and NICs	34.0%	32.0%	33.0%	31.0%
In-work benefit withdrawal rate (net or gross)	Net 70%	Net 55%	Gross 37%	Gross 39%
Gross equivalent withdrawal rate	46.2%	37.4%	37.0%	39.0%
Marginal tax rate from tax, NTCs and in-work benefits	**80.2%**	**69.4%**	**70.0%**	**70.0%**

arbitrary and create a series of capricious incentives. Added to the fraud and

59 Marginal tax rates (MTRs) measure how much income a person will keep for each additional pound earned. For example, a marginal tax rate of 70% means that a person will keep 30p for each additional pound earned. MTRs are calculated by taking into account withdrawals from taxes, National Insurance, and benefits. They are therefore different for different levels of earnings and family types. See Part 2.

60 If the gross earnings are below £6,535, the withdrawal rate will be 60% because of the 10p tax band.

61 If the gross earnings are below £6,035, the withdrawal rate will be 50% because of the increase of the Personal Allowance by £600. The Personal Allowance is the amount that can be earned before tax is deducted.

WTC Facts (taken from the Citizens Advice Bureau Advice Guide to the Working Tax Credit)[62]

Eligibility

There are four different ways to qualify for WTC, depending on the claimant's age, circumstances and the number of hours worked:

Those who are 25 or over and work 30 hours a week or more

Those responsible for a child

People aged 16 or over and responsible for a child or young person can claim WTC provided they work at least 16 hours a week at a low enough wage.

Those who are disabled

Claimants of disability benefits can draw WTC provided they work at least 16 hours a week and their income is low enough.

Those who are 50 or over and recently started work

Those aged 50 or over, who took a job within the last three months, and were previously in receipt of certain benefits (usually for a period of six months) are eligible for WTC if they work more than 16 hours per week.

There is no capital restriction to entitlement; savings are not taken into account in the Working Tax Credit calculation.

The WTC calculation (taken from the Citizens Advice Bureau Advice Guide to the Working Tax Credit)[63]

To work out entitlement, HMRC compares a claimant's income for the previous tax year to a figure of £6,420. If the claimant's income is the same as or less than this figure, he or she will get the maximum amount of WTC (and Child Tax Credit if this applies).

The maximum amount of WTC is calculated by adding together different elements which are based on your circumstances. These elements are:

- ***The basic element***: This applies to anyone who is entitled to WTC.
- **The second adult element:** This applies if claiming as a member of a couple. The claimant must claim as a couple if he or she lives with a partner. This includes same-sex partners, as well as opposite-sex partners.
- ***The disability element***: This applies if the claimant is disabled, receives certain benefits and works at least 16 hours a week. The severe disability element applies if the claimant receives the highest rate care component of Disability Living Allowance or the higher rate of Attendance Allowance. The claimant can also claim the severe disability element for his partner, if he qualifies.
- ***The 50 plus element***: This applies if he or she is 50 or over, began work within three months of the claim and was getting certain benefits in the six months before starting work.
- ***A childcare element:*** The claimant is eligible if he or she pays for childcare provided by a registered childminder, out-of-school club or

other approved provider. If the claimant's income is more than £6,420, this will affect the amount of WTC payable.

A single person without children who is disabled can earn up to £15,000 or £16,000 a year, depending on how many hours worked per week, before WTC is completely tapered away. These limits go up if the claimant is part of a couple.

error inherent in the complex system, it is a poor mechanism for delivering help to those who need it most. We describe the complexities of the Working Tax Credit further in Chapters 4 and 5. Reform of the system must focus on making the principles underlying the Working Tax Credit work better.

2.6.7 SUPPORT FOR WORKING PARENTS WHO STRUGGLE TO AFFORD CHILDCARE

Successive governments have sought to help parents more easily combine paid employment with parenting. In 1994 the Conservatives introduced a new childcare disregard in *Family Credit* (FC) to help with the costs of certain forms of childcare. Childcare costs of up to £40 p.w. could be disregarded from the family's income when the FC calculation was made. This covered spending on children aged 11 or under with registered childminders, day nurseries, and out-of-school clubs.

In 1996, the Conservatives increased the childcare disregard in Family Credit from £40 to £60 p.w., enabling low-income parents to receive more help with their childcare costs.

Having moved from a disregard to a direct payment, it is now possible to receive more in childcare costs than is earned by the job that the childcare is supposed to support.

WFTC included a *Childcare Tax Credit* for working couples and single parents. Childcare Tax Credit was effectively a subsidy for expenditure on approved forms of childcare. It was available to single parents and couples where both partners worked more than 16 hours per week, and covered 70% of childcare costs up to £150 p.w..

The value of childcare subventions for low-earning parents was more than 16 times greater in 2004 than in 1998, having risen from £46 million to £884 million.[64] Nonetheless, many parents continue to struggle to access affordable childcare.

2.7 Conclusion

Even this short series of introductions, makes it clear that our welfare arrangements is complex and for the claimant, intimidating. We might ask

62 Citizens Advice Bureau, 'Working Tax Credits', available at http://www.adviceguide.org.uk/b_working_tax_credit.pdf [Accessed August 6, 2009].
63 Ibid
64 Jane Lewis and Mary Campbell, "Work/Family Balance Policies in the UK since 1997: A New Departure?" *Journal of Social Policy 36* (July 2007), p. 373.

ourselves: if we are confused just by reading (and trying to describe) the complexity of a cursory few of these benefits, what can it be like for people who must rely on benefits for a major part of their income?

Setting aside a visceral reaction to this confusion, we need think about it analytically. There are certain themes to the historical narrative. Many of these remain problems in our benefit arrangements; but they can also act as a compass for the sorts of directions effective reform must take. For, despite efforts to the contrary, the system has not moved with the times.

Childcare element of the Working Tax Credit: Facts

Currently the childcare element of Working Tax Credit covers 80% of childcare costs up to a maximum amount payable of £175 p.w. for one child, or £300 p.w. for two children or more. The maximum amount payabe in childcare is therefore £240 p.w. In order to prevent people from suffering Housing Benefit (HB) and Council Tax Benefit (CTB) withdrawal, childcare-related income is disregarded from HB and CTB calculations.

2.7.1 THE END OF THE INSURANCE PRINCIPLE FOR WORKING-AGE BENEFITS

There has been a significant reduction in the proportion of unemployed people receiving *insurance-based* unemployment benefits. The proportion of unemployed people dependent on *means-tested* benefits has correspondingly increased from 35% in 1971 to 79% in 1996.[65] The recession of the early 1980s coincided with a large cohort of young people commencing work, many of whom had failed to build up the contribution record needed to qualify for insurance-based Unemployment Benefit. The recession also resulted in a considerable rise in the number of long-term unemployed claimants, who would have exhausted their entitlement to insurance-based Unemployment Benefit after 12 months.

The introduction of JSA compounded the reduction in the relative value of insurance-based Unemployment Benefit in the 1980s and early 1990s.[66] This in effect eliminated the key distinction between insurance-based and means-tested unemployment benefits.

We are left today with a mish-mash system, a mixture of contribution-based and income-based (i.e. means tested) benefits; indeed most benefits come in both flavours – income-based JSA, contribution-based JSA – paying at slightly different rates. Overall, despite the continued separate existence of the National Insurance Contribution, our welfare system is clearly not an

65 Robert Walker and Marilyn Howard, *The Making of a Welfare Class? Benefit Receipt in Britain* (The Policy Press, 2000), p.81.

66 The value of insurance-based Unemployment Benefit declined from 36 to 28% of average incomes between 1983 and 1996. Robert Walker and Marilyn Howard, *The Making of a Welfare Class? Benefit Receipt in Britain* (The Policy Press, 2000), p. 83.

insurance-based one with a means-tested floor: if anything it is largely means-tested with the remnants of insurance-based payment rates serving only to complicate matters.[67] The latest elaboration of this is the Working Tax Credit, a benefit that rewards those in work, and yet is means-tested. Certainly, if the purpose of an insurance-based system is to maintain the link between employment and out-of-work support, then this is not achieved.

Our review does not ultimately recommend a return to an insurance-based system, but we do show that benefits can be linked to work in a positive manner. The current work-incentives in the system are the subject of Chapter 3, where we ask whether work pays for those on low income. Chapter 4 examines other behavioural incentives in the system, as well as asking whether current arrangements are fair to all. Chapter 5 examines the effects on claimants of having such a complex system. These three chapters contain our central critique of the system, identifying principles of reform which our proposal in Part III seeks to pursue.

2.7.2 INADEQUATE WORK INCENTIVES (CHAPTER 3)

One of the recurring themes of the century's welfare reform is that *marginal tax rates* (MTRs) have actually increased.

The marginal tax rate determines how much better off overall a person will be for each extra pound of earned income, taking into consideration both tax and withdrawal of benefits. The Institute for Fiscal Studies (IFS) has examined how marginal tax rates have changed over time.[68] Its research shows that reforms introduced in the period 1980-87 increased MTRs, while reforms introduced after 1988 reduced MTRs. Since 1999, however, MTRs have increased by 3% on average. Recently the lowest income deciles have experienced the largest MTR rises.[69]

There has also been a marked increase in the number of people experiencing very high MTRs. The IFS's analysis of the impact of the 1997-2003 social security reforms showed that almost 1.5 million more people faced MTRs of 60-70% in 2003 than in 1997.[70] Nearly two million working people currently face MTRs of over 60%.[71]

For many, the apparent WTC work incentives from crossing an hours threshold is counter-balanced by the loss of passported benefits. As we will show, this is a clash of two differently configured systems that sit uneasily with one another. There is increasing evidence that the outcome of this is that the security of keeping what a claimant already has, trumps the potential opportunity from work.

While the effect of MTRs is acknowledged, even if little has been done about it, very little attention has been paid to participation tax rates (PTRs).

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67 Note that insurance principle still applies for pension contributions.
68 Stuart Adam, Mike Brewer and Andrew Shephard, *Financial work incentives in Britain: comparisons over time and between family types* (IFS, 2006).
69 Ibid, p.37 Figure 3.4.
70 Ibid, p.21.
71 Ibid, p.15 Table 2.3.

The PTR tells us how much better off financially a person would be in work at a particular level, compared to their current situation out of work: in other words it tells us the financial incentive for a workless claimant to enter the labour market. PTRs have become skewed against work; we argue that this regressive and ripe for reform.

2.7.3 PENALISING POSITIVE BEHAVIOUR (CHAPTER 4)

There has been a major increase in the number of parents receiving child-related means-tested benefits. Child-related benefits have become increasingly generous over time. Policy since the mid-1970s has developed in response to evidence that lone parents are particularly exposed to the risk of poverty. This has had a welcome effect on the financial position of many vulnerable individuals. However, it has reached a level now where the system has inculcated within it a large penalty against couples – especially couple parents.

The additional out-of-work benefits for those with children are often sufficient to lift a childless household out of poverty. This has two effects. First, it has provided welcome relief for many vulnerable children at the margin. Secondly, it has made life as a lone parent a more sustainable option.

The issues of the couple penalty and the so-called 'parent premium' have rightly been the subject of much debate. The question is: might the current benefit structure have an effect on the decision of whether or not to have a child vs. working as a route out of poverty?

Beyond the couple penalty, we might also ask ourselves if the effect of benefits is always socially positive. Central government expenditure on means-tested housing support increased from nothing in 1972/73 to £11.1 billion in 1998/99 (12% of the total social security budget).[72] In contrast, low earners with mortgages receive no support for their housing costs. The question of value arises. Should our system encourage home ownership, or should home owners be left to pay their own way? Which is the socially positive policy?

The 1970s and early 1980s witnessed an expansion of earnings-replacement benefits for sick and disabled people and an increase in their generosity relative to unemployment benefits. In the late 1980s and early 1990s, the tide began to turn. During this period, policy was, with rare exceptions, a response to fears that the changed attitudes and benefit provisions may have created excessive, or perhaps illicit, demand for benefits.

Since 1997, the Labour Government has sought to reform incapacity-related benefits in accordance with its guiding principle for welfare reform, "work for those who can, security for those who cannot."[73] It remains to be seen, however, whether these reforms will enable the Government to achieve its aim of removing one million people from the IB register over the next decade. This again is a question of value. The benefits system needs to take a view on

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72 Robert Walker and Marilyn Howard, *The Making of a Welfare Class? Benefit Receipt in Britain* (The Policy Press, 2000).

73 Labour Party, *New Ambitions for Our Country* (Green Paper, 1997).

the choices it affords claimants; the reforms to IB merely show that overall cost will inevitably form part of that view. There are several indicators that suggest that, in terms of home ownership, incapacity and savings, the current benefits system is wrongly constructed. Absent reform of the architecture of the system, the only possibility will be to continue to arbitrarily patch the system in a vain attempt to control costs.

2.7.4 COMPLEXITY (CHAPTER 5)

The complexity of the welfare system has increased over time. As a result of the growth in the range of benefits, potential claimants often have to navigate their way through several forms and agencies to receive support. The differences between benefits can often be confusing - their different award levels, and the availability of premiums for conditions ostensibly covered by another benefit. Earnings disregards and withdrawal rates also vary from benefit to benefit, with some benefits being withdrawn on gross income and others on net. There has also been increased complexity linking benefits to each other, in an effort to 'join up' thinking on welfare.

The effect of the complexity is that claimants often do not receive the support to which they are entitled; or they unwittingly receive too much and they are then made to return it. Moreover, the confusion makes rational decisions harder, and makes the consequences of changing one's circumstances unpredictable.

2.7.5 IMPLICATIONS

Successive reforms of the benefits system have failed to tackle the problem of helping the poorest families while also supporting their independence. Static models and tentative reforms have consistently failed. If we are serious about our goals of increasing welfare to work and ending child poverty, we have to fix its most ruptured lines. As such, in the next four chapters of this book we analyse four key critiques.

CHAPTER THREE

'Why Should We Work?': (Dis) incentivising Work

"If you can't get a job that covers everything, then there's no point."

Focus group participant, Hackney (A4e client focus group, March 2008)

3.1 A question of economic incentives

> *If you are on Income Support and in council accommodation you are laughing. If you are in a rented accommodation there is no way in hell that you ever will go back to work because the rent in private property is too much money. It is just ridiculous. They would never be able to get a job that pays enough to cover the rent, let alone be able to afford other things the family needs. Why would anyone go and get a job when the benefits pay the rent. There are places where you pay rent of £200 to 300 a week - and you will never be able to pay that.*
>
> Benefit Claimant[1]

John Wheatley of the Citizens Advice Bureau (CAB) recently complained to the Work and Pensions Select Committee:

> *For many people,* ***the only reasons for moving into work are the non-financial ones****, about it being good for your self-esteem, and being good to go and mix with adults for a change, and being good in the longer term for your career and hope that you might progress.*[2]

If we take this statement at face value, it makes for disturbing reading. Work is about more than money, but it should not be about everything *but* money. We conducted a poll of people who were out of work or in part-time work, and asked them if they would be better off or worse off if they took a job or worked more: incredibly, only a quarter said they would be better off, and 19% said they didn't know.

The evidence suggests that the current system adversely affects the work incentives of those who most need an incentive to work: those with the very

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1 Community Links, Low Incomes Tax Reform Group and Child Poverty Action Group, *Interact: Benefits, Tax Credits and Moving into Work* (2007), p.25 (Interviewee H).

2 House of Commons, Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006-2007, vol.1.* (Evidence from John Wheatley, Citizens Advice).

lowest earnings potential. The economic incentive structure of the benefits system itself has erected the barriers. This chapter addresses three major problems:

- *Disincentives to enter and progress in work*: High marginal tax rates owing to the combined impact of taxes and the overlapping withdrawal of multiple benefits; and no clearly greater reward for working than not working.
- *Life issues around work*: Further costs of work, for example transport, which are disproportionately significant for the lowest earners and which the benefits system does not adequately account for. Allied to this are the value of so-called 'passported' benefits-in-kind, such as free school meals, which are lost when people go into work.
- *Inconsistency between the arrangements in- and out-of-work*: Limited accessibility of in-work benefits due to the hours and age rules for the Working Tax Credit.

We asked people who are out-of-work or in part-time work:
"Thinking about your own personal circumstances and taking into account any benefits or tax credits you receive do you think you would be better or worse off if you took a job or worked more hours in your present job?"

Better off	25%
Worse off	39%
Would make no difference	17%
Don't know	19%

YouGov poll, commissioned by the Centre for Social Justice, May 2008

If the benefits system is to support civil society, and if those whose job it is to help people back into work are to stand a chance, the economic incentives to work have to be addressed by the Government as a matter of first priority.

"I can get a job, don't get me wrong. If I do go and get a job [as a security officer], they are gonna start me off on basic pay... so minimum wage... And I ain't gonna do it... because if I go into a job now, I'm not going to have any money to spend, [I'd have to pay] council tax, water bills, electricity... If I do go and get a job, I'm basically working for nothing.

I'm better off living on benefits. I get my rent paid, I get my council tax paid..."

Teto, Hackney (A4e client focus group, March 2008)

Welfare-to-work means giving people an economic incentive to work, an obviously apparent incentive to work; it means not negating or reversing that incentive through the structure of the benefits system. If work is not clearly more rewarding than not working, then no amount of tinkering with conditions for out-of-work benefits, or service contracts for back-to-work providers, will provide the crucial motivation for people to take work.

3.2 Disincentives to progression: high withdrawal rates

Work is supposed to pay. However, for many people at the lower end of the income ladder, taxes and benefits combine in such a way that it is not always clear whether work pays, or pays enough. Even though a person may start *earning* more from a job, the effect of taxation and the withdrawal of benefits may mean that his or her *net income* only increases very slightly, or in some cases not at all. (Please refer to Chapter 1 for a reminder of key terms.)

What is benefit withdrawal?

When a person who is on benefits returns to work, the amount of benefit they receive, per week or per month, begins to decrease. This is known as **benefit withdrawal**. Normally there is an amount of earnings, called the **earnings disregard,** below which no benefits are withdrawn. Above the disregard, benefits are withdrawn at a rate in proportion to the amount that is being earned: so for each extra £1 earned per week, the amount of a particular benefit received per week will drop by, say, 65p. In this case, the **benefit withdrawal rate** is 65%. Different benefits have different withdrawal rates, and some are on pre-tax and some on post-tax earnings, some on individual earnings and some on household earnings, and so on. At some point, a person's earnings will reach a point where all of a particular benefit has been withdrawn. If a person enters work above this rate, they will not receive this particular benefit.

The Working Tax Credit is similarly withdrawn as earnings increase, though it is not available in the first place to those working low hours.

Different benefits can be withdrawn at the same time.

The direct financial incentive is one of the primary drivers in a person's decision-making process when it comes to work. At its most basic, the direct financial incentive experienced by an individual can be summarised as follows: "What *net disposable income* do I have today, and how would it change if I took a different decision about work?"

To take an example, consider an unemployed single person, Jane, who has £150 p.w. income from benefits and is considering taking on some work. All other things being equal, Jane's incentive to do so is driven by what her net disposable income would become after accounting for increased wages, reduced benefit, tax and National Insurance (NI) payments, and the costs associated with working, such as travel expenditure, child care and so on. The results of this calculation will determine the size of Jane's incentive to work. If, say, she is £300 a week better off (with a total income of £450), there is clearly a strong incentive for her to work. If on the other hand she is only £30 better off despite working a full week, there is little incentive for her to work. Whatever

decision she takes, we can see that taxation and benefit withdrawal influences her patterns of earning and employment.

In our poll of people were out of work or in part-time work, we asked how much better off they would be if they earned an additional £50 p.w., only 16% thought they would be more than £10 better off.

We asked people who are out-of-work or in part-time work:
"If you were to earn an additional £50 a week from a job how much better or worse off do you think you would be after taking into account tax and any loss of benefits?"[3]

I would be worse off	38%
It would make no difference	12%
Less that £10 a week better off	7%
Between £10 and £19 a week better off	6%
Between £20 and £30 a week better off	5%
More than £30 a week better off	5%
Don't know	28%

YouGov poll, commissioned by the Centre for Social Justice, May 2008

In this section we look at the financial incentives to increase the number of hours one works, or take a higher paid job; and also the incentives to take a job from a position of unemployment.

The discussion will centre on two key concepts that have been touched on already – the marginal tax rate (MTR) and the participation tax rate (PTR). (There is a third factor, called the **income effect**, which is how work incentives are affected by the size of a person's current income. See Appendix C for further discussion.) The marginal tax rate is the proportion of gross income taken in tax and withdrawn from benefits as people progress through work. It determines the financial incentive to increase the amount of work one does. The participation tax rate is a measure of the incentive to enter work in the first place – how much better off one will be overall. Government policy has shown little awareness of the importance of either of these measures. At this stage in the argument we mainly seek to draw attention to the high rates and show how intuitively they are important, but it is crucial to what follows that it has been shown empirically that these rates do affect behaviour, as we discuss in Part II.

3.2.1 HIGH MARGINAL TAX RATES FOR LOW EARNERS

The effective **marginal tax rate** measures what proportion of a small rise in earnings would be lost to tax and withdrawal of benefits. The more the tax and

3 YouGov poll, commissioned by the Centre for Social Justice, May 2008.

benefits system reduces the gain from earning more, the higher the MTR. A marginal tax rate of 70% means that a claimant keeps 30p of each additional pound earned, the rest of it being lost on the amount that his or her benefit is reduced and tax is withdrawn. The MTR is an important driver of work. Simply put, you are likely either to earn less, or to declare less, if you feel taxes are too high, particularly on your last £1 of earnings.

The following example illustrates how marginal tax rate can escalate for low earners:

> *Jill, a working woman, aged 26, in a household on low income, is offered the opportunity to work an extra hour. She earns at just above minimum wage and the extra £6 could help. Jill takes that opportunity. How much of the extra £6 she earns ends up in her pocket at the end of the week?*

If we focus only on Jill's income tax, we might take the view that at 20% rate tax, Jill would get at least £4.80. This is a typical misconception. In almost all cases the family would keep considerably less than this. The precise answer varies with household characteristics, and also where the family live.

1. In some cases Jill's effective marginal tax rate equals 100%. If the household works fewer than 16 hours per week, this extra hour's work would provide no additional income. The increase of £6 in earnings would be matched by a reduction in Jill's out-of-work benefits. At a Jobcentre Plus, the likelihood is that Jill would have been told not to take the extra work, for she would get no money in her pocket from it.
2. If Jill was not working enough hours a week to be entitled to Working Tax Credit, and earned more than the personal tax allowance, then £1.86 would be taken from Jill for Income Tax and National Insurance, at 31% combined. Her net income from the extra hour of work would be £4.14.
3. If Jill was in receipt of Working Tax Credit (or Child Tax Credit), there would be a withdrawal of £2.34 in working Tax Credit, at 39% of gross pre-tax earnings,[4] as well as the £1.86 from Income Tax and National Insurance. This extra hour's work would therefore provide Jill a mere additional £1.80. She is experiencing an MTR of 70%.
4. If, in addition, Jill was also in receipt of Housing Benefit and Council Tax Benefit, this would have a significant impact on the MTR calculation.[5] HB and CTB are both withdrawn on income net of Tax Credits – i.e. as a proportion of the 30p of each additional pound earned. HB and CTB are withdrawn on net income (30%) at rates of 65% and 20% respectively, which gives a Marginal Tax Rate of 95.5%. This extra hour's work would

4 WTC is withdrawn in the same way that income is withdrawn through tax, taking a percentage of the gross earnings. WTC and CTC cannot be withdrawn simultaneously and rates of CTC withdrawal can be 0% or 6.67% in some cases, due to the family element.

5 Here we assume that the individual earns enough gross income to exceed the personal allowance, the national insurance 0% band, the WTC disregard and the HB disregard.

provide an incremental income of only £0.33, providing Jill with very little incentive to earn more.

5. There is an alternative. If Jill's employer, sensitive to the low net return for the extra hour's work, decided to pay at an over-time rate of £10 per hour, even then, very little of would find its way to the household. Following the same series of calculations, this £10 overtime would translate into a grand total of £3, if only working tax credit were withdrawn and only 55p if we add housing and council tax benefit to the equation. The rest goes to the Exchequer. (Consideration of this example also shows how little benefit claimants gain from a putative increase to a minimum wage.)[6]

Citizens Advice Bureau case study: Why work more hours?[7]

A lone parent of three school-age children was working 42 hours a week at £6.05 per hour, as a dental nurse. She wanted to spend more time with her children and had been offered the opportunity to work fewer hours. The adviser helped her calculate her income based on cutting her hours to either 25.5 hours or 34 hours. Working 34 hours would only give her about £6.50 more than if she worked 25.5 hours, which would mean working 8.5 hours for £6.50.

Casting our mind back to our analysis of the development of different benefits in Chapter 2, we gain some idea of how this policy might have emerged. The marginal tax rate is the combined effect of taxes plus lots of different benefits. These are limited to the households on the lowest incomes, have been separately designed at different times and for mixed purposes, as either poverty relief measures, cost reduction measures or work incentive measures, and have been combined with little regard for the overall tax-transfer picture - or indeed for the effects on families that are trying to escape from poverty.

For too many groups at very low earnings, marginal taxation rates are close to 100% before individuals are entitled to Working Tax Credit. The MTR while claiming Working Tax Credit can still be very high. The Institute for Fiscal Studies estimated that in 2006 nearly two million people had withdrawal rates of over 60%.[7] Consider also, there are six million people out of work who would face marginal withdrawal rates of 100%, if they were to work a few hours a week. All of this amounts to a huge disincentive to work, and makes it harder for those trying to persuade others to work.

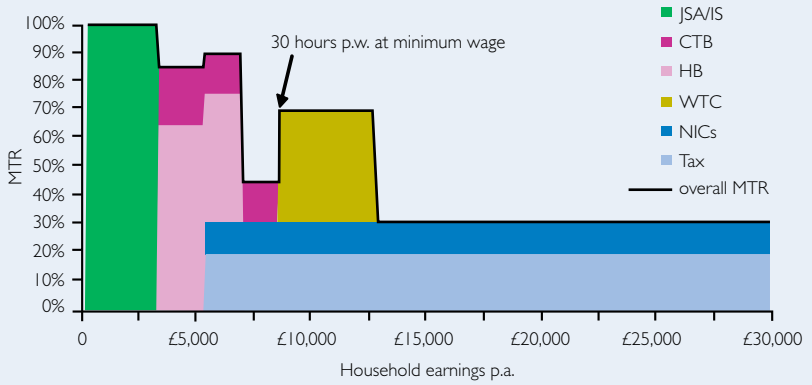
Let us look at a single person, without children, aged over-25 for a typical example of a marginal tax rate profile. There is a very low return from low-wage work for this group because of high MTRs. Figure 3.1 below shows the marginal tax rate (the total percentage) built up by different withdrawal rates

6 Citizens Advice Bureau, 'Single parents facing barriers to work says Citizens Advice' (5 November 2008), available at: http://www.citizensadvice.org.uk/index/pressoffice/press_index/press_20081105a [Accessed 5 June 2009].

7 Stuart Adam, Mike Brewer and Andrew Shephard, *Financial work incentives in Britain: comparisons over time and between family types* (IFS, 2006).

of different benefits and also tax. When the claimant, making his first steps into employment, is on low earnings, Jobseeker's Allowance is withdrawn at 100%. Once JSA is exhausted, Housing Benefit and Council Tax Benefit are withdrawn at 65% and 20% respectively, resulting in a MTR of 85% before the threshold of paying tax and NI. From this point on, his MTR rises to 89.65%: tax + NI + 85% of the remainder (as HB and CTB are withdrawn post-tax).

Figure 3.1 Average MTR profile showing benefit withdrawal rate and tax (single person over 25)



At the point of working 30 hours and receiving Working Tax Credit, the MTR is very temporarily negative. Receipt of Tax Credits is sufficient to cause the withdrawal of the remaining Council Tax Credit, so the gain from tax credits is not what it first seems. As Tax Credits are withdrawn, the MTR is 70%. It is only when the person starts earning approximately £13,000, the point at which all Tax Credits and Benefits have been withdrawn, that the marginal tax rate drops to the familiar 31%. What is particularly striking about this profile is that below earnings of £7,000 a person in this position, the MTR never drops below 85%, and for most of it is higher. He would keep 15p in the pound, at best.

Appendix A explores in further detail the MTR profiles of four typical household formations in the UK.

The UK is not alone in this regard. Daniel Shaviro, writing about the US, identified how multiple benefits with different applicability rules tend to hide the true impact from policy-makers:

> *Given marginal tax rates' important effects on wealth production and distribution, it would be useful for policymakers to know what rates they actually are imposing on low-income households. Unfortunately, accurate computations of broad applicability are hard to provide for a number of reasons. One is the wide range of household characteristics that affect the application of different programs.* [8]

8 Daniel N. Shaviro, *Effective Marginal Tax Rates on Low-Income Households* (Employment Policies Institute, 1999).

The effective marginal tax rate structure has dire effects on the decisions of those who can work more but are unsure whether they would be better off doing so. During a focus group session in Plymouth, for example, Chris, a 32-year-old benefit recipient currently working part-time, complained:

> *The problem is I'm thinking of going into full-time work. But am I actually going to be better off? Because if you go into full-time work, then you have to pay a proportion of your Housing Benefit out, and then you have all these other things to pay out.*
>
> Chris, Plymouth (A4e client focus group, March 2008)

In addition, a YouGov poll commissioned by the Centre for Social Justice showed that only 9% of those sampled thought that high withdrawal rates did not discourage people from progressing in work.

We asked a sample of the British population whether they agreed that:
The withdrawal rates of means-tested benefit are a disincentive for people claiming tax credits or housing benefit to try and increase their income - most of any extra income they earn will just be lost through income tax, national insurance and loss of benefits.

Agree	57%
Disagree	9%
Don't know	33%

YouGov poll, commissioned by the Centre for Social Justice, April 2007

The presence of punitive marginal tax rates on low earners is more than counter-productive. It is a hallmark of the failure of the current arrangements. The problem of high marginal tax rates for low earners has received little attention. In the US, during the debate that culminated in the enactment in 1996 of US welfare reform, it was barely mentioned.[9] Nor has it received much attention in the UK, despite a wide-ranging discussion about welfare, although recently the Work and Pensions Select Committee has started to highlight the issue:

> *These very high marginal tax rates on low incomes conflict with the principle that taxation should be fair and equitable as between different earners, and that it should be transparent and calculable.*[10]

9 Ibid.
10 House of Commons, Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006-2007*, vol.1.

There has been a broad failure to recognise that phasing out a benefit as earnings increase, though philosophically and intuitively different from imposing a positive marginal Income Tax rate, has identical incentive and distributional effects. In very basic terms, if a MTR of 94.5% was presented as an income tax, there would be few who would suggest that it is good fiscal policy.[11]

This brings us to our first objective for benefits reform. The combined marginal withdrawal rate of tax and benefits for low-wage earners should move downwards towards the rate paid by higher earners.

The withdrawal rate should be progressive, so that those on the first rung of the job ladder have reason to climb to the second.

Objective: Increase the incentives for low-earners to earn more, by reducing the highest benefit withdrawal rates they face.

3.2.2 HIGH PARTICIPATION TAX RATES

High marginal tax rates discourage low earners from increasing their hours of work and earnings. For those deciding whether to work or not, the most important effect is the participation tax rate (PTR). The PTR measures how worthwhile it is financially to take up a job: it shows the overall proportion of the gross earnings that is lost through tax and withdrawn benefit. It is in effect an average of marginal tax rates across every pound of earnings.

Calculating the PTR

To determine the PTR, we calculate the total level of withdrawal of taxes and benefits at the new earnings level: Income Tax, National Insurance and any reductions in benefit levels compared to their out of work levels. We then express this difference as a proportion of the prospective gross earnings; and the PTR shows the proportion of that gross earnings to give the PTR.[12]

For example, take an individual whose current income, from benefits, is £50 p.w. He is offered a job that pays £200 p.w. gross. Say he would have to pay £30 in tax and NI and would receive no benefits. This gives him a net income of £170. The difference between his current net income and prospective net income is then £170-£50 = £120. This means he has had a total of £80 withdrawn in Tax and benefits. The PTR is then given by £80/£200 = 0.4, or 40%.[13]

11 Daniel N. Shaviro, *Effective Marginal Tax Rates on Low-Income Households* (Employment Policies Institute, 1999).

12 For fuller discussion of this definition see Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and rates on earnings* (IFS, 2008). The Working Group thanks Mike Brewer for his assistance. Our analysis builds on their work.

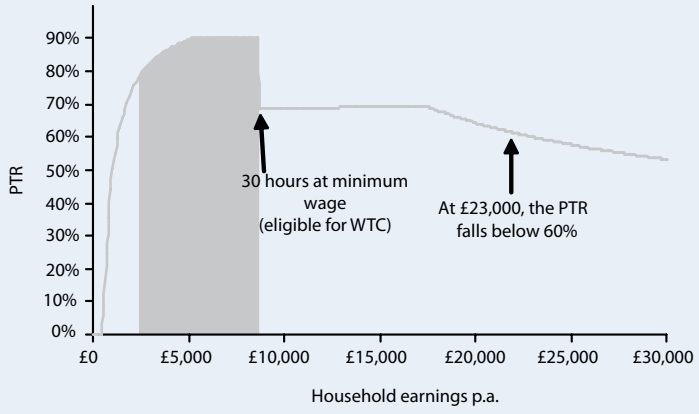
13 To summarise: 1 - ((200 - 30 - 50) / 200) = 0.4.

The higher the PTR, the more the tax and benefits system reduces the financial gain to work. Less reward from work creates an environment where it is economically better to stay at home than enter the workplace. If a PTR is more than 100% it means that a job seeker would be financially worse off in work than out of work. A low PTR means there is a greater reward from working. Under such conditions, we should expect more individuals to choose to return to work or to enter the labour market.[14] In extremis, it is possible to have a negative PTR whereby work is subsidised, with more generous benefits conditional on being in work or having positive earnings.[15]

PTRs are very high at the bottom of the earnings scale, meaning that there is little incentive for those who are out of work to take low-hour or low-wage jobs. These PTRs are higher in the UK than in many other European countries.[16]

As an example of high PTRs, consider a low income family with no children living in rented accommodation. Figure 3.2 illustrates the participation tax rate for a couple with no children and rent of £50 p.w. at different levels of household earnings. To calculate the PTR for each earnings level, we have calculated how much is withheld in tax and national insurance, and also by how much benefits have been reduced from their out of work level.

Figure 3.2 Average PTR for couple households without children



The graph shows that there is very little incentive for one of the couple to take a job which pays below £8,500, or 30 hours per week at the minimum wage. Thereafter, tax credits increase the total value of the job; but it is only when the couple is earning more than £23,000 per year gross that they get to keep more than 40% of their gross earnings.

14 It is worth noting some difficulties around choosing the hours that those who start work are assumed to have. We therefore draw the hours distribution from the population who are already in work, assuming that increases in this group reflect the decreases in the out-of-work group which occur with increased participation.

15 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and rates on earnings* (IFS, 2008).

16 Authors' calculation, based on an analysis of OECD data.

As the graph suggests, tax credits play a significant role in lifting single people and working couple families out of poverty. They provide a relatively low participation tax rate at the point at which they are first awarded. The Working Tax Credit provision when working hours are increased to 16 or 30 hours per week makes a large difference to whether work pays. However, if people are unable to find employment which fulfils these levels, they are left without support. Moreover, for many people living in private rented accommodation where the rents are higher, the value of the Working Tax Credit is effectively eliminated by Housing Benefit and Council Tax Benefit withdrawal.

Real-world Examples: PTR Trap

Consider Jessica, a single person with no children, who is unemployed but looking for a job, living in Hackney in social housing with rent of £100 p.w.. Her council tax is £20 p.w.. One day, she finds and takes a job. Jessica is working below the working tax credit threshold and earning £100 p.w..

There is an earnings disregard of 5% or £5. After that, Jessica suffers immediately from a series of benefit withdrawals:

1. JSA is withdrawn immediately at a taper rate of 100%, which loses her £60 p.w.
2. After all the JSA has been withdrawn, HB and CTB are tapered away from this at rates of 65% and 20% respectively. So she loses £22 housing benefit (0.65X£35), and £7 council tax benefit (0.2X£35) which loses her another £29.

So PTR = 1 – [(100-89)/100] % = 89%

She has taken on a job on £100 p.w., but now faces a PTR of 89%. Her salary may be £100 p.w., but despite her efforts she will be only £11 better off.

Her MTR at that point is (HB at 65% + CTB at 20%) = 85%: she will keep only 15p of the next pound earned This is clearly prohibitive to her moving up the income scale to take on more work. She is trapped.

Participation tax rates remain very high even for moderate earners, especially if they live in a household type that would be entitled to more generous out-of-work benefits. In particular, this is true of larger families living in private rented accommodation. Appendix A outlines these PTR patterns in greater detail.

"Why do we need to work? It seems so alien, it seems like this grey area out there. Everyone else has got great jobs, well-paid jobs, but we know that the only things that we can get are things that are very very poorly paid and there's a very slim margin between receiving benefits and receiving the minimum wage."

Stuart, Hackney (A4e client focus group, March 2008)

Benefit claimants who can work are often assailed by the doubt that it is all not really worthwhile. They are told objectively by their advisors at the Jobcentre Plus that it is not. A voluntary sector advisor, encouraging the claimant to see work as a means to effect a positive life transformation, is forced to concede that this transformation will not be financial in nature. 'Why should we work?' – under the current system, there is no satisfactory answer.

> "It's not worth me taking a full-time job at the minimum wage. I would have to pay full council tax and I would have to pay my rent, which is £400 a month."
>
> Angela, Hackney
>
> (A4e client focus group, March 2008)

There are two reasons to reduce the participation tax rates. Financial gains should go to the hard-working low-earners. They deserve more reward. For those of working age who can work, it must always be preferable to benefit payments as a sustainable route out of poverty. Hence, the net income from working (including all relevant benefits, taxes, and associated costs) should be clearly higher than that from benefits. Hence, our second objective:

Objective: Reduce in-work poverty.

For this to be realised, low earners should retain more of their wages. This means changing benefits received when earning, so that they provide a genuine financial reward for starting and progressing in work.

Objective: Increase the rewards for entering work, especially for those on low earnings and low hours.

The evidence we review in Part II shows that it is the participation tax rate that we should be most focused on when designing work-focused benefits systems. This is an important shift in the debate that must happen to break out of the trap that exists today.

3.3 Further barriers to work

One of the areas in which the voluntary sector excels is the personal treatment given to those who would seek to get into work. The type of support required may range from helping the individual with interview preparation to paying a few pounds in ready money to have a suit dry-cleaned.[17]

This is just the start of the costs of working. Once an individual gets a job, the costs mount. This in fact contributes to a higher participation tax rate than the bare incentives provided by the benefits would indicate. The net increase in *disposable* income provided by work is even lower than suggested in the last section.

17 For further discussion of welfare-to-work provision, see: Social Justice Policy Group, *Breakthrough Britain: Volume 2 Economic Dependency and Worklessness* (CSJ, 2007).

The two major factors are the expenditure costs of working and the withdrawal of 'passported' benefits.

> "There are still people for whom it is not financially sensible to move into work when you look at the perfect information, because they are moving into a low-income job, they have childcare costs and they lose free school meals or other help they might be relying on, and they have travel-to-work costs."
>
> John Wheatley, Citizens Advice Bureau, in evidence to the Work and Pensions Committee, 26 July 2007[18]

3.3.1 THE COST OF WORKING

We might include several expenses attached to work that (while relatively negligible for those on middle incomes) provide large financial barriers to those on the very lowest. These include travel, suitable work clothing, eating lunch away from home and many more. Some estimates place these extra costs at £25 p.w. in London and £20 p.w. out of London.[19] To put this into context, they overwhelm a net income of up to £14 a day in a minimum wage job and a PTR of 70-80%.

> "If I was to get a job, it would have to be local. I wouldn't go to the West End or the other side of London, because then you've got to take into account travel costs."
>
> Zelma, Hackney (A4e client focus group, March 2008)

Under the current welfare arrangements, a single person would have to work for at least 27 hours per week in order to overcome these concomitant costs. This represents an almost insuperable barrier for someone making their way back into work and into the realms of employment. As we saw in section 3.2.2, Jobseeker's Allowance is withdrawn at 100% and this may help get people off the benefit quickly, but it means there is a real hurdle to making work worthwhile.

Childcare is another large cost of work. Childcare benefits actually cover one of the important additional costs of work. However their receipt means that high MTRs last a long way up the earnings scale. Current government calculations fail to take these costs into account.

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18 House of Commons, Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006-2007.*

19 Off the Streets and into Work (OSW) and the Centre for Economic and Social Inclusion, The Costs and Benefits of Formal Work for Homeless People (December 2006).

> "When somebody is ready for working and they go to get a job the last thing they want is obstacles. They've found a job, the Jobcentre have sent them for a job and they've found it...and that's your benefit finished. You have a few days to find somewhere to live and get sorted."[20]

Consider this from the House of Commons Select Committee on Work and Pensions:

> *There is also a whole raft of hidden costs to being in work as well..... You have to pay fares to get to work; there are extra costs for clothes, for food, into-work calculations do not bring that kind of stuff to bear.*[21]

This engenders mistrust in the calculations of those who would try and convince an individual that work is a good idea. It is unhelpful to claimant advisers across the board, whether from the state or the voluntary sectors. It perpetuates the intuition that work might not be worthwhile.

3.3.2 LOSS OF PASSPORTED BENEFITS

Passported benefits significantly raise the value of various out-of-work benefits. They are largely disregarded in governmental calculations of the generosity of these benefits; similarly, claimants may find it hard to ascribe a particular financial value to them. These benefits are removed when people cross an hours or earnings threshold. As a result, they create a significant barrier to work. For those crossing that threshold, they face losing valuable benefits for only a marginal gain in earnings.

The Working Tax Credit was created to mitigate the effects of high MTRs and provide a real incentive to work. However, for many, the Working Tax Credit work incentives are counter-balanced by the accompanying, cliff-edge loss of the non-monetary benefits.

When in work, households have to use their income to pay for these items, which diminishes the financial gains from tax credits. While the loss of passported benefits is not a uniform cost to all people moving into work, where it is applicable it can be substantial. Moreover, while out-of-work claimants may not be aware of the precise value of these benefits, they are keenly conscious that taking a job means losing one that they may be currently using, and also foregoing the opportunity to take advantage of them in the future. The disincentive created by the actual value of the loss that would follow from a change of status, is compounded by claimants' uncertainty about the size of the prospective loss.

20 The costs and benefits of formal work for homeless people, OSW - December 2006

21 House of Commons, Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006-2007*, (Evidence from Michael Fothergill, OSW).

Community Links, a voluntary sector organisation that deals with these issues on a daily basis, has recommended that these costs should be recognised in the system:

> *Better-off calculations must take full account of the loss of passported benefits and the wider costs of moving into/increasing hours of work, including tax and national insurance contributions.*[22]

For some, the risk of using more of their tax credit to buy the passported services is a deterrent to increasing their income via paid employment. The withdrawal of benefits, particularly passported benefits including dental work and prescription charges, combined with poor budgeting skills have been cited as possible financial difficulties.[23] Several have highlighted the need for extensive planning prior to returning to work, to ensure that people had enough money to see them through, so that the loss of benefit had minimal impact.[24] These are exactly the situations in which the voluntary sector can help, but it needs the welfare state to play its part.

> "… two years ago I had a stroke and every month or every other month I have to pay £30 for tablets… that's £30 and I know I can't bargain for that because it is my health. My wages have increased and the ability to access things I could have accessed, and I can't. So therefore, I actually feel a lot worse off, very worse off, very much so, very much so"[25]

Given the value of rewarding work effort, having families potentially worsen their circumstances through loss of passported benefits when they enter work, or when low-earners increase their earnings, is unlikely to be desirable. The pernicious consequences include inculcating the norm that work is not worthwhile, with long-term consequences for society.

The welfare state must ascribe a better cost and accounting system to passported benefits. They are simply too large and too important to be withdrawn in one swoop, and for their effects not to be accounted for by government calculation. In order to ensure fairness, simplicity and transparency, these shifts must be ended. One way to address this is to change the way that passported benefits are all withdrawn at once.

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22 Ibid, p.7

23 Off the Streets and into Work (OSW) and the Centre for Economic and Social Inclusion, *The Costs and Benefits of Formal Work for Homeless People* (December 2006).

24 Ibid.

25 Community Links, Low Incomes Tax Reform Group and Child Poverty Action Group, *Interact: Benefits, Tax Credits and Moving into Work* (December 2007), pp.18-19, Interviewee T.

3.4 Restricted accessibility to in-work benefits:

In-work benefits such as Working Tax Credit and its childcare component can provide much needed financial relief to those eligible for them. However, they are restricted in their accessibility, meaning that for many they are not a true help or incentive to work.

Objective: Reduce the cliff-edge of withdrawal from passported benefits.

3.4.1 WORKING TAX CREDIT

The hours rules present in the tax credit system present a substantial barrier for those who cannot find work at a certain level.

For those with children, the difference in net incomes between a 15 hour job and a 16 hour job is substantial. For those without children, if work comprising 30 hours a week cannot be found, the household will receive no help through the Working Tax Credit. WTC is not available at all for those under 25 years-old and without children. The absence of WTC for under-25s creates a major barrier to work for those who are least likely to have developed a work habit.

For some, WTC provides a relatively strong incentive to get into work at the hours thresholds, i.e. 16 or 30 hours per week. They create low PTRs for those with children, but less so for childless couples. The WTC withdrawal rate of 39% on gross earnings means that the total tax and tax credit withdrawal rate is 70%. This leaves recipients with a modest return on a portion of earnings beyond the hours threshold.

In a report published by the Joseph Rowntree Foundation, Bell, Brewer and Phillips have shown that these hours rules have a significant impact on working patterns.[26] The hours worked by lone parents in part-time jobs peaked at four and 16 hours per week. These represent the points at which the PTRs were lowest – where the Income Support Disregard[27] ended and where WTC became available. Furthermore, as the hours threshold for tax credits moved from 24 hours to 16 hours, they showed that the numbers of those working in this band of hours increased at the expense of jobs with fewer or more hours.

Hours and age rules diminish the flexibility of families struggling to find work. Only some part-time and full-time jobs qualify for support in the eyes of the Government, and under-25s are not given the same incentives to work as older people. These restrictions create a barrier to work on the one hand, while on the other they remain unfair to those

26 Kate Bell, Mike Brewer and David Phillips *Lone parents and 'mini jobs'*, (Joseph Rowntree Foundation, 2007).

27 The £20 p.w. of income which is disregarded before IS is withdrawn from a lone parent.

who do work just below the current hours thresholds. These rules seem arbitrary. Testimony at CSJ evidence sessions bore this out:

> *I went back to working, but only part-time… then they cut my hours, and because I was on Tax Credits and the 16 hour threshold, I had to give up work again, and couldn't cope as I couldn't find another job to cover the hours.*
>
> Melissa, 29, Plymouth (A4e client focus group, March 2008)

The rules do not take into account the precarious employment status of those who are taking the admirable decision to get back into work and who can find themselves moving from job to job in those first few months, each with varying hours commitments.

For many, the Working Tax Credit merely replaces benefits withdrawn. Only for lone parents without Housing Benefit do they represent a genuine improvement over their out of work situation. For those in receipt of Housing Benefit and Council Tax Benefit, these are withdrawn at the rate of 85% of the increase in household net income as a result of receiving WTC – hence WTC can be worth as little as 15% of its headline value.

> "The problem is I'm thinking of going into full-time work. But am I actually going to be better off? Because if you go into full-time work, then you have to pay a proportion of your Housing Benefit out, and then you have all these other things to pay out."
>
> Chris, Plymouth (A4e client focus group, March 2008)

More qualitatively, there are two important shortcomings that need to be addressed.

1. Those working below the current hours thresholds do not receive access to WTC. They have very high PTRs.
2. Those who are in receipt of Housing benefit and Council Tax Benefit have excessively high MTRs: 94.5%. This gives them little incentive to work beyond the hours threshold.

The effect of hours rules on MTRs and PTRs are illustrated in Appendix A. As can be seen above, those working on the current hours thresholds are well supported, but those just below or above face greater penalties. It is time to end the arbitrary distinctions and anomalies thrown up by the effects of hours thresholds in the current arrangement of the Working Tax Credit, and provide encouragement and reward for all types of work, irrespective of the hours involved, so that there is a clear, coherent continuous connection between work and benefit.

In order to redress the balance, a greater range of incentives must be provided for claimants to enter and progress in the world of work. From the

first hour worked, the more work done, the more credit should be accrued. A greater range of incentives must be provided for claimants to enter and progress in the world of work: we must make working 29 hours per week attractive and working 31 hours per week more attractive than 30 hours.

Objective: Eliminate the hours rules in the benefits system, to reduce the thresholds and barriers to progression in work.

All types of work should be supported and encouraged in order to help the most vulnerable people out of a life of dependency. Furthermore, we must provide all the incentives of work to younger people, so as to help them start their adult life seeing work as a rewarding activity. A more modest withdrawal rate of out-of-work benefits for the lowest earners can achieve similar incentives to work for those on the hours thresholds and also provide a meaningful reward for those working below the hours thresholds.

3.4.2 CHILDCARE

Help with childcare is currently administered through the Working Tax Credit system. It effectively means that it is only available to those workers who work more than 15 hours per week. This can be a significant barrier, when taking into account the other losses that low-paid work inflicts on a welfare claimant.

> *When I started working again (after having my child), I wanted to increase the income for my family, but I was working really hard and spending time away from my children and the amount of money I was paying for the childminder I was not left with a lot frankly. I thought our family income would increase, but it didn't.*[28]

> *I am a housing shift worker. When I work at night I have to pay somebody to stay in the house and look after my 15-year-old daughter. This person is not certified to be a carer. I have to pay out of my pocket because she is somebody who lives in the neighbourhood, you can't find a childminder at those hours in the evenings.*[29]

Those in receipt of WTC can claim back 80% of eligible childcare costs, up to a maximum amount payable of £140 p.w. for one child, or £240 p.w. for two or more.

In order to avoid the loss of Housing Benefit and Council Tax Benefit, the childcare related income is disregarded from HB and CTB calculations. Parents on minimum wage earn £4.20 an hour if they can find a job providing at least 16 hours a week of work. Taking a job then requires some form of

28 Community Links, Low Incomes Tax Reform Group and Child Poverty Action Group, *Interact: Benefits, Tax Credits and Moving into Work* (December 2007), p. 23. Interviewee E.

29 Ibid, p. 24., Interviewee S.

childcare arrangement, either with family, friends or paid assistance. For school-age children the problem is at its worst during the 15-20 weeks of school holidays a year. At the best of times finding reassuring and reliable childcare is difficult; at low pay the net effect on earnings is likely to be significant.

There are other hurdles. Parents must gain proof from their childcare provider that they are purchasing a certain value of childcare which they then present to HMRC, who then repay the parents.

> "Having a young child made it more difficult to get a job. I didn't get much [state] support. Even if there were providers of childcare, I couldn't afford to pay for it. It's really expensive. I had to depend on my family for childcare."
>
> Focus group participant, Hackney (A4e client focus group, March 2008)

This can be done prior to paying up front costs if an estimate of future childcare costs is obtained from the provider. In many cases, however, families will have to pay childcare costs up front in the hope that they will be reimbursed at a later date.

Some of these hurdles are necessary; some are typical of the vicissitudes of getting back to work. However, the added complexity brought about by claiming as a result of the tax credit system will leave many reticent to leave themselves at the mercy of the faceless HMRC.

Case Study:
Michelle, 30, from Kingston is separated from her husband and has a 12 month old baby boy. She does not work because the work she would be able to get would be for only a few hours and for low pay. She would therefore not be entitled to the childcare element of WTC. As her family do not live nearby she would have no one to look after her son should she return to work.[30]

Childcare is a crucial aspect of supporting parents returning to work, and we must make sure that there is true access to childcare for all who need it. Again, an existing hours rule makes it inaccessible to those taking the first steps into employment with an entry-level or 'mini-job'.

Objective: Make childcare support more accessible, especially for those working fewer than 16 hours.

A possible reform could be to take the funding of childcare out of the tax credit system altogether, so that parents might be able to see exactly what level of support they will obtain. A system whereby childcare vouchers are

30 Case study based on evidence taken at the Mary Ward Legal Centre, May 2008.

distributed approximately in proportion to the amount worked would be a more socially just solution.

We should also remove the restrictions on who can be paid for childcare so as to dramatically increase supply and bring in the extended family.

Objective: Create a supply-side reform for child-care.

3.5 The truth about working

Current welfare arrangements in the UK actively discourage many of those in extreme poverty from getting back into work. High participation tax rates have resulted in significant and quantifiable reductions in employment.

Case Study:

Lee, a former client and now employee of Ecoactif, a welfare-to-work provider, told us about the 'value' of a job:

"I am fortunate because the job I do I love. I'm a great role model for my son. When I was growing up it was daddy's gone to prison, mummy's drunk, boy's on the street. My son sees mum working, dad working, boy goes to school. That's going to be his ideal, and it's going to be a natural progression to employment.

But I am only about £50 per week better off than being on benefits, for a full week's work, and you have [to pay] to get there. Surely there must be a benefit for getting up at 6am?"

Lee, in evidence to the Centre for Social Justice, July 2009

There is no sense of fairness in the way that benefits are withdrawn when in work. The rules associated with tax credits appear arbitrary and capricious. Moreover, given the value of rewarding work effort, having families potentially worsen their circumstances when they enter work or low-earners increase their earnings is counter-intuitive. These failures sustain the dependency of the most vulnerable people in our society.

"Consider a man or woman trying to get back into work, perhaps doing some casual shift work as a security guard or in a shop, their first steps back into employment at minimum wage. When you think that, for every pound extra they earn, they will take 5p home; that they work many hours a week for only a few pounds' worth of improvement; it is no surprise that kids on their estates have a name for them, or for anyone who uses low paid work to get back onto the employment ladder: 'Sucker.'"

Iain Duncan Smith

The problem of high withdrawal rates goes beyond mere lack of coordination between programmes. In large part, policymakers have erred due to an important misconception: the belief that it makes sense, as a matter of general programme design, to think in terms of phasing out specific benefits, rather than think in terms of an overall marginal tax rate. All too often, the combined MTR has formed a secondary consideration, rather than being placed at the heart of policy making. Moreover, a static world-view has created the perception that public finances require overall high benefit withdrawal rates, so that benefit receipt is limited to the very bottom of the income scale. Little consideration has been given to the 'employment trap' that such policies create, whereby people work less because making the effort to advance is not properly rewarded; or to its effect on national income. Ultimately, as we show in Part III, the cost-saving of higher withdrawal rates must be balanced against the expense of less earned income and the concomitant drop in tax revenue.

Even if high MTRs for low earners are financially efficient, there are still the social consequences that must be reckoned: reduced social mobility, a lack of confidence in the worth of work and subsequent equality of opportunity. These are very great sacrifices that were certainly not part of Beveridge's original vision.

Reform must tackle these issues as a matter of urgency.

The net income from working should be clearly higher than that from benefits: this means changing the in-work benefits so that they provide a genuine financial reward for starting and progressing in work. Our YouGov poll on the matter showed that the public overwhelmingly agrees:

We asked a sample of the British population if they agreed that:
"People should always be better off in full-time work than in part-time work or not working at all."

Agree	77%
Disagree	14%
Don't know	10%

YouGov poll, commissioned by the Centre for Social Justice, April 2007

The analysis in this chapter provides some solid objectives for reform. These objectives are not all easily accommodated by one system, but dynamic modelling makes it possible to identify the areas of compromise, conflict and trade-off. Cost pressures dictate the extent to which these goals will be achievable, but the nature of any economic system is that it involves compromise. Our modelling shows, for example, that reducing marginal tax rates on the lowest paid people would increase efficiency, even if it were offset by slightly increasing marginal tax rates on others (see Chapter 3).

It is a priority to be able to state unequivocally that taking a job is worth it, financially, and that working more is worth it. When everyone, from the advisors in the Jobcentre Plus office, to the voluntary sector organisations at the coalface, can say that this is so to claimants then the many announcements on the notion of 'welfare-to-work' will actually come to mean something.

CHAPTER FOUR
Unfair and Unwise

> "I spent some time recently sitting with a benefit officer in a Jobcentre Plus. In came a young couple. She was pregnant. He was the dad. They were out of work and trying to get somewhere to live. The benefit officer didn't really have much choice but to explain that they would be better off if she lived on her own. What on earth are we doing with a system like that?"
>
> David Cameron, speech to the Conservative Party Conference (October 2008)

The current benefits system has done much good, yet it also must bear responsibility for that which has come with the good. The previous chapter showed how its structure has created huge problems in the context of getting those at the lowest earnings levels who can work to elect to work. The benefits system, the main determinant of many people's income, is also implicated in other life decisions that people make.

The potential for the system to affect life decisions of those subject to it system is huge. Consider the research undertaken by the Institute for Fiscal Studies which suggested that, following their introduction in 1999, tax credits and other more generous benefits for children produced an extra 45,000 births among lower-income families.[1] This statistic should give us cause for concern.

More recently, a study published in the Economics Journal, led by Professor Marco Francesconi of Essex University, argued that the Working Families' Tax Credit has increased the chances of divorce 2½ times for married mothers in poor households, where the man is a low earner or earns nothing.[2] Again, if we are confident of the causation, this is a huge effect on one of the most personal family decisions.

The benefits system is a vital weapon in the fight against poverty in all its forms, and especially child poverty. Yet there are also social consequences to every measure within the benefits system, and at times it seems that this has been ignored. Having heard the opinions of many voluntary groups in this area, the Working Group believes that it is time for these effects to be discussed openly, and for these discrete social breakages to be repaired through reform.

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1 Mark Brewer, Anita Ratcliffe and Sarah Smith, *Does Welfare Reform Affect Fertility?* (IFS, 2008).
2 Marco Francesconi, Helmut Rainer and Wilbert van der Klaauw, *The Effects of In-Work Benefit Reform in Britain on Couples: Theory and Evidence* (Economic Journal, February 2009).

This chapter looks at the relative generosity of support given to particular groups: couples, lone parents, mortgagors and savers, and those claiming incapacity benefits. Two questions run through our exploration of these issues. First, is the relatively generous or ungenerous support given to various groups fair? Secondly, do these differing levels of support promote life decisions which are, by and large, in people's long term interests?

4.1 Comparing support for different households

Different kinds of households are supported to different degrees by the system. Some out-of-work households are given much greater help on their way to being above the poverty threshold. Some in-work households are expected to help themselves to a much greater extent than others.

4.1.1 LEVELS OF OUT-OF-WORK SUPPORT

Concentration of worklessness can be seen to follow the structure of the benefits system. The groups who receive higher levels of state support are often those who are most likely to be workless. Our review of the history of the benefits system in Chapter 2 shows that this correlation has been self-reinforcing. Groups with higher incidence of worklessness have tended to receive greater generosity over time; and when a benefit for a particular group becomes more generous, more people tend to become members of that group.

Our analysis of the Family Resources Survey has shown that worklessness is most likely if a claimant household:

1. is headed by single adult;
2. has two or more children;
3. has young children (aged 7 or under);
4. lives in social housing.

For example, only 7% of the 0.7 million childless couples living in private rented accommodation are workless. At the other end of the spectrum, of the two million single adults without children living in social housing, over 60% are workless.[3]

We have analysed whether the amount of benefit given to a particular household is a simple, fixed proportion of the income[4] the household needs to escape poverty (at each household type's equivalised poverty threshold) – and whether this is comparable across the board. Figure 4.1 below shows how likely it is that a workless household in rented accommodation escapes from poverty through receipt of benefits.

The reason that some non-earning households within a particular type are lifted above the poverty threshold by benefits, while others are not, primarily relates to differing levels of rent and council tax across the country.

3 Authors' calculation, based on an analysis of the FRS.
4 Including Housing Benefit.

Figure 4.1: The likelihood of different types of workless renting households remaining in poverty after benefits are counted[5]

Family Type		% chance of escaping (BHC) poverty through benefits	Number of workless households
Couple	no children	1%	185,172
	one child	15%	94,297
	two or more children	30%	167,690
Single	no children	7%	1,893,298
	one child	50%	366,966
	two or more children	68%	382,997
All workless renting households		**21%**	**3,090,420**

What is striking is the difference in generosity of benefits. Only one in a hundred workless couples with no children are lifted out of poverty, compared to 68 in a hundred workless lone parents with two or more children. In general, we see that workless couples are less likely to escape poverty than workless single adults, primarily because out-of-work benefits for couples do not reflect the higher poverty threshold. However, the presence of children does make the workless household more likely to escape poverty. (For a further discussion of the factors affecting the relative generosity of out-of-work benefits, see Appendix B).

4.1.2 LEVELS OF IN-WORK SUPPORT

In order to analyse which working claimants still in earnings poverty are helped most by in-work benefits, we first need to consider the average earnings required for each different household group to escape. The table below shows the gross income that different households must earn in order to escape poverty and the percentage of the poverty threshold that must be met by earned income assuming that the household is claiming its full typical benefit entitlement, including Housing Benefit.

The net income required to move different working households above the poverty line varies considerably. On average, working households are expected to earn 73% of the amount needed to escape poverty. This amount varies considerably across household type, from 19% for a single person with children in rented accommodation, to 93% for a couple with no children in their own house.

5 Authors' calculations based on Family Resources Survey data, assuming 100% take-up. Disabilities are not considered. People with disabilities will receive additional support but will also need more income to escape poverty; these two factors are assumed to cancel each other out. Poverty lines taken from HBAI, equivilising with the OECD scale.

The most significant factor determining how much work is required is the presence of children, followed by whether a person is single or in a couple, and finally by tenure. The effect of tenure is particularly significant for families with children, almost doubling the amount a household needs to earn to put itself above the poverty line. These have significant impacts on the life-decisions that a person in this position can take.

Figure 4.2: The amount that different family types must earn in order to escape poverty, assuming they claim their full benefit and tax credit entitlement[6]

Family Type		Tenure	BHC poverty threshold (equivalised)	Typical gross earnings at poverty threshold	Typical benefits (net of tax) at poverty threshold	Amount of poverty threshold made up by earnings
Children	Single	Rented	£12,105	£2,300	£9,805	19%
		Owned/Mortgage	£12,239	£4,100	£8,139	34%
	Couple	Rented	£16,667	£5,700	£10,967	34%
		Owned/Mortgage	£16,748	£10,300	£6,448	62%
No children	Single	Rented	£7,585	£6,500	£1,085	86%
		Owned/Mortgage	£7,588	£6,700	£888	88%
	Couple	Rented	£11,331	£10,300	£1,031	91%
		Owned/Mortgage	£11,327	£10,500	£827	93%
All poor working households			**£10,218**	**£7,500**	**£2,718**	**73%**

For those working there is another consideration: whether the amount of work a particular household needs to do to escape poverty is proportionate to the household's ability to work.

For example, Jack and Jill, a childless couple in rented accommodation (who have earned just enough to escape poverty), receive only 9% of the necessary amount to escape poverty in benefits, and need to earn about £11,000 per year; whereas Jane (a single mother in rented accommodation) gets 81% of the amount necessary, and need earn only about £2,300 year. It is necessary for any benefits system to strike a balance between helping Jane, who has pressing needs, and supporting different people in poverty fairly.

The system has not and does not regard those in equal levels of poverty equally. Many households find themselves in inescapable poverty. The level of work required to escape poverty may be beyond them. It is reasonable to expect a household with young children to do less work than a household without. It is also reasonable to expect that a couple is capable of doing more work than a single person. But is it reasonable that the childless couple should

6 Authors' calculations based on Family Resources Survey data. The table assumes that earners are working-age earnings working BHC poor, taking up full benefit entitlement (ignoring disabilities). The earnings shown for a given group are the level at which 98% of the group will escape poverty. Benefit units are households.

have to do about five times as much work as the lone parent in order to reach an equivalent income? Moreover, there is no reason to think that having a mortgage makes it easier to work more.

Many are discouraged from taking certain life decisions by the level of those disincentives. A complex system makes it harder to claim. For a long-term recipient of benefits, these several intricacies of the system present a headache. The Government has done little to make it easier and much to make it harder. A typical example of this is to be found in the rising numbers of those living 'apart together'.

4.2 The couple penalty

One of the strongest biases in the current arrangements is the bias against those on very low incomes living together as a couple and claiming as such. As we will show couples living together are financially penalised compared to their income if they were to live separately.

A couple may be deprived of some of the cost savings they make living together, yet not experience a material penalty. A material penalty exists when couples have a lower material standard of living together than they would if they lived apart. (The different equivalised poverty thresholds for different households, discussed in Chapter 1 reflect the materially equivalent thresholds.) Our benefits system enshrines both financial and material penalties. While a financial couple penalty may not be inherently wrong, the presence of a material couple penalty is an injustice.

Moreover, as with other incentives, being relatively better off living apart can be a reason for couples to live separately, sometimes even when they have children. Whether or not we think it is right that people make these sorts of calculations, the fact is that they do.

The couple penalty has been the subject of much political scrutiny. However, in order to understand the full ramifications of the couple penalty, we need to understand its impact from a personal perspective.

A YouGov poll commissioned by the Centre for Social Justice found that 71% of people felt that the benefits system should not enshrine a financial disincentive against couples living together.

We asked people who are out-of-work or in part-time work:

"Within the benefits system there should not be a financial disincentive against couples living together."

Agree	71%
Disagree	15%
Don't know	14%

YouGov poll, commissioned by the Centre for Social Justice, April 2007

Calculations concerning couple penalties

Take the case that a childless couple requires 75% of the income of two single people, in order to have an equivalent standard of living.

Suppose two individuals each had net incomes of £100 p.w., hence a combined net income of £200 p.w.. Suppose they chose to live together as a couple and as a result their combined net income fell to £135 p.w..

Their **financial** couple penalty would be £65 p.w..

Since the equivalised income for such a couple would be £150p.w. (75% of £200), then their **material** couple penalty would be £15 p.w.. This is the amount they are materially worse off, having accounted for the cost savings from living together.

4.2.1 THE EQUIVALISATION PROCESS

Equivalisation allows us to compare poverty across household types. If we take the general household poverty threshold and equivalise it (following the standard OECD scales used by the Government) for different kinds of households, there arises a range of poverty thresholds (see Figure 4.3 below). When it comes to the size of household, larger households benefit from economies of scale, as rental costs and other living costs are pooled. Equivalisation in this context means that the average income per person required to push the household above the poverty line will be less than the overall measure in large households, while smaller households will require their per person incomes to increase.

Owing to the size of housing costs, there are two different poverty thresholds: a before housing costs (BHC) threshold and an after housing costs (AHC) threshold. This means that the BHC poverty threshold is numerically higher than the AHC threshold as housing costs are still to be deducted. It also means that if the family's housing costs are low enough, it is possible to be in poverty on the BHC measure, but not on the AHC measure.

Some key poverty thresholds are shown in the table below.

Figure 4.3: Examples of poverty lines for different family types[7]

	BHC Poverty Threshold	AHC Poverty Threshold
Single	£7,567	£6,480
Couple with no children	£11,294	£9,672
Lone parent with two children	£12,085	£10,349
Couple with two children	£15,812	£13,541

7 Authors' calculations based on Department for Work and Pensions, *Households Below Average Income: An analysis of the income distribution 1994/95 - 2005/06*, (DWP:2007), using the OECD equivalisation scale and assuming that all children are under the age of 14.

Using the Government's poverty scales and applying the principle of equivalisation, a childless couple needs 75% of the combined incomes of two single people to have the same material standard of living. For a couple with two children, it would be 80% of the combined income of a lone parent and a single person.[8]

A couple does not need as much money to escape poverty as two single people. There are cost savings, such as rent, associated with being a couple. It is understandable that if the taxpayer is providing a net subsidy to a household, it should be able to recoup some of these cost savings. However, the amount by which couples are worse off is at unacceptable levels, particularly amongst those with children. We will further determine the contours of this penalty in the next few sections.

4.2.2 THE MECHANICS OF THE COUPLE PENALTY

The couple penalty arises in many places in the benefits system. The impact on households at the margin emerges from the cumulative impact of the penalty in each of the benefits they receive.

- **Housing Benefit, Council Tax Benefit, and Jobseeker's Allowance**
  The amounts given to couples through HB, CTB and JSA are slightly lower than that which equivalisation would demand. A childless couple receives about 66% of two single people's awards – lower than the 75% needed by such a couple.[9]
- **Earnings Disregards and withdrawal**
  There are inequalities between the amounts couples and single people can earn before benefits begin to be withdrawn. The amount that can be earned before this happens is called the 'earnings disregard'. For JSA and IS, the earnings disregard for lone parents are twice as high as those for couples (with or without children).

  Couples are moreover penalised by JSA's eligibility rules. Even if an unemployed person in a couple wants to work, if his or her spouse works more than 24 hours a week (or earns more than £22 a day), he or she is not entitled to JSA. This has two implications. First, as the first earner begins to work more than 24 hours a week, her additional earnings do not translate into additional household income, as she must compensate for the loss of her partner's JSA. This means the family faces higher marginal taxation for longer, due to being a couple. Secondly, the partner who is out of work is not engaged with the labour market. The state has effectively given up on trying to help that person find work.

---

8 See the equivalisation table in: Department for Work and Pensions, *Households Below Average Income: An analysis of the income distribution 1994/95 - 2007/08,* 2009, Table A2.1

9 A couple's award in 2008 is £94.95 p.w., a single's £60.50 p.w.. Couples with children, as noted in the text above, need more than 75% and are therefore worse off than childless couples.

- **Working Tax Credit**
  WTC has a more substantial material penalty than any other benefit. Couple families receive the same amount as a lone parent, meaning that for a range of situations couples find themselves relatively worse off.

  If the couple's WTC position is compared with that of two lone parents, the couple receives 50% of the income of the two lone parents.[10] Compared with a lone parent and a single person, the couple has 66% of the combined income – still materially worse off.[11]

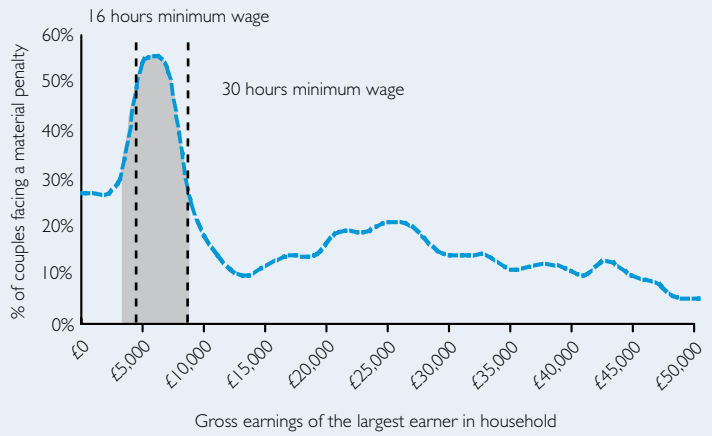
In fact, WTC only helps couples if they do not have children. The earnings disregard for WTC is exactly the same for couples as it is for single people, despite the fact that couples will usually need to earn more to escape poverty.

4.2.3 THE MAGNITUDE OF THE COUPLE PENALTY

A number of studies have attempted to assess the size of the couple penalty,[12] usually relying on illustrative couple families and then considering their positions if they lived apart. The main problem with this approach centres on the types of families chosen and whether they are representative of the UK's population.

To solve this problem, we have used the Family Resources Survey (see section 8.4.1 for further information) to obtain a representative set of different types of couples. With this set, we have compared each couple's current income with their income had they lived apart.[13]

Figure 4.4 Proportion of couples facing a material couple penalty, at different earnings levels



10 Couples and lone parents award are both £68.65 p.w.
11 Single's award is £34.62 p.w.
12 For example, see Don Draper, *Couple Penalty 2008/09* (Care Research Paper), August 2009.
13 A number of assumptions were made about couples that were 'separated' for this process. Where present, children were sent to the mother, and tenure was preserved (meaning homeowners stayed homeowners, etc). Rental costs, mortgage costs and Council Tax were all decreased proportionally to the number of individuals in a household. Capital was split between the two partners according to the earnings ratio. The analysis was carried out on the Family Resource Survey, with an adjustment to control for a misreporting of annual earnings where it would lead to an illegal wage (lower than the minimum wage).

Figure 4.4 above shows how the couple penalty affects couples at different earning levels. It shows the proportion of couples at any given earning level who are materially disadvantaged living together, compared to if they lived apart:[14] (NB it does not show how much a couple at a given level is losing out, just whether they are affected by a material couple penalty.)

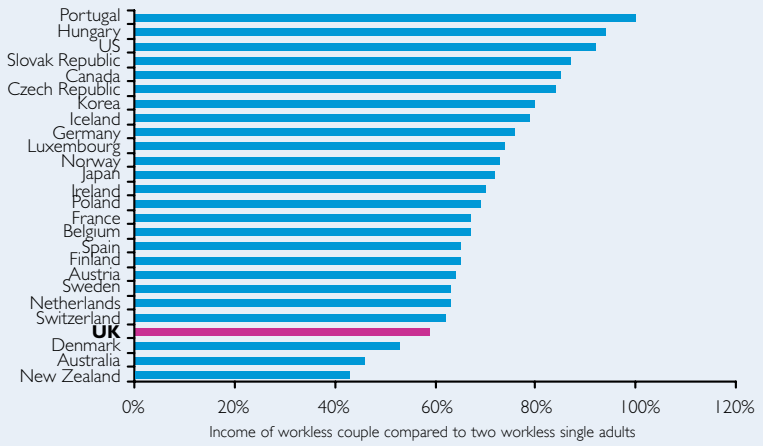
At lower gross earnings levels a high proportion of low-earning couples have a lower standard of living together than if they lived apart. The penalty affects a much greater proportion of low-earning couples compared to higher earners.[15] Between earnings of approximately £4,500 and £8,000, more than 50% of couples endure a lower living standard together than they would apart.

> "There are approximately 1.8 million couples who are affected by a material couple penalty, each losing an average of £1,336 p.a. On this basis the Government saves £2.4 billion every year by giving couples less than is fair (i.e. an equivalised level)."

There are approximately 1.8 million existing couples who are affected by a material couple penalty, each 'losing' an average of £1,336 p.a., compared to a fully equivalised level.[16] By appropriating more than the savings made by two people choosing to live together, the Government saves £2.4 billion every year. A key question is whether dynamic modelling can produce a fairer deal for couples while accounting for the cost pressures on the public purse.

The UK's couple penalty is one of the most severe by international standards. The graph below shows that workless couples in the UK receive only 60% of the benefits received by two workless single people. In the United States, by contrast, workless couples receive well over 90% of the benefits received by two workless single people. Of the OECD countries, only New Zealand, Australia, and Denmark have larger couple penalties than the UK.[17]

Figure 4.5 The couple penalty: international comparisons[18]



14 This is an under-estimate: it does not account for those couples that have not formed because of the penalty.

15 Peter Saunders and Natalie Evans (ed.) *Reforming the UK Family Tax and Benefits System* (Policy Exchange, 2009), p. 79.

16 Authors' calculations based on an analysis of the FRS.

17 Authors' calculations from OECD Tax and Benefit calculations

18 Authors' calculation, based on analysis of OECD tax and benefit tables.

4.2.4 LIVING APART

Why does the couple penalty matter? On one level it is simply unfair to those who live together. The other, very practical issue is that the penalty may encourage two people to live apart. This can happen even when those two people are in an otherwise stable relationship, even when they have children. It creates a pernicious situation where a couple in a relationship must, if they want to maintain or maximise their benefit income, live at different addresses and for all official purposes act as if they have no ties. As well as being bad for relationships, this is likely to be bad for any children which the couple may have. To force a member of the poorest segment of society to choose between a significant income contribution and a family life with their own children is a damaging policy.

Case Study: Lee left his partner and child to secure their income

Lee works for Ecoactif, a welfare-to-work not-for-profit company, where he was previously a client. He told us why he moved out of the home he shared with his partner and young child:

> My partner at this time had started doing a florists course and part-time work at the florists. So we were now expected to come up with £180 for part of childcare each month.
>
> Then they [the council] come up with a letter, saying, you didn't inform us that your partner was working, that she's earning in a part-time job. As a result we totally nullify your claim – you owe us four grand.
>
> I believe they knew – I was having monthly PPO [Persistent and Priority Offender] meetings with the council - they knew constantly what I was doing and where I was going.
>
> As a result of the mounting debt problem I run away to live for my mum. I wrote a letter saying I was no longer living at this property.
>
> When I moved out she is now claiming as a lone parent. She now gets £120 a week for wage, plus £272 Working Tax Credit and Child Tax Credit and £20 Housing Benefit. The rent cost is cheaper as well. Once my wages come into play, she loses the tax credit, the lone parent premium. As a couple I have to come up with £500 a month rent, £25 arrears, £179 council tax, the council tax deduction order, and an extra £240 childcare costs.
>
> I can't look after someone else if I can't look after myself, getting rid of this whole weight, this whole responsibility. Maybe it is a coward's way out but I see it as a way of securing their stability and security. The way I've done that is give her sole tenancy. She gets her benefits, they're not going to take it off her or my son, none of the debts were in her name...
>
> Lee, in evidence to the Centre for Social Justice, July 2009

Lee, in evidence to the Centre for Social Justice, July 2009

Claimants are aware that the system is stacked against couples. We asked people who were out-of-work or in part-time work whether they thought that they would be better-off living as a couple or living apart. Three times as many people said they would do better to live apart than as a couple.

We asked people who are out-of-work or in part-time work:

"In your experience (given the different amounts received in benefits and costs of living) do you think low-earning/unemployed people are materially better off living together as a couple or living apart?"

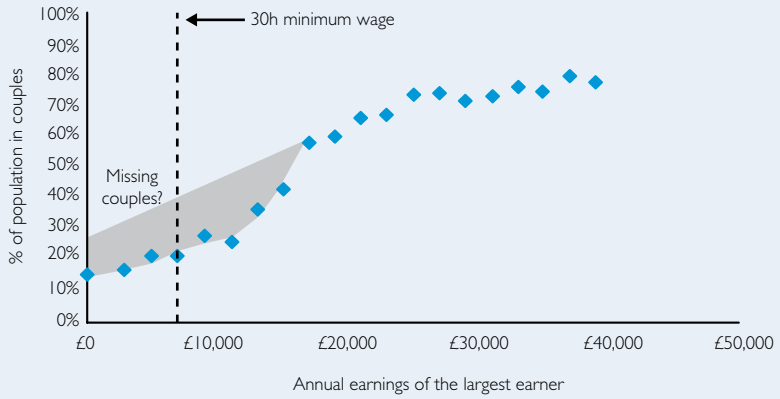
Living together as a couple	16%
Living apart	53%
Don't know	31%

YouGov poll, commissioned by the Centre for Social Justice, May 2008

It is possible to estimate the behavioural impact of the material couple penalty. Figure 4.6 below shows the proportion of the population which forms couples at different earnings levels.[19]

The proportion choosing to form couples increases slowly and fairly steadily as the earnings of the primary earner increases. However, for earnings below £15,000 p.a. there is a marked drop in the percentage of the population who form couples. While we would not necessarily expect this to be a purely linear relationship, the kink suggests an exogenous cause. The graph shows clearly

Figure 4.6 The couple penalty: proportion of the population in couples at different earning levels



that at the lower end of the income scale, many fewer people than expected are living together as couples: it seems that the proportion of the population forming couples is 10-15% less than we might otherwise expect at these earnings levels. The difference between the expected trend and the reality is highlighted in the graph, and indicates the 'missing couples': those who are, for whatever additional reasons to all other people, choosing not to live as a couple. We estimate that there are approximately one million 'missing

19 Authors' calculations based on Family Resources Survey 2005/06, controlling for the ages of the couples.

couples'. A candidate for this exogenous cause is the material couple penalty, given that for the same group of low earners, the incidence of the couple penalty is significantly higher.

> "Why marry a fellow - supposing an offer is there - when a benefit claim as a single parent results in more money proportionately than by marrying, particularly if the boyfriend also claims his welfare cheque, together with housing benefit, and sub-lets his flat while living with his girlfriend?"
>
> Frank Field, MP, 1999[20]

It is hard to disentangle from this whether the 'missing couples' did not form in the first place, have actually separated or are 'living apart together' – that is living separately but still closely involved.

In addition to these 'missing couples' illustrated in the shaded area of the graph, there is a further group of people with children who, though living together, do not declare this for the purposes of tax credits.[21] This group is effectively defrauding the system by claiming separately. The Institute for Fiscal Studies estimates that there are 200,000 more lone parents claiming tax credits than actually exist in the UK.[22] Whether couples are being driven to live separately, or to defraud the system, it is clear that the material couple penalty is having a serious impact on the livelihood of poorer couples.

We noted that the Government saves £2.4 billion per year by giving existing couples less than is fair. It may be that this is a false economy. If the penalty were eliminated there is good reason we could expect that the many of the 200,000 currently defrauding the system would begin to claim as couples. Not only would this be fairer on the Exchequer, but it would also be fairer on those individuals who have been forced to take an unjust decision between benefit and family. However, in order to make the elimination of the couple penalty fiscally neutral, we would need to see the formation of 800,000 more couples who claim as couples.[23] This seems an unlikely consequence of eliminating the couple penalty. Hence, it would need to be justified on the basis of fairness, rather than on cost (at least in the short term). The couple penalty is clearly a cost saving measure for the Government.

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20 Frank Field, 'Welfare dependency and economic opportunity', *Family Matters 54* (Spring/Summer 1999), available at http://www.aifs.gov.au/institute/pubs/fm/fm54ff.html [Accessed 29 July 2009].

21 These households appear as couples in the Family Resources Survey but are claiming child-related benefits as singles.

22 Mike Brewer et al., *Poverty and Inequality in the UK: 2009* (IFS, 2009), Appendix D

23 Authors' calculations, based on an analysis of the FRS.

4.2.5 REWARDING COUPLES IN WORK

A reformed benefits system should reduce the penalties for those who want to establish two-adult family structures, especially when these same structures help protect against long-term economic dependency. The first priority must be to reduce the impact of the material couple penalty. More of the benefits of forming family structures should be felt by working families themselves, rather than being taken by the Treasury.

Objective: Reduce the penalty against working couples, especially low-earning couples.

The out-of-work couple penalty can be reduced over time, by increasing benefits for couples faster than for singles.

As we have seen, the current configuration of Jobseeker's Allowance risks abandoning the second adult in a household. The support for finding work is currently withdrawn from the second adult in a couple when the first has found a job. This lost 'second worker' currently has no reason to engage in a welfare-to-work programme. This is a major disincentive to entering work and escaping poverty.

Objective: Reconnect the second worker in a couple with job support and strengthen conditionality around out-of-work benefits.

In Part II we will propose that the rules be changed such that if someone is entitled to benefits, then the first one they generally receive is one that has work obligations and support associated with it. It is right and fair that both adults in a couple should be able to access job-search support.

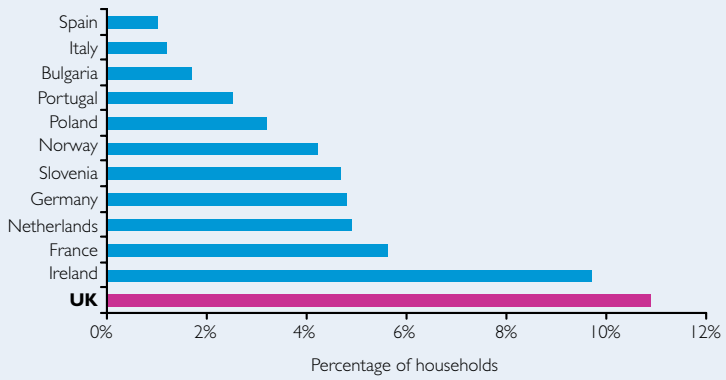
4.3 Lone parents and benefits

The welfare state exists to support the most vulnerable people in our society, and many lone parents certainly fall within that category. It is both right, in a moral and social sense, and rational, from a distributive perspective, that lone parents are allowed to claim more from the welfare state than other groups. However, with greater support comes potentially undesirable incentives.

Lone parenthood is a more notable phenomenon in the UK than in many other European countries. Figure 4.7 shows the proportion of families headed by an unmarried mother. The UK has a higher lone parent rate than any other European country.[24]

24 OECD, Eurostat.

Figure 4.7 Proportion of households headed by an unmarried mother (Eurostat)



Moreover, lone parents form a greater proportion of the workless population in the UK than in other European countries, and the UK also has a lower lone parent employment rate than many other European countries. Children in lone parent households make up 40% of all children in workless households.[25]

Figure 4.8 – Economic inactivity rates for working-age parents in the UK[26]

Never-married mothers	51
Widows	42
Divorced/Separated	33
Lone fathers	27
Women in couples	25

The UK's lone parent employment rate remains well below the average OECD lone parent employment rate, which is 70.6%.[27]

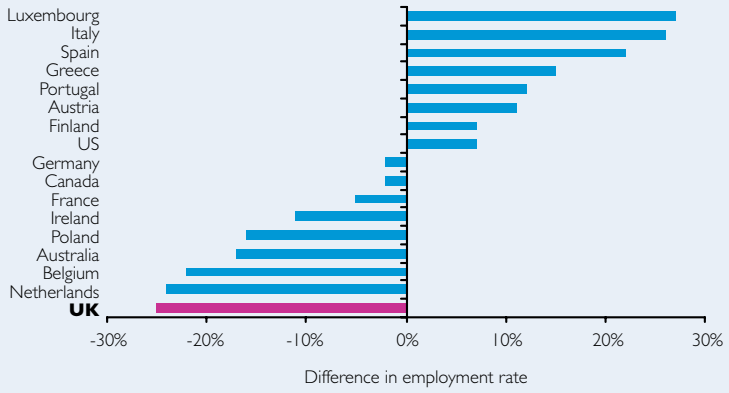
Focusing on lone mothers, the UK's employment gap between lone mothers and cohabiting mothers is also the highest in Europe. In some European countries, such as Spain and Italy, the lone mother employment rate is substantially higher than the employment rate for cohabiting mothers.

25 Office for National Statistics, *Economic & Labour Market Review 3:1* (January 2009), Table 6.01, Available at http://www.statistics.gov.uk/ELMR/02_09/6.asp [Accessed 22 July 2009]

26 National Statistics Database, Available at: http://www.statistics.gov.uk/statbase/product.asp?vlnk=8293.

27 OECD, Eurostat.

Figure 4.9 Employment gap between single mothers and cohabiting mothers



The Working Group could not see a good reason to leave unconnected a section of the workforce that is capable of working, especially with the attendant social benefits that work brings. There are certainly reasons, to do with the nature of family life and a desire to provide a stable home, why a given lone parent will elect not to work. However, our benefits system has created additional justification for not working, even when these other positive reasons are not present, and when there may be socially positive reasons to be in work.[28]

There is evidence that the UK's low lone parent employment rate is partly a product of the rational conviction on the part of an individual who can work that it does not make financial sense to take up paid work; nor is it expected. Note this from the Child Poverty Action Group:

> *Lone parents who were working were doing so predominantly for non-financial reasons: they wanted to fulfil their lives as an employed individual; their work ethic led them to want to earn their living rather than rely on what they saw as handouts; and they wanted their children to have a similar work ethic and appreciate working life.*[29]

This has resonances of the appraisal of the effect of marginal tax rates given in the previous chapter.

John Hutton, former Secretary of State for Work and Pensions, stated that up to one-third of workless lone parents seek to move "seamlessly" onto Incapacity Benefit as soon as their youngest child turns 16 – the point at which lone parents would be obliged to move onto Jobseeker's Allowance from Income Support.[30] Many of these lone parents state that depression or anxiety is their reason for being unfit for work. The widely recognised fact of

28 For a broader discussion on work expectations for lone parents, see: Social Justice Policy Group, *Breakthrough Britain: Ending the costs of social breakdown, Volume 2: Economic dependency and worklessness* (CSJ, July 2007).

29 Community Links, Low Incomes Tax Reform Group and Child Poverty Action Group, *Interact: Benefits, Tax Credits and Moving into Work* (December 2007), p.22

30 John Hutton, Secretary of State for Work and Pensions, speech (30 January 2007)

the matter, however, is that it is difficult for anyone to re-enter the workplace after many years of economic inactivity.[31]

We asked a sample of the British population if they agreed that:
"It is reasonable to expect that lone parents work part-time once their youngest child is 5 years old, and full-time once their youngest child is in secondary school."

Agree	71%
Disagree	18%
Don't know	10%

YouGov poll, commissioned by the Centre for Social Justice, May 2007

The UK has some of the highest out-of-work allowances for lone parents, and disproportionately high levels of out-of-work lone parents. A tough decision needs to be taken in order to free up the life choices of those lone parents who can work, for whom currently taking up paid employment may not be in the financial interests of themselves or their children. This will involve, over the long term, increasing support for childless singles and for couples with children, so bringing those groups closer to an acceptable parity with lone parents.

Worked example: the extent of the dependency trap for lone parents

Alex, a young out-of-work single person, receives £112 p.w.,[32] *compared to the £262 p.w. received by Erica, a 23 year-old lone parent with two children. An out-of-work childless couple, the Abbotts, receive £149 p.w., compared to the £283 p.w. received by the Evanses, a couple with two children.*

In these examples, when childless and out of work, Alex and the Abbotts are both below the poverty threshold. However, with two children, the Evanses are lifted to the poverty threshold, and Erica the lone parent is lifted to 15% above the poverty threshold.

The additional financial support for out-of-work households with children includes Child Benefit, Child Tax Credit, and an increased rent allowance through Housing Benefit. In both cases, this represents an increased income of over 70% more than the poverty threshold difference of £86.88 p.w., which takes equivalisation into account.

This level of financial support for children creates a financially attractive alternative option to work for single adults. A single adult would have to work a 30 hour week at minimum wage in order for their income to reach the poverty threshold for a single person. Hence, in order for Alex to earn enough to reach the 15% above the poverty threshold that Erica experiences as a single parent, she would have to work 35 hours per week at minimum wage.[33]

Another way to look at it is to consider the net income she would receive from different occupations.[34] If Alex does not have the training to be employed as one of the better paying examples listed below, she will struggle to escape poverty through work in the same way as Erica has with two children.

31 Jennifer Moses and Mark Bell, *Working on Welfare* (Centre Forum, 2007).
32 Assuming rent of £50 p.w. and Council Tax of £14 p.w.
33 Being under 25, she would not be entitled to Working Tax Credit.
34 Being under 25, she would not be entitled to Working Tax Credit.

Figure 4.10: Lone parent benefits, compared to typical employment

Occupation	Net income (p.w.) from median female wages
Single person out of work	£ 112 (all benefits)
Waitress/Bar Staff/Cleaner	£ 125 (inc benefits)
Shop Assistant	£ 140
Hairdresser	£ 165
Receptionist	£ 190
Typist	£ 230
Lone parent with two children out of work	£ 262 (all benefits)
Librarian	£ 320
Nurse	£ 365

The lack of return, and lack of security, from low paying jobs for young people, compounded by the inaccessibility of the Working Tax Credit for those under 25, means that, in today's system, life choices other than work are realistic and even rational ones to take.

The Centre for Social Justice has outlined in Breakthrough Britain the benefits of stable, two-parent relationships for the lives of children in some of the poorest families, and how some of the best outcomes for many of those children have their roots in a strong family structure. There are correlations between rising levels of crime and family breakdown: 70% of young offenders are from lone parent families. 23% of the adult prison population has previously been in care; compare this to the fact that nationwide, children in care and care leavers account for less than 1% of the total population.[35] We found correlations between rising levels of lone parenthood and rising levels of educational failure, with children from lone parent families more than 70% more likely to fail at school, and worrying trends in mental health and wellbeing.[36] Our research has suggested a conservative estimate of the total cost to the Exchequer of family breakdown of between £20-£24 billion per annum, between £680 and £820 for every taxpayer. Other research puts the cost of family breakdown at a staggering £37 billion.[37]

The current arrangements effectively hinder a low-earning couple who wish to bring up a child in just such a stable, two-parent relationship. On its own, this is enough reason for Government to structure benefit arrangements so as not to make living together in a two parent family financially prohibitive.

In the previous chapter, we stated objectives to increase the rewards for work especially for young single adults. Achieving these objectives will help significantly to increase the number of young mothers who have worked

35 Centre for Social Justice, *Couldn't Care Less* (CSJ, 2008), p.11.
36 Ibid, p.14
37 Relationships Foundation, *When Relationships go Wrong: Counting the Cost of Family Failure,*(RF, 2009)

before having children. This factor alone will dramatically increase their future chances of work.

In conclusion, we need to shift the relative balance of rewards and incentives, from singles to couples, from worklessness to work; so that the benefits system provides pathways for young adults that reduce the likelihood of dependency.

> "Incentives regarding family life have been affected: partnering has become less financially attractive for low-income individuals; having children has become more financially attractive."
>
> Mike Brewer and Tom Clark, 2003

4.4 Imprudence

We have argued that the system is unfair in the amount of support it gives to different groups, and also that it discourages choices which are by and large in the interests of individuals and their children: the choice to work and the choice to stay in a couple when there is a child. Placed side by side, they highlight further the confusion that surrounds the welfare system.

There are other aspects which encourage what we might term 'imprudence'. If a claimant has made some effort to save or to take a mortgage, then that effort is punished with decreased benefit. This effectively sends the wrong message: that one should not save and be prudent with money, as the Government will claw it back.

4.4.1 THE PENALTY AGAINST HAVING A MORTGAGE

The UK is one of the few countries where Housing Benefit is available only to tenants. In France, Germany, Sweden, and the Czech Republic, by contrast, HB is available to all low-income home-owners. HB covers most of the rental costs for workless and low-earning families, while little to no support is given to equivalent households with mortgages.[38] The bias against mortgagors affects every family type. Yet the child-related components in HB mean that families with children with mortgages are hit particularly hard. Overall the penalty affects 1.9 million families.[39]

Case Study: The Mortgage Problem

A lone parent from Gloucestershire was working part-time. She had three children one of whom was disabled. Having recently separated from her husband, she needed to start paying the mortgage. However, she could get no help with the cost of her mortgage while she was working and felt she had no choice but to give up her job and claim income support. The alternative was to leave the family home and rent elsewhere, but as their home had been adapted to meet the needs of her son's disability she didn't want to do that.

Many of those affected are the most vulnerable people in our society. Analysis of the Households Below Average Income report shows that 30% of working-

38 IS and JSA claimants can receive support to pay for mortgage interest after 39 weeks of claiming benefits.

39 Predominantly earning below the tax-credit threshold. For those working above the hours levels for tax credits, housing benefit is reduced by 65% of the tax credit value. Hence those with mortgages receive the full value of Tax Credits, while those with lager HB support receive only 35% of the value of the WTC.

age adults in poverty pay a mortgage on their own house. Another 20% are home owners. The design of the benefits system makes it extremely difficult for workless and low-earning families with mortgages to escape poverty. Most workless households with mortgages will always fall below the poverty line even with their benefits.

In its recent changes to the HB disregard rules, the Government has explicitly focused its attention on low-earning families living in social housing. Nothing has been done to help low-earning families with mortgages. For those higher earners in receipt of Working Tax Credit, the mortgage penalty is substantially reduced, as Housing Benefit is replaced by WTC for many renting households, resulting in mortgage holders receiving the same level of benefit.

There is a gulf between UK government policy and public attitudes on this issue. A YouGov poll commissioned by the Centre for Social Justice showed that 64% of those expressing an opinion felt that low earners with mortgages should receive support with their interest payments. While the perception among Government appears to be that those who have a mortgage should not need help, research conducted by the Centre for Social Justice in its report, *Housing Poverty: From Social Breakdown to Social Mobility,* suggests that the aspiration to own one's own home offers hope to those who find themselves in dysfunctional communities. While cost pressures make mortgagors an easy target, this is certainly not in the best interests of social justice.

We asked people who are out-of-work or in part-time work:

"Who do you think should be eligible to receive Housing Benefit?"

Low earners who live in council or housing association housing, but not those in private rented accommodation or who have a mortgage	10%
Low earners who live in rented accommodation, whether it is privately rented or council or housing association housing, but not those who have a mortgage	23%
Low earners who live in rented accommodation, or who pay a mortgage on their house	32%
All low earners, including those who own their home outright without a mortgage	27%
Don't know	9%

YouGov poll, commissioned by the Centre for Social Justice, April 2008

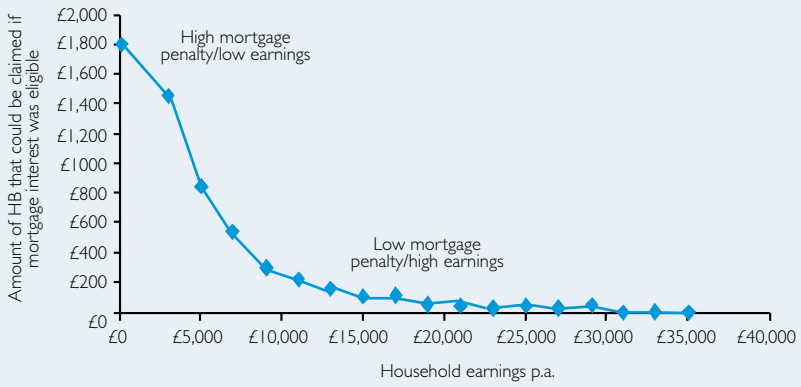
Moreover, it is the low-income mortgagors who are most vulnerable to defaulting on their mortgage repayments. If they are evicted they will likely move back into the private rented sector, and start to claim Housing Benefit. It is surely better to avoid this by supporting people earlier in their own homes.

4.4.1.1 THE MAGNITUDE OF THE MORTGAGE PENALTY

In order to calculate the size of the penalty, consider how much extra would be paid to families if HB covered interest payments on their mortgages.[40]

The following graph shows the size of the mortgage penalty at different levels of gross income:

Figure 4.11 The mortgage penalty: average amount of HB that could be claimed by a household if mortgage interest was eligible



As the above graph illustrates, people with low earnings experience the most severe mortgage penalty. Indeed, at the bottom of the income scale, the mortgage penalty is likely to be the most significant factor which prevents households who are mortgagors from escaping poverty.

The mortgage penalty counteracts the aspiration to own that even the poorest families entertain – and with it the socially-positive behaviours that come with home ownership. The option is simply not open to them.

The Centre for Social Justice has previously commented on these issues in Housing Poverty: From Social Breakdown to Social Mobility. There we stressed that there needs to be a proliferation of the types of tenure, but the ultimate aspiration remains home ownership. There is no justification for Government to try to end this norm.

Given the attention paid to, and historic Government support for, helping first-time buyers secure a foothold on the property ladder, it is unfortunate that at the same time it is unwilling to support the lowest earners who are left in poverty as a result. Those with low earnings who are trying to get onto, or

40 Authors' calculations based on Family Resources Survey data, assuming HB can be paid for mortgage costs, but limiting these costs to the local reference rent in an area (as is currently the case when HB calculations are made). Data was not controlled for groups earning below the minimum wage.

stay on, the housing ladder are just as in need of support as those in rented accommodation. We support reducing the mortgage penalty for low-earning households, not currently eligible for WTC, particularly in the current economic environment.

Objective: Reduce the mortgage penalty for low-earning households.

If mortgages continue to be penalised, the Government will increasingly find that low-earners will opt for rented accommodation. This potential surge in the Housing Benefit bill can be avoided through supporting those who want to try to own their own home.

4.4.2 PENALISING THOSE WHO SAVE

The savings penalty occurs when people who have savings suffer from a loss of means-tested benefits. Income Support, Jobseeker's Allowance, Housing Benefit, and Council Tax Benefit all currently have a 'capital' test.

Claimants who have more than £16,000 of capital are ineligible for any these benefits. Claimants who have capital of less than £6,000 are entitled to the full amount, but for every £250 above this threshold, £1 a week is assumed as income from the savings, and added to earned income to decide benefit entitlement.

It is reasonable to assume that claimants will derive an income from savings. However, £52 income from savings of £250 implies an interest rate of around 21% for savings above £6,000. This is approximately 21 times higher than current interest rates. If a claimant's interest from savings was to match the amount of benefit lost, they would have to be making returns many times bigger than those offered by relatively high-risk funds. Moreover, the assumed savings rate has continued at the same level, despite commercial interest rates dropping significantly in the last year.

At the other end of the scale, it is instructive to consider what would happen if a person with savings converted them into an index-linked lifetime annuity. With typical long-run returns on capital this would give a return of 2.5%,[41] effectively depleting assets over their remaining lifetime. A middle-aged woman with savings of £16,000 could only expect an index-linked lifetime income of £400-£600 per annum. However, if the woman decided to keep these savings, she would probably lose well over £1,000 per annum in benefits.

We would reasonably expect someone with assets to deplete them somewhat in order to overcome a temporary shortfall in savings. However, the current arrangements amount to asking a low-earning saver to deplete their assets at a rate far faster than someone in financially stronger position.

41 Taking a 40-year-old woman as a case study.

4.4.2.1 The magnitude of the savings penalty

Figure 4.12 below gives insight into the working of the Savings Penalty.[42] It shows the amount of benefit lost because of the restriction on savings, against a fairer baseline where benefits would be withdrawn at a 5% rate to compensate a return on capital more reasonable than the 21% currently assumed.[43]

Figure 4.12 The savings penalty: amount of benefit lost due to capital test

The top line on the graph shows the cumulative amount assumed to be lost through the penalty on IS/JSA, HB and CTB. Households with no earnings can be assumed to lose £1,500 through the savings penalty. Below the £10,000 mark, most of the loss is due to IS/JSA restrictions. Once this is mostly withdrawn, however, the majority is lost through CTB. The support lost from CTB affects mostly home-owners (or mortgagors), who are not eligible for Housing Benefit.

The dramatic drop in the savings penalty is also a function of the fact the Working Tax Credit does not have a capital means test. As households with savings increase their working hours beyond the WTC threshold, they become entitled to WTC, even though they may not have been entitled to Housing Benefit. The savings penalty is targeted on the lowest earners.

The total cost of abolishing the savings test would be just under £1 billion, and would help more than 750,000 households.[44] The positive dynamic effect of more savings would be realised in the longer term: greater savings allow greater personal independence and the ability to participate more fully in our economy.

Other countries have recognised the corrosive effects of capital limits on benefits and have introduced much higher thresholds and more accommodating

42 The way to determine this is to measure against upper £16,000 threshold, simulating entitlement if this threshold was scrapped. We also consider the cost if the means test assumed a much lower rate of return on capital. Using an approximation of interest as a base, we consider the increased expenditure associated with reducing the income assumed from £1 p.w. in £250 to £1 p.w. in £1,000 (or 5% p.a.). This calculation is combined with the abolition of the top threshold, as detailed above.

43 Results displayed as the penalty faced by benunits with capital savings larger than £6,000. We have calculated on the basis of a reasonable long-term rate of return rather than today's..

44 Households as benefit units.

> "Poverty is not just about how little you earn; it's also about how little you own."
>
> Iain Duncan Smith, 2008

tapers. For example, an Australian home-owner can have assets of A$166,750 (£80,590) and a non-home owner can have assets of A$287,750 (£139,069) before their 'Newstart' allowance starts to decline.[45]

Just like the mortgage penalty, the savings penalty hurts those who have been prudent, and creates a disincentive to save. It is more stringent than in many other countries. It is especially iniquitous because it only applies to benefits for the lowest earners, but not the Working Tax Credit. Hence we would propose that it be reformed. Part of that reform must also include making sure that the job-search support and expectation is provided to all, including those with savings.

Objective: Over time, the savings penalty should become less stringent.

4.5 Incapacity

Benefits to support those who cannot work because of a physical or mental incapacity are among the most necessary provided by the welfare state. Yet Incapacity Benefit/Employment and Support Allowance is one of the most problematic parts of the benefits system.

Something is broken within the incapacity benefit regime. Today's IB and ESA recipients stay claiming these benefits for longer than was previously the case. The average IB claiming period increased from three to five years between 1985 and 1995.[46] As at February 2009, of the 2,221,890 incapacity claimants, 1,224,820 (56%), had been claiming for a duration of 5 years of more.[47] A further 488,000 had been claiming for between 2 and 5 years. Previous research showed that 35% of IB claimants had been claiming for more than 8 years, and 46% for more than 6 years.[48]

The average age of an IB claimant has fallen in recent years. According to the 2007 OECD Economic Survey of the United Kingdom, the number of people aged 20-44 receiving Incapacity Benefit increased by more than 20% between 1995 and 2005.[49] Of the UK's 20-34 year-old working population, 5.3% currently claim ESA. This figure is considerably higher than the equivalent figure in many other OECD countries.

There is a final significant trend: a greater proportion of current IB recipients of all ages suffer from mental and behavioural problems than was previously the case. In 1995 25% of the IB recipient population were suffering from

45 Available at: http://www.centrelink.gov.au/internet/internet.nsf/payments/chartab.htm#a.
46 Robert Walker and Marilyn Howard, *The Making of a Welfare Class? Benefit Receipt in Britain* (The Policy Press, 2000), p. 173.
47 DWP Benefit Caseload National Statistics data (February 2009). Available at: http://83.244.183.180/100pc/ib/ctdurtn/cnage/a_carate_r_ctdurtn_c_cnage_feb09.html (accessed August 2009).
48 Nicholas Boys Smith, Reforming Welfare (Reform, 2006) p. 58
49 2007 OECD *Economic Survey of the United Kingdom* (OECD, 2007)

mental problems; by 2004, this figure had risen to 38%.[50] Many have genuine mental problems which prevent work. Many have pointed out, however, the difficulty of independently and confidently assessing the severity of a person's mental problems and the resultant difficulty of managing the benefits system. As such, it is not surprising that the number of claimants has risen.

Research conducted by Beatty and Fothergill found that 53% of IB claimants had left work for reasons unrelated to health.[51] Similarly, a Department of Work and Pensions study of the IB recipient population found that 58% of people claiming IB did not think their health was a major barrier to preventing them from taking up work. [52] Finally, a study conducted by the Prime Minister's Strategy Unit found that the proportion of economically inactive men with health problems or disabilities who wanted to work was higher than those without.[53] Growing recognition of mental illnesses has made some contribution to the rise in the number of people receiving IB since the 1970s. Yet there has been no significant deterioration in the health of the UK population during the last 30 years or so. The evidence is that

> *the large numbers on incapacity-related benefits represent an employment problem and not one of overwhelming levels of disability.*[54]

The numbers for those claiming Disability Living Allowance are up 50% since 1997. The total cost has doubled. There are enormous ranges in incidence from 1.9% in the town of Windsor to 10% in the whole of Northern Ireland, and 12.8% in Merthyr Tydfil.[55]

Worked examples: The incapacity trap

A single person, Pete, receives benefits of just over £6,000pa. With a full time job at the minimum wage, he would get an extra £3,200: approximately £2 extra per hour worked. Alternatively, he could seek to move to IB and then long term IB after a year. This would raise his total benefit by around £2,000 per year, effectively half of the return he would have received from working full-time.

Take another couple, with two children who receive around £15,500 a year in benefits. If they both tried to move to IB, this would immediately raise their income by £2,000pa; more than half the return from working full-time at minimum wage, without the costs of working.

It is also worth noting the down-side for a lone parent: when her youngest child leaves education at 16 or 18, she effectively becomes an unemployed single person and loses half of her benefits. This underpins the phenomenon, identified by John Hutton (cited above), of up to one third of workless lone parents seeking to move onto Incapacity Benefit (IB) as soon as their youngest child turns 16.

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50 Nicholas Boys Smith, *Reforming Welfare* (Reform, 2006), p. 59.

51 Christina Beatty and Stephen Fothergill, -*Incapacity Benefit and Unemployment*-, (Sheffield Hallam University, 1999); Moussa Haddad, The Incapacity Trap (Social Market Foundation, 2005), p. 7.

52 Julia Loumidis, Rachel Youngs, Carli Yessof and Bruce Stafford, New Deal for Disabled People: National Survey of incapacity benefit claimants, DWP Research Report No. 160; Moussa Haddad, The Incapacity Trap (Social Market Foundation, 2005), p. 7

53 Prime Minister's Strategy Unit, *Improving the Life Chances of Disabled People, Analytical Report, June 2004; Moussa Haddad, The Incapacity Trap* (Social Market Foundation, 2005) p. 14

54 Moussa Haddad, *The Incapacity Trap* (Social Market Foundation), 2005, p. 6.

55 Department of Work and Pensions, cited in *The Business*, 6th June 2007

Taken together, the data suggests that the number of people receiving IB is hiding the 'real' level of unemployment in the UK.

Incapacity benefits perform a vital welfare function. It is a basic facet of civilised society that they exist. However, we are concerned by the rising number of claims, the increasing length of claims, and the decreasing age of claimants. As the Centre for Social Justice explored in *Breakthrough Britain*, the structure of the benefit makes it attractive as a more secure and rewarding source of income than alternatives.

One of the key objectives of any reform will be to unlock the potential of many currently on Incapacity Benefit. In a poll by YouGov for the Centre for Social Justice, 80% of those polled thought that those who were disabled or who had health conditions, but who nevertheless could work, should do so.[56] It is by mobilising every part of our workforce that the country will bolster its fundamentals and emerge strongly out of recession.

Since the publication of *Breakthrough Britain*, James Purnell, who later resigned as Secretary of State for Work and Pensions, introduced the Employment and Support Allowance. This was predicated on these principles. The assessment for eligibility is based on what claimants can do, rather than what they cannot. Early results, for new claimants, show that approximately two-thirds of applicants are being rejected, compared to one-third in the past.[57] However, it has also been suggested that Jobcentre Plus advisers are not coping with the increased demand from those who must now claim JSA instead.

While the current regime is working better than in the past, we would like to find a way to split the work test from the payment of the premium – in this way, fairness will begin to be restored. In the same vein, we must eliminate economic incentives for claimants to move onto a benefit regime such as that for incapacity that moves them further away from the labour force than their circumstances require (regimes with fewer work obligations, or higher long-term rates of payment).

If we are to move into work those who qualify for IB and yet can work, we must follow the recommendations of *Breakthrough Britain* and stress capacity rather than incapacity. The Government has begun to recognise this in the move from IB to ESA: but there is some way to go so as to effect a culture shift within the administrative organs of the DWP.

Objective: Reduce the incentives to move to IB, and recognise the work capacity of claimants, rather than their incapacity.

Objective: Those receiving benefits on the basis of incapacity should still have the same financial incentives to work as all others.

56 YouGov poll, commissioned by the Centre for Social Justice, April 2007.
57 *The Financial Times*, 'New blow to sickness benefit applicants' (12 July 2009).

4.6 Conclusion

We have highlighted ways in which the benefits system is unfair to certain groups. These inequities also create financial disincentives for behaviour that is a surer bulwark against poverty for families and their children. Redressing the couple penalty, the mortgage penalty and the savings penalty, and facing up clearly to the incentives for lone parents and those on incapacity-related benefits not to work; these are key to a benefits system that plays its part in transforming society, rather than entrenching the problems it is supposed to redress. It is the nature of benefit dependency that people will live their lives in certain ways, so as not to jeopardise an important stable income; and ultimately to increase that income through the structure of the system itself. The next chapter shows the very complexity of the system increases this dependency on benefits. Reform of the benefits system must create other paths to a secure stable income, based more on earnings than receipt of benefits.

CHAPTER FIVE
The Burden of Complexity

We have already looked at the complexity of the benefits system from a political perspective: the lack of co-ordination and clear purpose, the creeping creation and elimination of different benefits over time, the adjustment or rates, conditions, eligibilities. This chapter looks at the complexity which this incoherence has created in the operation of the system.

> "You don't want to muck around with your benefits because you're going to end up in arrears. And if you end up in arrears, you get thrown out of your house."
>
> Zelma, Hackney (A4e client focus group, March 2008)

The day-to-day operation exacerbates many of the effects on work incentives that we have discussed above. It adds to the administrative cost of the system, and makes it almost impossible for the Government to control the level of spending on the main benefits.[1] It makes it harder to reform. It makes the rewards of work less certain. But most profoundly, it is this very mundane complexity which, entangles claimants in the system and entrenches dependency.

First, we analyse its sources in the current welfare arrangements:

- The system is composed of too many different benefits, with too many eligibility and payment rates.
- The administration is heavily repetitive and bureaucratic: the system is run in a manner that is unresponsive, and not attuned to the circumstances of claimants.
- Too many people are involved in the benefits system, and as this combines with the tax system, the effect is that what the Government gives in benefits with one hand, is taken away with the other.

Secondly, we evaluate the effects of this complexity, both in administrative terms and in terms of economic dependency:

- Claimants and administrators are confused by many aspects of the system.
- There is low take-up and unnecessary poverty.
- The design of the system leads to lags that cause cash flow challenges. These challenges are simply impossible for many to handle without getting into debt.
- Many claimants fear to change their situation.

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1 David Martin *Benefit Simplification: How, and why, it must be done* (Centre for Policy Studies, 2009).

In a YouGov poll of the general public conducted for the Centre for Social Justice, 88% agreed that the benefits system should be simplified, suggesting an overwhelming public desire for change.[2]

5.1 Sources of complexity in the benefits system

5.1.1 TOO MANY BENEFITS AND CONDITIONS

At least 51 separate benefits comprise our welfare arrangements. This compares to 27 in 1979 and only 7 in 1948.[3] This could be seen as evidence of a more responsive system. However, of the 51 benefits, 26 are nugatory, accounting for less than 1% of total expenditure, but with wildly disproportionate contribution to the complexity of administration, so the responsiveness, if responsiveness it be, comes at a mismatched cost.

There are a myriad of different qualifying criteria, timetables, tapers and tests. The DWP administers around 40 of these benefits, allowances and grants, and its Decision-Maker's Guide runs to 14 volumes and thousands of pages.[4,5] The 2007/8 'Benefits Uprating Statement' included 460 different rates for the different allowances, premiums, limits, deductions and disregards in the system which determine the level of benefit payable.

Many benefits have complex rules for eligibility, requiring applicants to provide, and agencies to administer, large amounts of information.[6] For example, 169 questions are needed to gather information in a straightforward lone parent claim for Income Support.[7] A recent Centre for Policy Studies report highlighted the case of a woman with a disabled son who had to complete ten different application forms, containing over 1,200 questions, to apply for the benefits she needed.[8]

Clearly a certain amount of complexity will be intrinsic to a system which has to deal with people in very different circumstances. Nonetheless, several institutions have already made the case against undue complexity in the current welfare arrangements. [9] For example, the National Audit Office has stated that the welfare system fails to find:

> *an equilibrium between the system being complex enough to meet the needs of a wide range of different individuals in various circumstances,*

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2 YouGov poll commissioned by the Centre for Social Justice, May 2007.
3 Nicholas Boys Smith, *Reforming Welfare* (Reform, 2006), p.17.
4 House of Commons, Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006-2007.*
5 David Martin *Benefit Simplification: How, and why, it must be done* (Centre for Policy Studies, 2009), p.5.
6 Jim Bennett and Graeme Cooke (eds.) *It's All About You - Citizen-centred welfare* (IPPR, 2007).
7 Ibid.
8 David Martin *Benefit Simplification: How, and why, it must be done* (Centre for Policy Studies, 2009), p.5.
9 Much of our work here builds upon these earlier studies by the NAO, Parliamentary Ombudsman and Department for Work and Pensions Select Committee.

yet straightforward enough to run efficiently.[10]

In Chapter 2 we identified a broad historical shift towards means-tested benefits. One practical effect of this has been much greater scrutiny of claimants' current earning levels and income streams and a requirement for much more information about their circumstances, as the system attempts to respond to small changes in earnings. The Work and Pensions Select Committee found that there was "a direct correlation between the amount of means-testing and the complexity in the system."[11] We bear this conclusion in mind when we note that the Institute for Fiscal Studies has characterised the New Labour period as "an extension of means-testing, although in a new, more generous and, it hopes, more palatable, form."[12] Whatever else it has done, means testing has greatly increased the complexity of the system.

Multiple benefits means multiple income streams to monitor. The large number of benefit income streams, each with differing withdrawal triggers and rates, creates the confusing variation in MTRs for low-earners, as well as unfairness whereby people experience very different MTRs.

Case study: sources of income and reporting requirements for a lone parent on low earnings

A lone parent working 10 hours per week has six different sources of income:

1) Earnings;
2) Income Support;
3) Housing Benefit;
4) Council Tax Benefit;
5) Child Tax Credit;
6) Child Benefit.

Six sources of income requires six different sets of information on eligibility criteria, as well six different attitudes to work, as increasing earnings will produce six different consequences. For example, an increase in earnings means that IS will taper away, but tax credits kick in, as do tax and National Insurance withdrawals. Now eight different flows of money need to be managed.

How tax credits relate to the rest of the system is a particular cause of confusion. In a poll of benefit claimants, we asked which benefits were the most complicated and difficult to understand. The most common answers were Working Tax Credit and Child Tax Credit.

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10 Other studies including one from the DWP. House of Commons Select Committee on Work and Pensions (26 July 2007) http://www.publications.parliament.uk/pa/cm200607/cmselect/cmworpen/463/46304.htm

11 House of Commons Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006-2007*, (HC, 2006-07) [51]

12 Mike Brewer and Tom Clark, *The impact on incentives of five years of social security reforms in the UK*, (IFS) p.2

We asked people who are out-of-work or in part-time work:
"Which if any of the following benefits do you think are the most complicated and difficult to understand [Please select up to two]."

Working Tax Credit	32%
Child Tax Credit	22%
Incapacity Benefit	18%
Housing Benefit	17%
Council Tax Benefit	16%
Income Support	13%
Job Seekers Allowance	7%
Child Benefit	1%
None of them are difficult to understand	18%
Don't know	17%

YouGov poll, commissioned by the Centre for Social Justice, April 2008

5.1.2 ADMINISTRATIVE COMPLEXITY

There are few things more impersonal than bureaucracy. Yet a welfare claimant is repeatedly faced by a characterless multi-agency bureaucracy in his or her quest to find the right level of benefit. This exacerbates the problems already inherent in the system.

The onus to register entitlement and report changes to earnings or personal circumstances currently rests with the claimant. If a person becomes unemployed, or has a change of circumstances which would entitle him or her to a larger reward, they have to report the changes. Failure to report a change that would lower one's award is a type of fraud. However, reporting changes requires a great deal of effort from claimants.

First, under current arrangements benefits are administered by a number of different government departments, executive agencies and local authorities. Some claimants have to deal with a number of different bodies simultaneously to secure all their entitlements. Moreover, as Sue Royston (a leading expert on benefit complexity) has pointed out, even within the Department for Work and Pensions different benefits are dealt with separately from one another, effectively requiring claimants to deal with separate agencies with different requirements for the same evidence.[13] Making a plea for one point of contact, she said:

> *It is where somebody reports, 'I have done some extra work' to one department and then thinks that that goes through, but it does*

13 House of Commons Work and Pensions Committee, *Benefit Simplification: Seventh Report of Session 2006-2007*, HC (2006-07) 463-I [72].

> *not get passed on… From all the disability groups and the welfare rights groups I have talked to the sharing of information was a huge request. It probably came top of the list.*[14]

Indeed, so disconnected from each other are the various benefit administration regimes within the DWP, that the Child Poverty Action Group, in evidence to the Work and Pensions Select Committee, referred to a test case in which

> *the DWP successfully argued that even though one part of it knew about a change in circumstances, other parts of the DWP could not be assumed to know about the change.*[15]

An organisation may be expected to understand its own 'organograms'. Asking the same of a welfare claimant is a different matter altogether. That this could be used as a legal defence is a symptom of how dehumanised the system has become. At one level this is a systems problem – the level of integration in IT systems between different delivery bodies, though improving, remains limited. [16]

Reporting changes can be tortuous. The second aspect of administrative complexity is that their claimants are unsure about what personal changes they have to report. Internal research conducted by the DWP found that:

> *Some customers fail to report changes in their circumstances for the following reasons: Customers' awareness and knowledge of the specific changes that have to be reported can be patchy …; Customers struggle to apply the requirement to report changes in circumstances to real-life situations.*[17]

The complexity of the actual requirements is compounded by a failure to communicate effectively what is required. The DWP acknowledges this:

> *Information is a problem. It is difficult for customers to find clear and concise information about what, when and how to report changes in their circumstances. This causes unnecessary confusion and results in customers not providing important information to the Department.*[18]

Beyond the difficulty of reporting changes in personal circumstances, the way that the system then responds to these changes can create problems for

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14 Ibid, [193]
15 Ibid, [196]
16 National Audit Office (2005), cited in: Jim Bennett and Graeme Cook (eds.) *It's All About You - Citizen-centred welfare*, (IPPR, 2007).
17 DWP, Getting Welfare Right: *Tackling error in the benefits system* (January 2007), paras 1.17-1.18
18 MISSING

claimants. Janet Allbeson from One Parent Families suggested that the system which administers Housing Benefit did not have the capacity to manage the sheer number of times that a claimant's circumstances may change:

> *The models do not take on board how swiftly people's circumstances change, particularly those of working age. Tax credits made that mistake, Child Support has made that mistake. The systems just cannot cope with it. Housing Benefit cannot cope with it. In a sense, it is modelling systems around real live claimants. . . but certainly a customer-focused, client-centred view has to recognise how complex people's lives are and how they change. . . because it is not just about income; it is also about security of income; that is something that people worry about.*[19]

Fundamentally, however, the administration has evolved to deal with the complexities of particular benefits, rather than dealing with the complex personal circumstances of individual claimants. As one scathing consultant remarked:

> *Processes are not designed from a customer focused perspective, and there is no central oversight or responsibility to identify and eliminate inconsistencies and contradictions, or remove work disincentives which arise from cross-system interactions and rules.*[20]

The result of lack of responsiveness is overpayment (which is expensive, and must be reclaimed) or underpayment, as well as unfortunate gaps between when changes of circumstances are reported and when benefits are paid. The potential for fraud is also greater where separate benefit agencies only have a loose grip over the relevant circumstances of claimants.[21]

The problems of overpayment have been particularly acute with the Working Tax Credit and its rules for reconciliation. For example, if a family's income rises by less than £25,000 above their assessed rate, they will not be required to pay back the 'undeserved' part of the tax credit award they had received. However, if the income drops below the assessed level, entitling them to a greater award, and then rises, again, they are liable for paying back

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19 House of Commons Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006–07*

20 Community Links, Low Incomes Tax Reform Group and Child Poverty Action Group Interact: *Benefits, Tax Credits and Moving into Work* (December 2007), p.6

21 David Martin Benefit Simplification: *How, and why, it must be done* (Centre for Policy Studies, 2009), p.11.

the overpayment.[22] In other words the tax credit system penalises those whose income stream is less secure.

Complications arising from tax credits can have a net negative effect on some households' entitled to benefits. This is not merely an issue of financial incentive but also of procedure and human interaction, of which the current system takes no note. Pay is often delivered in monthly cycles, yet there may be a delay on a tax credit payment. The books will record that the claimant is in credit; the reality is often quite different. The Parliamentary Ombudsman raises this concern:

> *This can be particularly problematic for those on the lowest incomes because had they not received those tax credits payments at the time they might well have been entitled (or had an increased entitlement) to other benefits such as income support or housing benefit. Because of the rules governing entitlement to those benefits, however, the tax credits claimant cannot make a backdated claim for those benefits so long after the event. Hence those on the lowest incomes can end up, over time, receiving less than their overall entitlement to financial support and be seriously disadvantaged.*[23]

The Ombudsman reported receiving many complaints about the recovery of overpayments and, in 2006-07, 74% were partially or completely upheld. In his report he noted that the proportion of complaints upheld about tax credits was "higher than for any other department."[24] This led the Ombudsman to question whether "a system of this nature, which includes a degree of financial uncertainty and the possibility of debts arising, can really meet the needs of this particular group of individuals and families, and the policy objectives."[25]

The overall result is a system which regularly underpays and overpays, delays payment, and enmeshes people in the benefits system. Just how many people are caught up is the subject of the next section. We explore these consequences, and some possible responses, in section 5.3.

5.1.3 GIVING WITH ONE HAND AND TAKING AWAY WITH ANOTHER: TAX AND BENEFIT CHURN

Under most welfare arrangements in the current system, it is possible to receive benefit from the state and pay taxes to the state. The concept of paying

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22 To calculate the amount of Working Tax Credit a person receives in a given year, HMRC assumes a person's income is the same as during the previous tax year, unless it is otherwise notified. Any rise of up to £25,000 in the actual income for the year is disregarded and the tax credit award remains the same. So, if a WTC claimant had an income of £10,000 last year and £34,000 this year, she would receive the tax credit this year proportionate to £10,000 (i.e. a larger amount). However, if during the year a person's income falls from the previous year, and then rises again, the rise from the lowest point is not disregarded and the overpayment becomes recoverable. So assume our claimant's income drops to £9,000. She informs the Revenue and receives more tax credit; but subsequently her income increases back to £10,000. This payment is now recoverable as it is below the previous year's award.

23 Parliamentary and Health Service Ombudsman, *Tax Credits - Getting it Wrong?* Fifth Report of Session 2006-07.

24 House of Commons Committee on Public Accounts, *Tax Credits and PAYE: Eighth Report of Session 2007-08*, p. 5.

25 Parliamentary and Health Service Ombudsman, *Tax Credits - Getting it Wrong?* Fifth Report of Session 2006-07.

tax with one hand and receiving benefits with the other is known as churn.

There is a clear need for individuals to contribute to the state via taxes. Equally, there are good reasons for having in-work support programmes. However, where there is little or no net income transfer, there arises an efficiency issue.

The poorest 20% of households pay little tax, as they mostly earn below the Income Tax threshold. However, the next poorest 20% receive approximately 40% of their income in benefits, even though they are almost all taxpayers as well, mostly paying 31% of that income back in tax.[26] Over a quarter of those who are net tax-payers receive means-tested benefits, and a quarter of all net recipients of benefits also pay tax.[27]

Case study: Churn

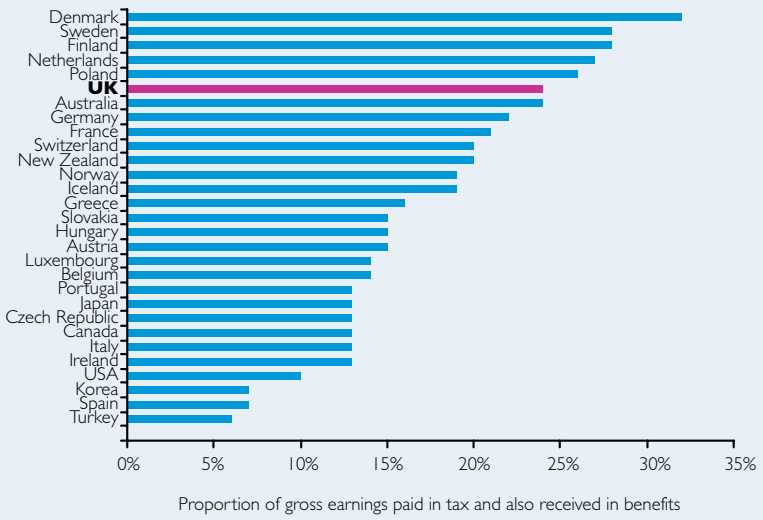
A couple, the Smiths, earning £20,000 a year in total, just made the transition from being net recipients of benefits to net payers of tax.

At this point they will simultaneously pay £5,000 in tax and receive £5,000 in benefits – their gross income including benefits will be £25,000 but they will be paying £5,000 in tax.

This overlap is equivalent to one quarter of their earnings.

At the break-even point, where a household pays as much in tax as they receive in benefits, the churn is equal to about a quarter of total earned income. This is significantly higher than most other industrialised nations, as Figure 5.1 below shows.

Figure 5.1 Tax and benefit overlap at break-even point



26 Authors' calculation based on an analysis of the FRS.
27 Authors' calculation based on an analysis of the FRS.

A few Scandinavian countries aside, nearly all other countries have managed to reduce levels of churn.

Tax churn makes it necessary to withdraw taxes and benefits simultaneously. This means that those who are receiving benefits and paying tax tend to have some of the highest MTRs of all the working population. The negative impact of tax serves to increase the disincentives to work and compounds the problems of benefit withdrawal for those on low pay. Owing to the impact of Tax and National Insurance Contribution withdrawals, we calculate that 170,000 households are 'taxed' back into poverty, despite otherwise earning enough to escape earnings poverty.[28]

Churn is rightly seen as a symptom of a wasteful economic culture. High rates of churn indicate that more people than necessary are involved in the system. As a result it means that the Whitehall machine must do twice the work for a family, taking taxes and giving tax credits and benefits, often through cumbersome methods. These effects are compounded by the byzantine administration outlined above.

5.2 The consequences of complexity

The large number of benefits, rules and conditions, the large number of people who receive benefits (even when they are taxpayers) and the disjointed administration have serious consequences. Claimants cannot understand what the system will do if their circumstances change, and even administrators are unclear. The system as a whole wastes money on overpayments and reclaiming them. The complexity means that claimants are not aware of their entitlement in some cases or are unwilling to navigate the bureaucracy, leading to unclaimed awards. Changes in earnings or circumstances can push people into debt. The net result is a suspicion of the system, significant disincentives against going into work and a great entanglement in the benefits system. In describing these phenomena we also elicit further objectives for reform.

5.2.1 CONFUSION FOR BOTH CLAIMANTS AND ADMINISTRATORS

To a claimant, anxious to understand his or her situation, the calculations that comprise their entitlement are so complex as to be not worth considering. People entering work can face further difficulties in calculating their financial situation, particularly in understanding the interaction between benefits and tax credits.[29]

Some argue that a claimant does not need to know how his or her entitlement works. However, we would argue the opposite: that understanding one's income stream is a form of responsibility and that those who want to understand and so take a step towards taking control of their lives should be empowered by the system to do so. Currently they are not:

28 Authors' calculation based on an analysis of the FRS.

29 House of Commons Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006–07*

> *I still don't understand how they worked it out.... the actual arithmetic... I couldn't understand one single bit of it. I've had to rely purely on the fact that they understand my figures and that I'm getting the right rate.*[30]

This makes it impossible to know for certain, or for advisers to advise, whether a claimant will be better off in the longer term doing x rather than y – for instance, staying on benefits or going into work – when a complex set of calculations based on today's circumstances can be transformed by a change in those circumstances.[31] Consider the following:

> "I don't have a clue about my entitlement, how the calculations are made or anything."

> *I used to get WTC but now I only get CTC. They used to give me £120 and now I do not get anything in WTC. For working 30 hours per week I only get £20 more for my CTC than what I got when I was working 16 hours a week. It does not make any sense.*[32]
>
> *[My husband]... was working 30 hours and saw the amount reduced and it is about the same. He was offered more hours to work and he wanted to increase his income and it took us to where were before. He didn't get any benefits.*[33]

Entitlement to Housing and Council Tax Benefit is often a source of confusion, as there is a prevailing misunderstanding that housing support is a passported benefit that comes with Income Support.[34] Off the Streets and Into Work, a homelessness and housing charity, reported to the Work and Pensions Committee:

> *We have found from quite a lot of our research that people have absolutely no idea what in-work benefits they are entitled to. Certainly in relation to Housing Benefit, I have found it remarkable that people do not know that they are entitled to this.*[35]

Even the staff who administer the system at times appear not to understand the various benefits in play.[36] Some attempts by central administration to help clarify matters for claimants and advisors that themselves only added to the confusion. The case study below describes the history of the 'Better-Off Calculator'.

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30 Community links, *Low Incomes Tax Reform Group and Child Poverty Action Group*, 'Interact: benefits, tax credits and moving into work', Dec 2007, p.26.(Interviewee B).
31 Ibid, p.29.
32 Ibid, p. 20.
33 Ibid, p. 21.
34 House of Commons Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006–07* 463-I [151]
35 As cited in House of Commons Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006–07*.
36 House of Commons Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006–07*.

Case study: Better-Off Calculator

In order to help people through the maze of benefits, a Better-Off Calculator was developed to calculate the interaction between wages and in-work benefits, and clarify an individual's budget once they begin employment.

The DWP acknowledged that "less experienced advisers found the [Better-Off Calculator] difficult to use and interpret; more experienced advisers found aspects of the BOC problematic, such as the selection of the financial year or where incomes had varied during the year."

And it doesn't always work. In its evidence to the Work and Pensions Select Committee, the charity Off the Streets and Into Work stated that the complexity of the Better-Off Calculator itself compounded the potential for inaccurate outcomes:

"[it] is too complicated for people to use, it is just too lengthy to use really for Personal Advisers….When [claimants] have got a whole raft of different benefits, they are really interested to find out exactly how that is going to translate into work, but Personal Advisers really do not have the time to do that."

One Citizen's Advice Bureau adviser had to translate an incomprehensible better-off calculation provided by Jobcentre Plus from whom the client had sought advice on returning to work. The calculation included the following statement: "A WTC estimate based on CY income is not appropriate where CY income is more than PY but less than £25,000. Please refer to PY WTC report for an estimate of WTC." The CAB comments, "Not surprisingly… he felt it was difficult to make an informed decision about returning to work."[37]

The DWP's better-off calculator has proven to be unreliable and cumbersome and rather than elucidating the benefits system has added yet another layer of confusion.

A key step in simplifying the benefits regime will be to reduce the number of benefits, so that there can be fewer sets of conditions, fewer agencies managing the regime, fewer withdrawal mechanisms.

Objective: Reduce the number of benefits.

There are a limited number of purposes for benefits (albeit with many different triggers), and these should be aligned with different benefits:

a) Living costs – for housing, dependents and disability;
b) Job search support;
c) Other discrete costs that are incurred in different ways by different people, e.g. childcare expenses, prescriptions, etc.

Objective: Eliminate distinct in-work benefits.

The current system causes complications, and creates unfairness whereby people experience very different MTRs. A reformed system should be

37 Citizens Advice Bureau, *Evidence December 2007*, (CAB, 2007) p. 7. Available at: http://www.citizensadvice.org.uk/evidence_dec_07.pdf,

dramatically simpler. It must increase the transparency of the advantages of work, making it clear and predictable what levels of benefits are available to each claimant. This requires simplifying and aligning the rules, as well as reducing the number of exceptions and special cases.

Objective: Simplify the benefits system, with just one type of withdrawal mechanism, so that it transparently rewards those who make an effort.

The application process for benefits needs to be much easier. Managing benefits should not be a job in itself for claimants. It should also be straightforward enough for computer systems to support it readily, which is not the case today.

This can be better achieved through a simplification in the rules, and a small number of agencies in contact with claimants, without needless duplication or hand-offs from one agency to another. Ideally, there should be only one agency deciding and handling the total amount paid out in benefits, even if there are different drivers and conditions to be set.

Objective: Reduce the number of agencies administering benefit.

This is good for claimants and good for the Exchequer. The complexity of the benefits system has significant consequences for the overall costs of the system to the state. The sheer scale of the regulations and guidance governing the administration of the system produces high costs in terms of staff time for processing claims, re-determinations and appeals, staff training and information systems.[38] Sue Royston has also suggested that a single point of contact would also reduce the incidence of overpayment. This would save both the direct cost of claims which are not retrieved and the expense of chasing down those which are.[39]

Improvements in design should also make it more affordable in the long run, and is more rational and fair than relying on the low uptake induced by complexity to keep costs down.

Objective: : Simplify the administration needed for Whitehall, local government, and the claimant.

5.2.2 LOW TAKE-UP AND UNNECESSARY POVERTY

There is strong evidence to suggest that increasing take-up of benefits could reduce poverty significantly. People sometimes do not understand what they can claim; or do not have the time or energy to persevere with attendant

38 Jim Bennett and Graeme Cooke (eds.) *It's All About You - Citizen-centred welfare* (IPPR,2007).
39 House of Commons Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006–07*, 463-I [193]

bureaucracy. A recent paper for the Joseph Rowntree Foundation examined various ways to reach the 2020 child poverty target. It stated that "Without a rise in take-up, none of [the government's] policies can abolish child poverty by 2020."[40] However, very often, the complexity of the current arrangements means that take-up is not as it should be.

Levels of take-up by benefit

The Department for Work and Pensions conducted a review of benefit take-up for the year 2007/08,[41] and HM Revenue and Customs did similarly for tax credits.[42] Their findings were as follows:

Housing Benefit (HB)

- Take-up is between 80% and 87% by caseload and between 85% and 91% by expenditure.
- Since 1997/98 take-up among the working-age population has fallen by at least 7%.

Council Tax Benefit (CTB)

- Levels of take-up are much lower than they are for HB: between 62% and 68% by caseload and between 63 and 70% by expenditure.
- Since 1997/98 take-up among the working-age population has fallen by at least 9%.

Out-of-work benefits

- Income Support (IS) is taken up at almost double the rate of Jobseeker's Allowance (JSA). IS take-up in 2007-08 was in the range 78% to 88% by caseload and 85% to 93% by expenditure.
- JSA take-up was between 52% and 60% by caseload and between 54% and 65% by expenditure.
- Together unclaimed amounts of IS and JSA are between £1.5 billion and £2.96 billion.

Tax credits

- Child Tax Credits are taken up at a rate of 81% by caseload and 88% by expenditure.
- The level of Working Tax Credit take-up is much lower, at just 57% by caseload and 77% by expenditure.
- In addition, the size of the tax credit award has a significant effect on the level of take-up. The lower the value of the award, the lower the take-up.

The Government compels many in earnings poverty to pay income tax. There is a real argument that the same Government ought to structure the system in a way that allows those low earners and others to collect their allocated benefits without excessive burden.

> "The main thing for me is going from being on benefits to paid work how you survive in between coming off benefit and getting paid."
>
> Eileen, Plymouth (A4e client focus group, March 2008)

5.2.3 DELAYS AND DEBT

One of the biggest, and very real, complexities for claimants is managing cash flow – which is particularly challenging when moving into or out of work.

Uncertainty about the effects in the near future of moving into work can be a significant deterrent to taking work. Recent research found that 48% of 'ready for work' benefit recipients

40 Mike Brewer, James Browne, Robert Joyce and Holly Sutherland, *Micro-simulating child poverty in 2010 and 2020,* (Joseph Rowntree Foundation, 2009) p. 30

41 Department for Work and Pensions, *Income Related Benefit Estimates of Take-Up in 2007-08* (DWP, 2009).

42 HM Revenue and Customs, *Child Tax Credit and Working Tax Credit Take-Up Rates 2006-07* (HMRC, 2009).

were deterred from seeking employment by these transitional income risks. Particular concerns identified were "up-front job costs; the time delay between benefits ceasing and receiving wages; fears about eligibility for benefits if they have to reclaim in the event that a job did not work out".[43] Moreover, in a recent survey of the homeless, the time lag between benefits stopping and clearance of wages was an area of particular concern.[44]

Many jobs pay only monthly. In some cases, a new employee taken on mid-month may have to wait six or seven weeks for their first pay cheque. This, combined with more immediate termination of benefits, can cause significant cash-flow problems. The average time to become established with the right rate of benefit is between 12 and 16 working days, with more complicated cases taking much longer.[45]

If, having taken a job, the claimant subsequently becomes unemployed again, the time taken to re-establish the right level of benefit can amplify these cash-flow problems.

Moreover, delays in the payment of tax credits meant that, without alternative subsidies, some people struggle to retain their job: "We have a lot of clients who have to wait up to ten weeks for their tax credits to come through, so if we are not there to support them I do not see how else they would get through that period."[46]

A number of witnesses to the Work and Pensions Select Committee stressed the importance of claimants experiencing a smooth transition from benefits to in-work support. "The first month is critical, because once you start a job you are not paid until the end of your first month".[47] The sluggishness in response times can cause cash-flow problems which can escalate into serious debt. In fact many aspects of the system can push people into debt: the unexpected demand that overpaid benefit be repaid, and the underpayment or reclaiming of Housing Benefit due to poor coordination between the DWP and HMRC, are two common causes. As the Public Accounts Committee reported:

> *A particular group of the poorest people in the United Kingdom are saying that their experience has got them into debt where they previously had not been in debt—causing distress, anxiety, and even family break-up—and wishing to have nothing more to do with the [system].*[48]

Voluntary groups can provide training and services to help manage cash-flows, but there is little such a group can do when the physical delivery of benefit money is held up by system complexity.

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43 Jim Bennett and Graeme Cooke (eds), *It's All About You - Citizen-centred welfare* (IPPR, 2007).

44 Off the Streets and into Work, *The costs and benefits of formal work for homeless people,* December 2006.

45 David Freud, *Reducing dependency, increasing opportunity: options for the future of welfare to work* (DWP, 2007), p. 100.

46 Abigail Howard from the Wise Group , evidence to House of Commons Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006–07.*

47 Ginny Lunn from the Prince's Trust, evidence to House of Commons Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006–07.*

48 House of Commons Committee on Public Accounts Tax Credits and PAYE: *Eighth Report of Session 2007-08*, p. 7.

Case study: Claire, 35, suffered from a number of complications from returning to work.

First, her HB immediately stopped being paid and she fell into arrears with her rent. She organised a payment plan for paying this back but, as she did not hold the job for long, she was not able to make the payments under the plan as well as paying her other priority debts (namely, utilities) and non-priority credit debts. She, like many, did not understand the difference between priority debts (where the repercussions of non-payment are loss of home, imprisonment or disconnection) and non-priority debts (where the most serious immediate consequence is a county court judgment).

She therefore made payments towards her credit cards (who called and harassed her the most) rather than her utilities. She fell into arrears with her electricity and water. She had to arrange a payment plan with the utilities so that she would not be disconnected.

Such situations are very stressful for individuals and certainly create a feeling that they should be content with any situation where all bills are being paid on time – even if this entails being reliant on Benefits and not returning to work to make more money.

For many looking to enter the world of work, a potentially unstable pattern of earnings poses many risks, and deters the first steps into work. A better benefits system will take account of the realities faced by those entering low wage jobs. Security of income is important, especially when a potential worker has a partner and children to consider. Benefits should be provided quickly: they are to supplement the income of those who cannot afford a decent living otherwise. They should be managed in a way to reflect or compensate for the natural cash-flow issues of those transitioning into and out of work.

Objective: Reduce the problems of delays and backdating in the transition to in-work benefits – reducing the financial risks of entering work.

In an age of instantaneous bank transfer, we can envisage a system that would allow benefit withdrawal to take place by way of PAYE, only if the claimant has earned enough to have the benefit withdrawn; though this is not possible with the current complexity.

5.2.4 FEARING TO CHANGE ONE'S SITUATION: DEPENDENCY AND COMPLEXITY

The sum total of these many complexities is to make the movement from unemployment to employment significantly less attractive in the mind of the claimant. Complex welfare erects barriers to work.

> "Living on benefits... is habit-forming, and we all know humans are creatures of habit, even if that habit is uncomfortable. You just get into a routine of every fortnight receiving a minor payment. You buy your shopping, you pay your top-up on your rent, your life is just still. That's your routine. Your life builds up to that and nothing else happens in between."
>
> Ben, 27, Plymouth (A4e client focus group, March 2008)

A claimant assesses what needs to be done to get off benefits, based on the actions of his or her peers, and based on the actions of previous generations. A sense that getting off benefits and going to work presents a significant risk can transmit across generations and within communities.

Feelings of success that should be attached to getting off benefits and into long-term work, become tied in to the supposed security of benefits compared to work, and this preference is reinforced by the experience of generations and families. As Donald Hirsch (formerly of the Joseph Rowntree Foundation) has stated:

> *It creates the opposite of flexibility. If you are getting something and you have an opportunity to do something else, you are afraid of changing your status. That is particularly also to do with the difficulties we have in huge distinctions between your status when you are working and not working.*[49]

It is harder for people to assess the extent to which they will be better off in employment.[50] If individuals believe they will lose their benefits if they move into work, they will ignore the advantages of employment. In spite of policies having been focused on "making work pay", many claimants will express rightful concern about becoming worse off as a result of entering the labour market.[51]

In particular, as a result of confusion regarding eligibility rules, Housing Benefit has become a barrier to work, since people feel that it will be lost if even a small job is taken. The fear of losing it is the fear of not having a roof over one's head. It appears that even some Jobcentre Plus Advisers are unsure what happens to Housing Benefit when a job is taken.

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49 House of Commons Work and Pensions Committee, *Benefits Simplification: Seventh Report of Session 2006–07.*

50 Jim Bennett and Graeme Cooke (eds.) *It's All About You - Citizen-centred welfare* (IPPR, 2007).

51 Off the Streets and Into Work, *The costs and benefits of formal work for homeless people* (OSW, 2006).

> "Once we've got everything straight, you know, our Housing Benefit is paid and our Council Tax is paid, we don't really want to rock the boat very much. Because even when you just tip the boat...any little change, and all hell breaks loose. So most of us don't really want to mess things about that much."
>
> John, 25, Hackney (A4e client focus group, March 2008)

These complications can insert doubt in the minds of those who cannot afford to lose more money. Those with health problems fear for the implications for essential medicines. Those with children consider what will happen to them.

> *claimants value greatly security and stability in income. In particular, claimants with children do not want to put their children at risk of benefit changing or being withdrawn.*[52]

So we have a claimant unwilling or seemingly unable to change their situation. It is a position many welfare claimants find themselves in.

Case Study: Claimants calculating whether work pays

Lee started volunteering at Ecoactif, a welfare-to-work not-for-profit company, before being offered a job as a job-search assistant:

When I was offered the job at Ecoactif I looked into it, studied it hard, the only reason I took it – they were sure I was going to turn it down and remain in the voluntary sector – the only reason was because I believed the temporary housing was governed by the reasonable rent rate policy. A false belief led me to entering job. I'd never earned a penny in my life, I was always a no one. Sitting on benefits is so simpler.

It was April 2008 that they offered me a job. I thought being in temporary accommodation we'd still be entitled to the reasonable rent policy. Then they called me down to the council office and said, you have to pay £189 a week rent and £48 a week council tax. The actual rent was £336, so the council was paying half...I couldn't afford to pay that, I really couldn't – I was paying £400-500 a month, with debts [on top].

I walked away from work for a week – it was only through the kindness of people at work that I came back to work. I was quite prepared to fall back into drugs, back into my old lifestyle - I just didn't see how I was going to get out of my situation.

5.3 Reforming the burden of complexity

To conclude, we want the system to be empowering in its interactions with benefit recipients, thereby reducing the level of benefit dependency.

Complexity is not merely a procedural issue. It is a barrier to social mobility. It means that people become unnecessarily caught up in a system, feeling that

52 House of Commons Work and Pensions Committee, Benefits Simplification: *Seventh Report of Session 2006–07.*

they must protect their income; and it generates mistrust of employment. It makes the job for those trying to help people into work that much harder, when they must hesitate before answering truthfully whether a job is worthwhile.

The system itself has become part of the problem.

CHAPTER SIX
A Manifesto for Benefit Reform

6.1 The need for a new benefit framework

Our welfare state is in need of urgent reform. For many of those who rely on it, it stifles aspiration, and makes industry less attractive. It discourages behaviour which makes life better for individuals and their families.

Part I of this report has identified key areas of failure and corresponding objectives for reform. It has also drawn attention to the piecemeal manner in which benefit reform is usually conducted: without considering the cumulative effect of myriad conditions of different benefit regimes, both on incentives for the claimant and the overall predictability of the system.

In the following manifesto, we summarise the objectives and aspirations for a reformed benefits regime. It provides a direction, though we will not be able to achieve all these objectives fully in through one system. In Part III we will describe the trade-offs we make in developing our reformed benefits system.

The objective of the welfare system

Benefits should relieve poverty, while supporting work and independence, in a fair and affordable way.

6.2 A manifesto for benefit reform

We will measure success with reference to the following objectives:

Relieve poverty

We must support the weakest and most vulnerable people in our society, and ensure a respectable standard of living is accessible to all. It is our goal to minimise the numbers of households in earnings poverty, while simultaneously alleviating the financial situation for those who remain so.

A complex system will be used by fewer people than a transparent, elegant system. It means that many people who need welfare will not get it. We must deliver change while keeping a watchful eye on the cost to the public purse.

Reduce worklessness and earnings poverty

A welfare system should never discourage those who want to work, and can work, from doing so. The system should be more work-focused. Low earners should retain more of their wages, so that for those who can work, it is always preferable to benefit payments as a route out of poverty.

- Increase the rewards for entering work, especially for those on low earnings and low hours.
- Reduce in-work poverty.
- Increase the incentives for low-earners to earn more, by reducing the highest benefit withdrawal rates they face.
- Reduce the cliff-edge effect of withdrawal from passported benefits.
- Eliminate the hours rules in the benefits system, to reduce the thresholds and barriers to progression in work.
- Make child-care support more accessible, especially for those working fewer than 16 hours
- Create a supply-side reform for child-care.

Increase fairness and equity.

Those with low or no earnings should be treated more equitably, with fewer unfair situations such as the couple-penalty.

- Reduce the penalty against working couples, especially low-earning couples.
- Reconnect the second adult in a couple with job support and strengthen conditionality around out-of-work benefits.

Support positive behaviour.

We want the system to support the positive behaviours that protect against long-term poverty, such as savings, greater home-ownership, and avoidance of the incapacity trap where possible.

- Reduce the mortgage penalty for low-earning households.
- Over time, the savings penalty should become less stringent.
- Those with reduced benefits because of capital should still stay connected to the job market.
- Reduce the incentives to move to IB, and recognise the work capacity of claimants, rather than their incapacity.
- Those receiving benefits on the basis of incapacity should still have the same financial incentives to work as all others.

Reduce benefit dependency.

The welfare state should be a personalised, efficient service that works to protect and empower the poorest and most vulnerable people. All too often, claimants are faced with a dehumanised bureaucracy. We want the system to be simple and empowering in its interactions with benefit recipients, thereby reducing the level of benefit dependency.

- Reduce the number of benefits within the system as a whole.
- Eliminate distinct in-work benefits.
- Simplify the benefits system, with just one type of withdrawal mechanism, so that it transparently rewards those who make an effort.
- Reduce the problems of delays and backdating in the transition to in-work benefits – reducing the financial risks of entering work.
- Reduce the number of agencies administering benefit.
- Simplify the administration needed for both Whitehall and the claimant.
- 'Personalise' the system by offering the flexibility for bespoke incentive payments to welfare-to-work providers.

Increase value for money.
We must ensure the system is economically sustainable, and maintains public support. In addition, we want the marginal expenditure to be focused on reducing dependency, rather than increasing it.

6.3 The end of the static welfare state

Successive Governments have taken the original vision of the welfare state and stretched over it an impenetrable net of dependency and poverty from which it is very difficult to escape.

A claimant must listen to his or her advisers and make a judgement. As we have seen, advisers are hamstrung by the current system, in which it is actually irrational for an able person to work at all on low pay. Our benefits system systematises worklessness; puts barriers between families; and promotes imprudence.

Frank Field, MP, speaking ten years ago, drew attention to the pernicious effects which the benefits system can have on people's lives:

> *Of course, for many people, means tested benefits are a lifeline, rightly seized after what is often long periods of low paid employment. And other beneficiaries claim help and remain pure as the driven snow. But not all claimants by any means are in these categories. For them the rules are well known: do not work, and the state will look after you. Do not save, and the state will come to your rescue. Do not tell the truth, and the state will reward you with taxpayers' money.*[53]

This may seem like exaggeration. Yet it is impressive insofar as it is one of many passionate cries against complacency, in favour of necessary reform.

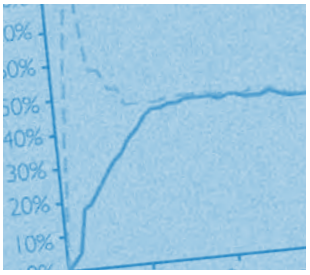
Where this part of the report has identified problems for claimants, Part II proposes a new way of thinking about the benefits system. It makes the case for dynamic design: using simple, human behaviours to predict the true effects of economic reform. Dynamic modelling is the means to more efficient

53 *What Then Was Unthinkable*? - Lecture delivered to the Christendom Trust, December 1, 1998

policymaking – allowing us to make informed trade-offs between different aspects of reform. It gives the design for tools that enable us to pick through this seemingly impassable minefield of contradictions.

In Part III of this report, we will show how these objectives can be achieved within the budgets currently available for welfare reform.

PART II: BETTER BENEFIT DESIGN



Chapter 7: The Dynamic World View

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Chapter 11: Why We Need the Dynamic Welfare State

CHAPTER SEVEN
The Dynamic World View

Part I analysed the current benefits system and proposed a wish-list of objectives for reform. We also showed that, historically, the development of benefits has been piecemeal, with little consideration given to the overall effect of particular reforms. The effect is a highly complex system which gives people little incentive to work and earn more.

There is a better way. Part II presents the Dynamic Benefits model, and the instructions to operate it.

The static world view is interested only how much money is given to which groups, and how much better off those groups will be. This is important, but it is only one part of the picture. People change their behaviour in response to changing circumstances. A dynamic approach to benefit reform does not just recognise this abstractly, but accounts for it fully in the design of the system. It repudiates guesswork for empirical evidence.

Part I described the very high marginal tax rates and participation tax rates that accompany low-paying and part-time work – rates that are far higher than for those further up the income scale. For some time, it has been considered a difficult problem of policy that a claimant's loss of benefits as he takes up employment creates a disincentive to work – though few historically have realised the full extent of the disincentives, or considered their role in perpetuating dependency.

That is not to say that dynamic modelling has been unheard of. In the past, dynamic models have been used to examine the impact of tax regimes on higher earnings in an economy; and the Institute for Fiscal Studies provided this Government with an early version of a dynamic model in the early 2000s, though there is little evidence of it having played a major role in decision-making. Dynamic modelling has not been used to consider the effects of marginal tax rates at the lower end of the income scale; nor, crucially, has it been used to predict whether some arrangement will discourage people from entering into work.

Dynamic models measure the change in incentive structure that comes with a particular reform – in our case, the changes in PTR or MTR – and combine it with empirically observed measurements of how people respond to these incentives. The key advance of our model is that, using the latest econometric research, it combines responses to both MTRs and PTRs. This is wholly new.

Dynamic modelling allows us to understand whether a particular change to the benefits system will encourage or discourage people to work or earn more. It provides a more realistic idea of the costs of the system, and also what the

effects will be on tax revenue and national income. We decide what outcomes we want; and the model tells us what the system should look like.

The power of our dynamic model calls for new objectives – or rather, more precise objectives. Some of the traditional ways of defining objectives for welfare reform have entrenched problems: ignoring, for example, the superior value of a pound earned to a pound received in benefits, both to an individual and their family and community. We bring together the insights of economic analysts who have highlighted the importance of dynamic models, but mostly applied them to optimising a more abstract concept of social welfare (see chapter 9), and those insights of policy-makers who know the importance of earned income and employment.

With greater clarity of objectives and a better tool to realise those objectives, comes a need for greater discipline in design. Achieving one set of objectives absolutely may preclude another set of objectives, or offend against broad conceptions of fairness. In addition, we will show that whatever objectives one has for a benefits system, and whatever model one uses, there are necessary trade-offs and certain fundamental constraints on what can be achieved.

Dynamic modelling provides an entirely new set of tools with which to assess policy impact and efficiency, both economically and socially. The case for the Government to adopt dynamic modelling is the case for a benefits system that is based on the most up-to-date economic methods to understand the effects of previous policy and create better policy for the future, from both an economic and a social perspective.

Outline of Part II

Over the course of Part II we will expand the possibilities of the dynamic world view to provide entirely new critiques and metrics for assessment of current economic and social policy. We chart in three stages the way that a dynamic model can be combined with a sense of the good, in order to deliver a better benefits system.

- **The principles of dynamic modelling:**
  The key concept which allows for the creation of a dynamic model is an understanding of how individuals' work decisions respond to taxes and benefits. Measuring and quantifying these decisions has been the focus of an increasing amount of academic study in the UK and recent work which has focused on the decision of whether to work has provided the key to our Dynamic Benefits Model.
- **Objectives and choices**: A dynamic model is a tool. It can quantify the trade-offs between tax and the structure of the benefits system, between national earnings, and distribution of earnings. However, it cannot recommend an optimal tax and benefits schedule without clearly defined objectives for reform. Once we have the model, the next step is to articulate the social objectives of the combined tax and benefit system more precisely than has been done to date. These objectives are fed

into the model, and the outline of an optimal tax and benefits structure emerges. Later, in Part III, we will feed more specific proposals back into the model, to see how we can achieve the optimal result from the starting point of the existing system.

- **Framing the benefits system**: There are constraints on what a tax and benefits system can achieve. In some cases we may want to prioritise certain objectives rather than others, clear in the knowledge of what we are sacrificing. There are also intrinsic constraints on the precise configuration of cost, generosity, employment incentives and work incentives: some combinations are not possible.

Ultimately, we offer the principles of better benefit design to Government and policy-makers: agree or disagree with our objectives, but dynamic modelling must be the guiding principle for reform of the benefits system.

CHAPTER EIGHT
The Principles of Dynamic Modelling

Key Conclusions

- Dynamic models reflect how people respond to changes in taxes and benefits - they therefore provide a much more accurate economic picture than static models, which do not. Government has been slow to adopt them for this purpose.
- People's behaviour is not influenced by income tax alone, but rather by how much of each pound earned is taken away through a combination of taxation and benefits withdrawal: this is the 'true' tax rate on low earners.
- Participation tax rates – the overall proportion of income taken away – play an important role in determining the number of households in work, especially for low-earning households.
- Marginal tax rates – the proportion of the last pound of earnings taken away – play an important role in determining how much those in work will earn.
- A dynamic model of the benefits system will allow us to design a benefits schedule that will deliver our objectives in an effective and predictable way.

A simple way of understanding dynamic modelling is as follows. When thinking about benefits reform, we can take one of two theoretical approaches:

- We could assume that, when confronted by a change in benefit rules that causes a change in their financial position, people will not reassess their decisions or rearrange their affairs. This type of assessment is called ***static modelling.***
- We could assume that, when confronted by a change in benefit rules that changes their financial position, people can and will reassess their decisions and rearrange their affairs. This type of assessment is called ***dynamic modelling.***

8.1 Why dynamic benefits?

The first reason to take dynamic modelling seriously is that it makes intuitive sense. It reflects reality better than a static model. In this case, the 'dynamic' element gauges how financial incentives affect people's decisions. It is important because, in the benefits system, decisions about work and other arrangements are directly linked to financial gains and losses. Changes in the rules and amounts of money will therefore change some people's behaviour, especially those who are most dependent on benefits for their income.

Being able to model the effect of these changes is crucial to successful benefit reform. Institutional design is a complex endeavour; institutional re-design even more so. The welfare state is a complex system and, as with any complex system, reform will produce a broad range of personal and social consequences for those who depend upon benefits.

Dynamic modelling accounts for, and allows us to map, the way that the structure of the benefits system affects some of the decisions of those in the system, and so allows us to understand more clearly the consequences of reform. Moreover, it allows us to compare different reform proposals in a meaningful way. This is a very worthwhile tool for policy-makers.

Throughout sixty years of the welfare state and its reform, such accounting and mapping would have been a painstaking and unenlightening process. As such, with each successive reform, the attitude has been to 'wait and see' what happens, with little understanding of the consequences that would flow from reform. So arises the second reason to take dynamic modelling seriously: because it inaugurates a shift in the welfare state that starts with a culture-shift in Whitehall. There is no room to hide from the consequences of inertia or bad policy.

The third reason for dynamic modelling is cost-effectiveness. By accounting for claimants' life-decisions, dynamic modelling allows us to estimate the fiscal impact of benefits reform with far greater accuracy than at any time previously. This will enable us to make investments where the social returns are greatest, and where the benefits of job-creation produce fiscal returns. This is vital in recessionary times: if applied effectively, it will help us to emerge from the recession with a stronger society.

If we want to reform benefits in a way that is not counterintuitive, with reforms that do not create or exacerbate harm and with consequences that do not remain unseen or ignored, we must get to grips with the dynamic world view. As such, this chapter will focus on the concepts that underpin dynamic modelling.

8.2 Basic dynamic modelling

A dynamic model allows policy makers to see what reforms will do to the economic landscape, now and in the future.

Government policy often involves identifying a group of claimants who have less money than others, and directing funding their way. The end goal is to make a particular group financially better-off by the amount of money transferred. It is a static approach to welfare. The dynamic approach, by contrast, takes into account the consequences of this transfer, such as high marginal tax rates, decreased incentives to move into work and reduced social mobility that results. We need to understand what this will do to the people affected by the relevant benefit rules, and how the system relates to an individual claimant.

Under the static world-view, assessing the financial impact of different options is straightforward. People are assumed not to alter their behaviour as a result of reform; sections of society do not make different decisions if their taxes and benefits are altered. Policy is relatively easy to devise, a matter of shifting money to various groups.

Private sector analogy: price cuts vs. price rises

Consider the price of apples in a supermarket.

With the static world view, one would assume that if the price of apples increased, people would still buy just as many apples as before. We know this is not true. While price may not be the only – or even the main – determinant of how many apples are bought, all supermarkets know that if they increase the price of apples, they will sell fewer apples.

With the dynamic world view, if the price of apples increased, we would account for the fact that some people would choose to buy pears or oranges instead - or indeed may not buy any fruit at all - when forecasting the number of apples that would be bought and sold at the margin.

Just as the price of apples is not the only determinant of how many are sold, the withdrawal rates may not be the only determinants of how or why people choose to work. However, changes in the benefits structure will undoubtedly lead to people who are at the margin of working and not working to choose to change the amount they work. If the reward from working that next hour has decreased, making the effort to work has become more expensive.

Say that the supermarket stocks both apples and pears (unfortunately no other fruit is available), and that the price of pears drops. This will give people a reason to buy pears instead of apples. We would expect more pears and fewer apples to be sold than before the price drop.

The same principle applies to thinking about working or not working. If we increase the generosity of out-of-work benefits, we make them more attractive relative to work. We should expect, on the whole, fewer people to work, and more not to work than was the case previously.

Let us take this farther. Suppose that the supermarket sells 1,000 apples for 10p each, and makes a profit of 5p on each apple, giving us total sales of £100, and a profit of £50. What if the supermarket wishes to assess the impact of increasing the price of an apple to 11p, thus increasing the profit to 6p per apple?

With the static world view, we would assume that the supermarket would still sell 1000 apples, leading to total sales of £110, and profit of £60. Using this approach, raising the price seems like a very good idea for the supermarket.

However, using dynamic modelling, the supermarket would realise that if they raised the price by 10%, they would see some decline in the volume sold. If this decline was 25%, they would only sell 750 apples at 11p. This would lead to sales of £82.50, and profit of £45.

Here, dynamic modelling would suggest that is better to reduce the price of apples, in order to maximise profits. When determining the withdrawal rate for benefits, the same considerations apply.

However, in the real world millions of people will make different choices when their financial situation is changed. Dynamic modelling reflects important decisions which balance minute considerations of economic efficiency and social justice. Changing one group of claimant's income in-work compared to out-of-work by a few pounds can make all the difference to a claimant within that group. The manner in which this is done can be very significant on a wider scale. It is thus all the more important that it is well understood.

> "... if one is to design a tax and benefit system with some element of optimality one needs to know how individuals react to taxes and benefits."
>
> Meghir and Phillips[1]

8.3 Responding to incentives: which incentives, and how do people respond?

8.3.1 A QUESTION OF EARNINGS AND EMPLOYMENT

There are many ways in which the structure of a benefits regime influences the life-decisions a claimant will take. There a large number of aspects of the system that could be changed, and many different effects that we could model. We will focus on those that pertain to earnings and employment.

Our goal is to encourage those who are unemployed or under-employed to work or work more. So we need to analyse how the benefits regime influences two major life decisions:[2]

1. I am unemployed: should I take the decision to get back into work?
2. I earn £X per week. Should I take the decision to earn more by working more hours, or moving to a higher paid job requiring more effort, or perhaps taking on a second job?

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1 Costas Meghir and David Phillips, *Labour Supply and Taxes* (IFS, 2008).

2 There is a third decision that may be relevant to the decision to work or work more: the return from capital compared to earnings. Other than the impact of means-testing on savings, this is not a major consideration for those in whose lives the benefits (as opposed to tax) system plays the major role.

> "... welfare is a most powerful agent for shaping behaviour – for good or ill – and politicians ignore this elementary fact at enormous cost to society at large."
>
> Frank Field MP[3]

Our analysis suggests that there are three measurements that inform these two decisions. Understanding these three measurements helps us understand the way that dynamic modelling works in practice. They are:

- Marginal tax rate (MTR): On the next £1 earned, the amount that would be withdrawn through tax, NI or reduced benefits. MTRs drive decisions around whether or not to work harder to earn more.
- Participation tax rate (PTR): The overall proportion of gross earnings lost through tax and benefit withdrawal. PTRs drive decisions around whether or not to work at all.
- Level of net income: In particular levels of benefits.

For a fuller explanation of the MTR and PTR please refer to section 3.2, and Appendix C for a discussion of the income effect.

8.3.2 BENEFITS AS WELL AS TAXES

> "Policy analysis requires one to consider the incentives implied by the entire tax and benefit system as an integrated whole."
>
> Meghir and Phillips[4]

As we will see in the next section, there is now a wealth of empirical evidence showing how people respond to these incentives. But we need to draw out what determines these incentives for those in low-income.

Much of the analysis on the number of people who contribute to an economy has focused on above-average earners. It has concentrated on estimating wage elasticities, accounting for tax and national insurance rates. As such, it has focused primarily on the effects of taxes. It did not account for the receipt and withdrawal of benefits, nor for the costs associated with working. These factors are hugely implicated in the size and security of income for low earners. We saw in Part I that when it comes to the psychology of claimants in their assessment of the journey from welfare into

3 Frank Field, "What Then Was Unthinkable?" in *The State of Dependency - Welfare Under Labour* (SMF, 2000).
4 Costas Meghir and David Phillips, *Labour Supply and Taxes* (IFS, 2008).

work, benefit withdrawal and taxation are combined in their conception of the barriers to work.

For those in receipt of means-tested benefits, as they earn more they will not only pay more tax, but will also have benefits withdrawn. This is equivalent to an additional tax on these earnings as it similarly reduces their total disposable income. And the incentive to work is reduced as much by losing benefits as by paying taxes.

In fact, the net disposable income for a low-earning individual depends on four principal factors:

- Their wage;
- Plus the receipt of any benefits for which they are eligible;
- Less payment of tax and NI;
- Less the costs associated with working (child care, transport etc).

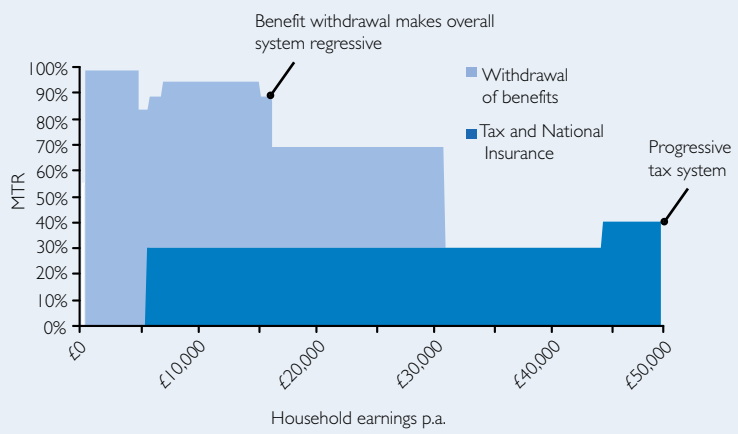
To take an example, suppose Ally will be taxed at 100% if she earns more. She would clearly have no financial incentive to work more. Similarly, suppose a benefit was deliberately targeted very tightly on a group of low earners, such that earning an additional £10 causes Beth to lose £10 of that benefit. Beth too has no financial incentive to work more. This is less transparent than the first scenario, but the disincentive is just as real.

The highest earners alter their behaviour to minimise tax liabilities; so too will those at the lower end of the income spectrum, albeit in different ways. If an economic incentive is in place for the poorest members of our society to move into work, there are strong prospects for long-term gain.

From the point of view of maintaining financial rewards from work, there is no difference between taxation and benefit withdrawal. Accepting this, we note further that while the current Income Tax and National Insurance schedule

Figure 8.1 The tax and benefits system can be regressive even the tax system itself is progressive

(Average MTR for couples with two children)



leads to progressive MTRs – higher earners lose more of their income – the combined tax and benefits system has a very different (and regressive) shape: Our modelling process explicitly combines tax paid and benefit withdrawal rates at each point in the earnings distribution.[5] When we use our model to explore the optimal marginal tax rate, this is the combined rate of taxation and benefit withdrawal.

There are three commonly stated arguments as to why benefits should be withdrawn at a higher rate than taxes, and these should be considered:

1. *Many argue that it is important to make the distinction between withholding of tax, and withdrawal of benefits. Benefits are given to claimants, whereas tax is taken – and the withdrawal of benefits at a high taper rate is therefore 'fairer' than the withholding of tax at an equivalent rate; as in some respect, the benefits are being 'paid back' to the State.*

It would be disingenuous to suggest that an MTR is precisely the same thing as tax paid and received by the Government. Of course it can be argued that it is legitimate to withdraw benefits at a higher combined rate for those just paying taxes. Hence in nearly all societies, taxes and the withdrawal of benefits are separated. That is not to say that the administration needs to be separate, but just that the schedules tend to be kept distinct.

2. *Benefits can be interpreted as a 'cost' that needs to be contained. High withdrawal rates on benefits appear to keep costs down and focus payments where they are needed most: at the bottom end of the earnings' scale. Support is given to fewer people. This 'affords' increased generosity to those who are most in need of support.*

However, with a dynamic perspective, in many cases this can be seen to be a false economy:

> *To say that transfers should be limited to the poor is just a nice (and perhaps inadvertent) way of saying that, as one moves past the poverty line, one should have little if any incentive to work and retain little if any of the net reward if one does work.*[6]

Costs and claimant numbers will vary with the withdrawal rates and the level of out-of-work benefit. There is a saving to be made that far trumps such savings if the dynamic effects of the welfare system are understood. We can maintain generosity at current levels while also increasing withdrawal up the pay-scale to end the work disincentive – but only if we think in terms of the aggregate effect of withdrawals and tax.

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5 This is the same approach as used by Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings,* (IFS, 2008)

6 Daniel Shaviro, *Effective Marginal Tax Rates on Low-Income Households* (Employment Policies Institute, 1999).

3. *It is argued that reduced withdrawal rates will lead to more people, and higher earners, receiving state support, which could be seen as a negative social outcome (see Chapter 9). It is argued that the role of the Government is to reduce the numbers who are supported by benefits. As a result, benefits are rarely thought of as an instrument of progressive redistribution (at whatever level one thinks desirable) across the entire income spectrum.*

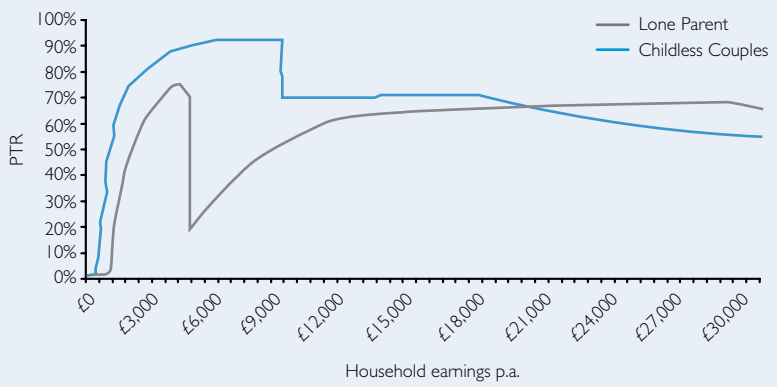
A system in which many people both pay taxes and receive benefits is to be guarded against, and clearly some systems will be unsustainable if too many people are receiving benefits as well as paying taxes. However, this is not really an argument against the importance of considering taxation and benefit withdrawal together: rather, it underlines that any system will require trade-offs – as we explore in Chapter 9 – in this case between ensuring that there is some incentive for all, and maintaining high incentives for middle earners. The issue is best addressed by increasing personal tax allowances, so that more benefits can be withdrawn before tax is withheld.

The reality is that if taxes and benefits were combined there would be much greater political pressure to reduce marginal tax rates, as their regressive nature would be exposed for all to see.

8.3.3 WHO YOU ARE AFFECTS THE DECISIONS YOU MAKE: ELASTICITIES

We have used the concepts of PTR and MTR to describe the size of the incentives to work or to work more. We have also seen that they can be higher or lower at different points on the earnings scale, and also for different types of people at the same point on the earnings scale. Figure 8.2 below shows typical PTRs faced by lone parents and childless couples (see Appendix A for further illustrations.)

Figure 8.2 PTR profiles for lone parents and childless couple households



What we have not done yet is to show how people respond to those incentives. How much more likely is someone to work an extra hour, if that extra hour earns them £20 compared to £10? Would more single parents work an extra hour for £10 than singles with no children?

Everyone is different; motivated and inspired by different things. But, most of the time, all other things being equal, people will respond to financial incentives. Economists call the factor that determines the size of this response the **elasticity**. The more 'elastic' someone is, the more likely they are to respond to incentives.

It is impossible to find an elasticity for every individual: however, if we observe millions of people, patterns emerge. We can then split the population into various (large) groups, and find elasticities for each group. For this purpose, we have been able to draw upon a wide body of literature.

Definition: Elasticity

Elasticity is a measure of how responsive people are to incentives.

One way of thinking about elasticity is as follows. Suppose we had a population of 1,000 unemployed single people, each receiving £100 per week income from benefits. Each one is considering taking up work that would result in a new net disposable income of £120 per week.

- If only a few individuals considered an increase from £100 to £120 sufficient to be worth going into work, we would describe the population as having a low elasticity to net disposable income.
- If most of them took the decision to take the job, we would describe the population as having a high elasticity to net disposable income.

An elasticity equation is a key component of a working dynamic model.

Labour elasticities have been researched since the 1970s. Many models have simulated the effects of various factors on decisions about work and the changes in earnings required to stimulate those decisions.

The Institute for Fiscal Studies has synthesised results from a number of different sources to create a rich picture of how changes to marginal and participation tax rates will impact behaviour for a diverse range of claimants.[7] The IFS work has linked marginal tax rates to earnings elasticities (how the MTR influences decisions to work more or less) and participation tax rates to employment elasticities (how the PTR influences out-of-work people to take jobs at different earnings levels).[8] The focus on employment elasticities and the recognition that they are quite different from earnings elasticities are key features of this new work. These studies have yielded a mine of information on elasticities, and elicited some interesting nuances about the impact of financial incentives to work:

7 Stuart Adam, *Measuring the marginal efficiency cost of redistribution in the UK* (IFS, 2005).
8 In technical literature these are referred to as work participation responses or extensive responses.

- The most significant observation has been that employment elasticities are higher than previously thought, especially for low earners. (See Appendix D):

> *The decision whether or not to work by low education men is somewhat more responsive to incentives than previously thought ... the number of people working among the low skill[ed] can be very sensitive to the design of benefits and tax credits.*
>
> Meghir and Phillips[9]

This result means that the optimal participation tax rate for low earners is significantly lower than had been previously thought.

- A change in withdrawal rates is more likely to cause a claimant on lower earnings to enter or leave work altogether, than to seek to change earnings, while the opposite is true for a higher earner.
- For individuals with high earning potential, their employment elasticity is very low, as the tax burden is unlikely to affect whether or not they work. However, for the same people the earnings elasticity is substantial. Therefore, MTR is likely to have a strong impact on the amount they earn.
- Not everyone at the same income level has the same participation elasticity. Women, for example, have been observed to be more 'elastic' than men.[10] There are also interesting differences between the decisions of the second worker in a household and those of the first worker. The empirical literature has shown that the labour supply of secondary earners is more responsive to taxes than that of primary earners.[11] These factors may be related.
- For some groups, such as women with young children, taxes and benefits can affect the decision of whether to work or not, as well as how many hours they work. For other groups, such as unskilled men, tax and benefit incentives are important, but only for the decision to participate in work; their hours of work are relatively insensitive to changes in taxes and benefits: these men either work full-time, or do not work at all, with some 25% choosing the latter option.

Figure 8.3 below shows the average individual's earnings and employment elasticity over a range of earnings.

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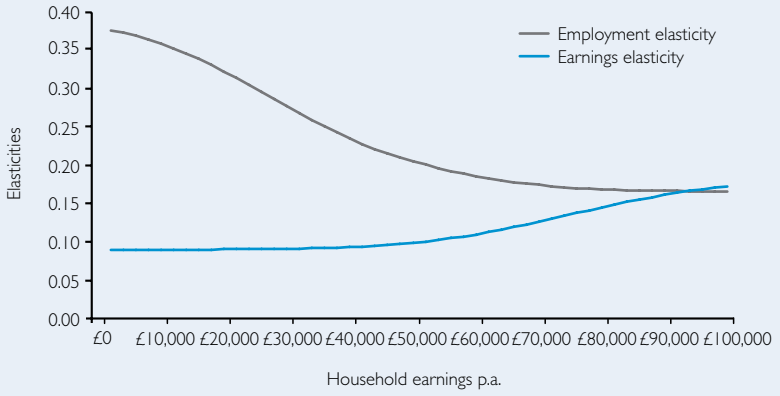
9 Costas Meghir and David Phillips, *Labour Supply and Taxes* (IFS, 2008).

10 See, for example, Costas Meghir and David Phillips, *Labour Supply and Taxes* (IFS, 2008); and Michael Boskin and Eytan Sheshinski, *Optimal Tax Treatment of the Family: Married Couples* (NBER, 1984).

11 Costas Meghir and David Phillips, Labour Supply and Taxes (IFS, 2008); Richard Blundell and Thomas Macurdy, "Labor supply: A review of alternative approaches" in O. Ashenfelter & D. Card (ed.), 1999. "Handbook of Labor Economics" (1999).

Figure 8.3 Average earnings and employment elasticities



An optimal benefits system will account for the relative differences in responsiveness to MTRs and PTRs along the earnings distribution. The higher employment elasticity among low earners suggests it is better to have low participation tax rates for low earners. Likewise the higher earnings elasticity for high earners suggests they should have low marginal tax rates.

When quantifying the impact of reforms we must account for these differing elasticities for different groups in the population. However, when designing a system, it will not be possible to take advantage of all these differences in elasticities (we cannot, after all, have different tax schedules for men and women).

Furthermore, there is still much further work to be done in quantifying longer-term earnings and employment elasticities across more detailed substrata of the population. This would be a very valuable focus of future research.

8.4 The Dynamic Benefits Model

We have identified the key components of our model: marginal and participation tax rates for different groupings, and the related elasticities. We now introduce the Dynamic Benefits Model.

This report evaluates incentives using a dynamic worldview, and attempts to capture behavioural changes resulting from changed incentives. This required the development of a dynamic tax and benefit model at the level of individual households.[12]

The Dynamic Benefits Model tells us how people change employment status and earnings levels in response to changes in taxes and benefits.[13] This enables us to compare the success of policy options against both social and fiscal metrics. From a social perspective we can look at the net impact of a system

12 See Chapter 1, n. 18.
13 Some models allow hours to vary, but we only vary taxable income.

change on employment levels and the number of workless households across households with various characteristics. From a fiscal perspective we can look at the net cost after accounting for any increase or decrease in the value of benefit claimed and any increase or decrease in tax revenue. It also allows us to estimate the change in total national income.

This model predicts the marginal changes to employment and earnings over and above a base case. Clearly there are many factors beyond the tax and benefits regime that influence levels of employment and household earnings (for example, the state of the broader economy).[14] This model does not seek to capture all of these drivers. It measures the impact of changes in withdrawal rates from a base case of employment and earnings levels. Therefore, as a starting point, we believe this model to be a good first order representative of what might happen in any economy (and certainly much better than a static model), but future refinements are welcomed.[15]

The key advancement of the Dynamic Benefits Model is that it incorporates both the earnings and employment responses. As we explain in Chapter 10 below, most models looking at the effect of tax and benefits on work have only considered earnings responses – how the amount of work people do is affected by tax and benefits – not whether those not working choose to enter work. Our model looks at both. It does not ignore the important decisions that people within a certain benefit regime make about the decision to work (or not), but instead accounts for them. (See Appendix D for further discussion.)

No comparable model exists.

This is either because dynamic modelling is still in its infancy regarding policy formulation, or because Government has simply been slow in keeping up with advances in this area.[16] Previous studies have recommended that a dynamic model should be developed for the evaluation of tax and transfer programmes. However, no useful model has emerged.[17] A recent IFS paper for the Mirrlees review noted:

> *There are very few empirical studies of optimal tax systems that incorporate intensive [earnings] and extensive [employment] responses… one approach [to optimal taxation] ... would have been to use an optimal tax model that allowed for intensive and extensive responses to solve for the optimal schedule.*[18]

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14 The goal of these proposed reforms will be ensuring that worklessness is reduced as fast as possible, as the economy recovers – in contrast to the pattern after previous recessions.

15 There is also scope for longer-term and more finely-grained elasticities – especially to differentiate the responsiveness of younger households compared to older ones.

16 The Bank of England uses a model to better predict the UK economy, interest rate changes and inflation effects, but this is a far wider level than the personal tax and transfer model detailed here.

17 Tax Reform Commission, *Tax Matters: Reforming the Tax system*, (Tax Reform Commission, 2006), p. 21 and Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings*, (IFS, 2008), p. 27.

18 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings*, (IFS, 2008), p. 27.

8.4.1 HOW DOES IT WORK?

The model takes a representative sample of today's working population at a household level. For a given proposed tax and benefits regime, it calculates the MTR and PTR for household type groupings before and after the change in structure. The differences in MTR result in an adjustment in earnings based on the elasticities for those household groups. The differences in PTR result in a change in the number of households in work. The model also calculates the cost implications of the new distribution in terms of benefit expenditure and tax revenue.

We use the elasticities and calculations outlined in the report by Stuart Adam to determine the impact of changes in withdrawal rates.[19] As an example, lone parents have high employment elasticities (0.45) for the lowest earners. PTRs for lone parents working fewer than 16 hours per week are approximately 75%. If this were reduced to 65%, then we would expect to see up to 15% more lone parents engaged in this pattern of work. These elasticity calculations are described in more detail in Appendix D.

In common with other tax and benefit models,[20] the underlying population data used is from the Family Resources Survey (FRS).[21] This is an annual survey which includes 24,000 working-age private households and through a detailed interview gathers information on social characteristics of the households, such as the number of children, work status, and benefits received. The FRS does not itself measure household income: this is done through matching FRS households with households identified in the Households Below Average Income (HBAI) survey.[22] (The surveys are designed so that individual households can be matched.)

The Dynamic Benefits Model uses a number of key household characteristics derived from these surveys, such as the number of children, adults and wages to characterise the distribution of employment and earnings levels in the sample (before and after the change).

Key household characteristics used to describe distribution of employment and earnings:

- The number of adults in work;
- The earnings of each adult in work;
- The different benefits entitlements and levels;
- The Income Tax, National Insurance and VAT paid;
- The MTR & PTR levels;
- The net government transfer to each household (benefits minus all taxes);
- Income of household;
- Child poverty level.

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19 Stuart Adam, *Measuring the marginal efficiency cost of redistribution in the UK*, (IFS, 2005).

20 Notably TAXBEN of the Institute for Fiscal Studies; or PSM (DWP), or IGOTM (HMT/HMRC), or POLIMOD or EUROMOD (ISER).

21 Our model is based on data from 2005-06 FRS. Delays in the release of the 2006/7 FRS meant that we were unable to use when we began our modelling. See Chapter 1, n. 18.

22 We relied on data from the 2005-06 HBAI – see previous note.

In the interests of brevity, in this chapter we have limited ourselves to a very general description of the Dynamic Benefits Model. Appendix D describes the equations and the various elasticities that comprise the Model.

8.4.2 OUTPUTS

The Dynamic Benefits Model tells us how any given change to the structure of the benefits system affects different households, according to the following measures:

- Winners and losers from the change: whether a particular grouping is directly better-off or worse-off (a static measure);
- Changes in MTR and PTR levels;
- Change in employment, earnings, and income (both individuals, and households);
- Change in poverty levels;
- Change in benefit payments and tax receipts.

Based on the impacts on individual households, we can scale up to the entire population to determine the national impacts of changes, particularly with reference to:

- Net cost to Government (for example increases in total cost of the system and savings in the form of greater tax receipts);
- Change in total national income.

The model allows us to change any of these variables and see what would happen to the others. For example, it can predict the effect of a policy which aimed at ensuring that no families with children were below the poverty threshold: indeed, this is the Government's existing child poverty target, and we will use it as an example throughout the following chapters.

8.4.3 VALIDATION/METHODOLOGY

In order for the model to be sound, it must capture all of the different employment and earnings behaviours that result from changes in the benefits system. Following the approach taken by the Institute for Fiscal Studies as part of the Mirrlees review, we have constructed a set of formulae to capture these behaviours based on the same elasticities used by Brewer, Saez and Shephard.[23] (For further information see Appendix E).

In designing our model we were grateful for the advice of Mike Brewer, Director of Direct Tax and Welfare at the Institute for Fiscal Studies, and a

23 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings,* (IFS, 2008)

contributor to the Mirrlees review of taxes, benefits and labour supply.[24] Mike met frequently with CSJ researchers to discuss the details of our methodology and, in particular, how to reflect the likely impact of tax and benefit changes on decisions whether and how much to work. However, the IFS has not been able to assess our specific results, primarily because this model is unique, and so this should not be taken to imply that Mike or the IFS necessarily agree with our specific results or policy conclusions.

8.5 The opened door

In the past, policymakers have neither had the tools to develop a unified benefits policy, nor the ability to accurately predict its effects. As a result, policy has prompted changes in people's decisions that have rarely been completely aligned with the policy-makers' original intentions. High quality dynamic modelling can reconnect the well-intentioned goals of the policy-makers to the actual effects on society and plan for what were previously unknown or unintended consequences.

However, real social transformation can only take place if we harness the benefits of dynamic modelling to the end of improving society. Having the power to predict more accurately the effects of our reforms will force policy-makers, as it has forced us, to be clearer about the ends that we are pursuing. It is this choice of objectives to which we now turn.

We will show that being precise in our choice of objectives affects greatly what the model recommends. We will also show that certain objectives will necessarily conflict and that there are moreover fundamental constraints on any objectives that one might choose.

24 James Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles and James Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press, forthcoming).

CHAPTER NINE
Objectives and Choices

Key Conclusions

- We need to establish clear and attainable objectives for reform, and face up to their full implications.
- We must recognise that we are trying to achieve several – often conflicting – goals. Any approach based upon simplistic, monolithic objectives has serious conceptual and practical drawbacks.
- To be effective, the objectives need to be not too narrowly targeted, and must be aligned with other social objectives and policies.
- We must recognise that employment and earned income are social goods in and of themselves.
- Hence, our proposed objective is to maximise the number of working-age households with at least one member in work, while ensuring all households receive a fair minimum income.

A system of taxation and benefits can do many good things, but not all of them at the same time or to the degree we would wish. In Part I, we outlined our overall objective: to build a benefits system that relieves poverty, while supporting work and independence, in a fair and affordable way. The specifics of this vision now need to be worked out, and inevitably there will be trade-offs between how far each goal can be achieved.

We have to make choices between possible objectives for our system, and we have to assign priorities to each. These choices must be conscious and explicit, if they are not to be inconsistent or to infringe real and important constraints: the analysis cannot happen, nor can it inform our choices, if our preferences are not clear.

Much is at stake for those who receive benefits, and for those who pay for them. Furthermore, the tax and benefits system is central to people's emotional and ideological conceptions of a good society. It is not surprising, then, that politicians have tended to express their objectives for the welfare state in broad, inspirational terms. This has never been clear enough to allow meaningful study of its effectiveness.

Brewer, Saez and Shephard have highlighted a common aspect of political discourse in this vital area.[1] One type of policy-maker will rarely state

1 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings* (IFS, 2008), provide more complete examples of this.

explicitly that he has little taste for income redistribution, but will argue that the adverse responses to the high taxes and generous benefits are large (but without quantifying this effect). Another type of policy-maker will emphasise the redistributive virtues of benefits, and will assume that the high tax rates needed to fund the redistribution will result in a negligible adverse response, again without explicitly quantifying this effect.

The predictive power of dynamic modelling forces us to be very clear, since it tells us many of the important knock-on effects of different policies. For example, we want to strengthen family life and make the benefits system fairer to couples: our model will tell us that different ways of doing this will affect overall work-incentives and affordability in different ways. The political process of making choices for a benefits system and the analytical process we describe in these papers will be greatly enhanced, if the choices at every level are explicit. Clarity is not all, however. In this chapter, we use the Government's Child Poverty target as a case study, to examine the resulting requirements and consequences of a clear policy objective.

The first section demonstrates the need for very clear objectives, by examining some of the objectives which academic analysts have historically chosen. We argue that these objectives need to be refocused to reflect clearly desirable outcomes. Clarity must then be supplemented by discipline in teasing out where different objectives may clash, and acknowledging that there are limits on what can be achieved using only the tax and benefits system. These intrinsic constraints are the subject of Chapter 10.

We do not expect that every reader will agree with our objectives, but we do hope to convince that clarity and discipline, and facing up to necessary consequences, are essential if we are to have a unified benefits system.

9.1 Clear objectives

The tax and benefits system is, in essence, a tool for redistributing wealth. Academics and philosophers have long argued over the objectives of redistribution. Should the purpose of redistribution be to promote equality of income? Or to make sure that the worst-off in society have as high an income as possible? Ultimately, each of these positions can be represented by an income distribution pattern across society, also referred to as a **social welfare function.**

Since the 1970s, academic analysts have been using dynamic models to design tax systems which best achieve these objectives. They have understood that different marginal tax rates will have incentive effects on how much people work and earn, and have incorporated this into their models. However, they have focused on the optimal distribution of income, assuming that it did not matter whether that income was earned or received through the benefits system. Under these assumptions, £100 of benefit income has the same value as £100 of earned income. Indeed, as we will show, under some assumptions that have been used the benefit income brings even greater social good than

earnings, because a person has a greater quantity of personal 'leisure time' (because they do not have to spend their time working).

We said above that the goal of the benefits system is to redistribute wealth. But fundamentally, different social welfare functions are different ways of promoting **utility**. Crudely speaking, utility is the amount of happiness or benefit someone gets from a particular arrangement. It is traditional for many analysts and philosophers to use a combination of income and leisure as a proxy for utility. Income approximates to utility, on this understanding, because more income means more freedom to choose and buy the things that will make one happy.

This approximation, though it may seem very technical, is one of the key reasons that the tax and benefit system keeps people out of work and in earnings poverty.

Section 9.2 describes various distribution objectives, and outlines the broad shape of the tax and benefits system that would be required to achieve each, when using income as a proxy for utility. Section 9.3 reviews this approximation, and shows how subtly different characterisations of utility result in systems with quite different incentive structures. A step-by-step analysis of these utility characterisations leads us to formulate our own distribution objectives, focusing on income in preference to 'leisure' for those without work, earnings in preference to other forms of income, and a distribution of earnings among households in preference to minimising the number of households in receipt of benefit.

9.2 Patterns of utility distribution

How do we ascribe a preference to a distribution of social outcomes? In an early review of optimal tax models, Cooter and Helpman identified a set of different social welfare functions, each of which values different distribution of utilities.[2] We illustrate each archetype by highlighting the likely consequences on the tax and benefits system of targeting these distributions in terms of an income-based utility, though we will go on to explore these social welfare functions using different definitions of utility.

The first three options emphasised maximising the utility of particular members of society, without particular concern for the others:

- **"Elitist"**: This objective set would have us focus on maximising the utility of the most able or highest earners.

  This would tend to raise taxes on lower earnings, so as to minimise the tax take from higher earners.
- **"Democratic"**: This objective set would have us focus on maximising the

2 Robert Cooter and Elhanan Helpman, 'Optimal Income Taxation For transfer payments under different social welfare criteria', *Quarterly Journal of Economics* (1973).

utility of the median. How the median is calculated might reference those who are averagely able, average earners and so on.

This would tend to reduce taxes for lower earners, and raise them for higher earners, so as to maximise the utility for the median earner.

- **"Rawlsian"**: This objective focuses on maximising the utility of the person with lowest income in society.

  In income terms, it seeks to maximise the levels of affordable out-of-work benefits. This would require maximising the total tax base, in effect setting very high marginal tax rates for many earners, high and low.

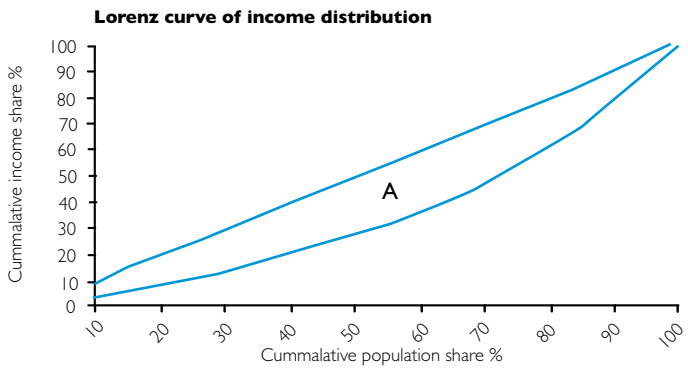
In addition to these approaches, three others were proposed, which take a broader perspective on distribution.

- **"Benthamite":** This objective set would have us focus on maximising the mean utility. It is not concerned with the utility of any particular member; only the combined utility of all; which means it would have no particular care for the weakest in society.

  This would tend to set taxes at a low level to generate the required funds for general Government expenditure, with the least distortion on earnings – so as to maximise overall income.
- **"Egalitarian"**: This objective does not seek to maximise utility, but merely considers its distribution. It focuses on minimising the Gini coefficient defined on net income.[3]

  Uniquely among these different objectives, this one would say that reducing the utility of high earners[4] would be a good thing in itself, in order to reduce inequality, even if doing so reduced the utility (income) of the poorest and reduced overall social welfare.
- **"Nash"**: This objective set would have us focus on maximising the (un-weighted) product of individual utilities. This will favour a more

3 Gini-coefficient of inequality: The coefficient varies between 0, which reflects complete equality and 1, which indicates complete inequality (one person has all the income or consumption, all others have none). Graphically, the Gini coefficient can be easily represented by the area (A) between the Lorenz curve, or cumulative income share against the distribution of the population and the line of equality.



4 By, for example, setting marginal tax rates higher than the tax maximising level so as to depress both earnings and net income.

equal distribution of individual utilities, while also seeking to maximise the overall utility of society.

This is an example of an objective that gives positive weight to the welfare of all individuals, albeit at different levels - low earners, as well as those with no earnings, are also deserving of support. A numerical example explains what we mean by this. If we had £5 to distribute between two people, the Nash approach would favour giving £2.50 to each over giving one £3 and the other £2, or one £4 and the other £1. However, unlike the Egalitarian objective, it would not prefer £2.25 each over £3 + £2, as the resultant equality of distribution is outweighed by the fact that the overall amount would be less.

The Rawlsian approach has been very influential. But our analysis suggests that focussing on different forms of utility (for example income, or earnings, or employment) results in substantially different outcomes. A Rawlsian approach based on utility-as-income will prioritise the level of income of those who are out of work, without consideration of the impact on others: this is exactly what has created the current unemployment trap.

Furthermore, there is little to be said for an approach which deliberately reduces the welfare of both the poorest and the richest in order to minimise the gap between them.

While they are a useful categorisation of potential types of distribution, all have weaknesses. From the perspective of practical policy, none of the first five potential objectives is appropriate.

More recent approaches have adopted and modified the broad principles of the Nash approach, and have valued the marginal utility of those on lower earnings to a greater degree than that of those on higher earnings. Technically, they impose a declining value to increasing the utility of progressively higher earners. The gradient of this decline determines how redistributive the 'optimal' tax and benefits regime is.[5] The practical implication of this is that the stronger the redistribution function (the less we value increasing the utility of higher earners), the higher the resulting marginal tax rate.[6]

This sketch of different distribution of income objectives has shown the basic contours of the resulting tax schedules for each case. But these will change depending on how we characterise utility. We cannot determine the ideal distribution without also considering the specific social good whose distribution we are seeking to optimise across society.

5 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings,* (IFS, 2008), provide more examples of this.

6 Compared to the Rawls objective, these objectives tend to result in lower MTRs for low earners, as they place positive value in their income – in contrast the Rawls approach values only the income of the lowest – i.e. non-earners

9.3 Choices of social good

There are four basic types of utility whose distribution we might seek to optimise. They are:

1. *Utility as Personal Welfare.* Non-paternalistic objectives that seek to 'maximise happiness', where 'happiness' is driven by some combination of income and 'leisure' time.
2. *Utility as Income.* Similar to welfarist objectives, but here utility is driven only by income, with 'leisure' time not playing a part.
3. *Utility as Earnings*. These objectives propose that a pound earned is worth more than a pound transferred in benefits.
4. *Utility as Employment*: These objectives prioritise employment per se, over and above the resulting distribution of earnings.

We discuss in each case the consequences for a tax system of determining utility in each of these ways.

9.3.1 PERSONAL WELFARE OBJECTIVES

Objectives based on personal welfare assume that society cares primarily about how individuals perceive their own well-being. Traditionally, discussions of utility in this context place a positive value on both net income and 'leisure time' (the antithesis of work).[7]

A definition of utility that values an individual's leisure time, as well as income, will always place a disutility on earned income when measured against the same income in benefits, because the time taken to earn that income eats into the individual's leisure. Hence, such an objective encourages redistributing income to households, if that redistribution makes individuals feel better off, even if it means reducing hours of work or quitting work altogether.

The majority of historic optimal tax studies have adopted a personal welfare assumption.[8] As part of the recent Mirrlees review, Brewer, Saez and Shephard[9] reviewed optimal tax schedules derived from Rawlsian and modified Nash distributions of utility as personal welfare, which applied a positive marginal utility to leisure.

Seeking to optimise personal welfare can be very attractive. A Benthamite approach that maximised the overall combination of income and leisure in society can be one useful component of an objective.

However, this approach under-values the benefits to the individual and to society of earning through work, and the benefits of genuine economic

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7 Leisure' is a term much used in philosophical discussions of income distribution. It is contrasted with work, and encompasses both the ideas of free time - for example, a person's choosing to surf rather than work – and being out of work, insofar as work is available at some pay level: the assumption is that a person chooses not to work.

8 For a survey, see Peter Diamond, 'Optimal Income Taxation: An Example with a U-Shaped Pattern of Optimal Marginal Tax Rates', *The American Economic Review*, Vol. 88, No. 1, (March 1998), pp. 83-95.

9 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings*, (IFS, 2008).

independence. Income and leisure tend to be inversely correlated; as such a Rawlsian approach that sought to increase the personal welfare of those with the lowest earnings tends to accept and indeed induce a world of greater worklessness. Work brings the benefits that attend a constructive lifestyle; it can make good citizens and reinforce positive relationships.[10] The obverse of work is neither good for society, nor for families.

We must therefore turn to income- and earnings-based objectives.[11]

9.3.2 INCOME-BASED OBJECTIVES

Income based objectives are concerned solely with the optimal distribution of income in a society, without regard for the underlying trade-off between work and leisure time. The elimination of a utility for leisure time also removes the concept of a disutility in work.[12] Hence, social welfare functions that value income rather than leisure lead to greater emphases on work.

An early example of an income-based tax optimisation model is that of Besley and Coate,[13] which assumed that society wishes to raise the incomes of the poor, preferably to reach some minimum income target, though it did not factor in a disutility for any loss of employment involved in doing so.

Another example of an income-based objective is the current Government's stated goal to eliminate child poverty by 2020. This could be described as a Rawlsian policy as it seeks to raise the income of the poorest family with children to a certain level (although focused only on households with children).

UK Government Child Poverty Targets

The Government's child poverty goal is to ensure that the incomes for all households with children will rise to 60% of the equivalised median household income, on a before housing cost basis.

In 1999, Government set itself three specific targets on child poverty:

- To reduce the number of children in poverty by a quarter by 2004/05 (compared with 1998/99 levels);
- To reduce child poverty by half by 2010/11;
- To eradicate child poverty by 2020.

One of the most obvious examples of an explicit egalitarian income-based policy is that of New Zealand: here policy proposals have been, recently,

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10 See Chapter 1.

11 For more on this, see Robert Moffitt, 'Welfare Work Requirements with Paternalistic Government Preferences', *Economic Journal 116*, (November 2006),

12 One might want to introduce a disutility for work beyond a certain weekly limit, but this would have only a minor second-order effect on any resulting tax and benefits policy; in any case, regulations limiting working time could be a more effective way of achieving such a goal, if so desired.

13 Timothy Besley and Stephen Coate, 'Workfare Vs Welfare: Incentive Arguments for Work Requirements in Poverty-Alleviation Programs', *American Economic Review 82*, (March 1992), pp. 249-261.

explicitly assessed against the Gini coefficient (see box below). In the next chapter, we will discuss further how such a choice of an objective impacts the design of a benefits system.

Income-related objectives contrast with personal welfare objectives in the following way: more income denotes more social utility, even if it means a loss of 'leisure time'[14] that might otherwise be valued more by the individual than by the society.

However, targeting income alone can set a trap for a well-meaning Government, as well as its least fortunate citizens. A system – such as the current one – that trades off cost and income distribution in a way that leads to large numbers of households earning little or nothing, yet receiving large transfers of income, ends up imposing greater long-term costs on society.

The challenge can be seen in the Government's performance on child poverty to date. The Government missed the first target. In order to have a 50% chance of making the second target, it is estimated the Government will need to spend an additional £4 billion on child-related tax credits.[15] Meeting either target appears increasingly unlikely. In the last two years, child poverty has risen.[16]

Case study: New Zealand and the Gini coefficient

Officials at the New Zealand Treasury were asked to advise on the main strategic choices and the trade-offs involved in the design of the tax package for New Zealand's 2008 Budget. The overall goal was to reduce the marginal tax rates, but ministers had outlined four tests for proposed tax measures in the 2008 Budget:

- To cut taxes without increasing borrowing;
- To cut taxes without cutting public services;
- To cut taxes in a way that does not exacerbate inflationary pressures;
- To cut taxes in a way that does not lead to greater inequalities in society.

The fourth test was regarded as the most important. The choice of social good which the ministers chose to equalise was equivalised household disposable income. There were two tests they used: the first was to measure the Gini coefficient, and the second measure was the income ratio, calculated as the ratio of the 80th percentile of equivalised household disposable income to the 20th percentile. In both cases, a lower value indicates greater equality.

Each scenario was measured against its effect on Gini coefficient (as well as the other measures).

The weakness of objectives that purely measure levels of income is that they do not differentiate between the value of a pound transferred through income and the superior social value of a pound earned through work. They are neither truly empowering from the point of view of stressing that work is the best way out of poverty, nor do they provide a sustainable means to alleviate poverty.

Neither of the two characterisations of utility discussed so far promotes the value of work. Income-optimising objectives call for transfers that are

14 See Chapter 9, n 7.
15 DWP, *Departmental Report 2008*,(DWP, 2008) reports slippage against child poverty targets.
16 The HBAI statistics for 2007/2008 show that child poverty increased in that year. Available at http://www.dcsf.gov.uk/pns/DisplayPN.cgi?pn_id=2009_0086 [Accessed 3 August 2009].

unsustainable, and can also create a poverty trap because it creates systems which provide no incentive for those on benefit income to go into work.

9.3.3 EARNINGS OBJECTIVES

An objective that values earnings distribution places a high value on the marginal earnings (as well as net income) of the most vulnerable in society. It is concerned by the pre-tax-and-transfer distribution of earnings, rather than just the resulting distribution of income.

As a result, this objective is more concerned about the sources of income, regarding a pound earned as worth more than a pound transferred. It is our view that earnings distributions have been under-analysed, and under-emphasised, when assessing and implementing changes to the benefits system.

As we argued in Breakthrough Britain, sustained poverty relief must be driven by increasing earnings to reduce the underlying problem, rather than simply by discrete transfers of money. Expressed another way, focusing on income is akin to treating the symptoms of dependency and poverty, whereas explicitly recognising the role of earnings would help us to treat the cause.

Seeking to reduce earnings inequality helps address the root causes of poverty. Such an objective would lead to a system with much-reduced marginal tax rates on lower earnings: this generates a lower tax take from both low and high earners. (See the box below for an explanation.) The result will be a larger economy than those more focused on income distribution, because incomes for those who can work will shift towards wages and away from benefits.

Marginal tax rates at lower earnings

Changes to the marginal tax rate at one level affect the MTR of all people who experience that rate at their current level of earnings, but not those who experience a different tax rate. However, a change in MTR will affect the income of everyone who earns above where the change occurs.

Consider two examples:

- If the 40% top rate of tax were to be changed, that would affect only those paying the higher tax rate.
- If the 20% basic rate were changed, it would affect the MTR for standard rate payers, and would change the total tax bill for higher rate payers, but would not affect their MTR.

This has the important consequences that increasing an MTR at a lower point in the scale does not affect the MTR work incentives for much higher earners, but it does affect the tax take from them.

9.3.4 EMPLOYMENT OBJECTIVES

A further refinement of a distribution of earnings objective is to regard not all earnings as equal, but to value an increase in employment over and above seeing earnings increase only for those already employed.

Beyond valuing earnings distribution, society may actually wish to subsidise (and so incentivise) work to a greater degree than individuals might otherwise prefer. This refinement can be taken even further by recognising that the spill-over effects of a job in a household mean that it is better to develop a policy that moves more households into work, than focuses on improving the work incentives for second earners within a couple.

An example of this is found in the model described by Moffitt, whose objective was to present a society that cared about work in and of itself.[17] The goal of maximising the number of households with work also secures a more favourable earnings and income distribution. Provided the right jobs are there, it is also more sustainable.

There has been a debate around whether 'mini jobs' should be encouraged or not. The main arguments are set out by Bell, Brewer and Phillips.[18] It is our contention that, given the social benefits of a household being in employment, there is an intrinsic value in these jobs – as well as being a potential stepping stone to other jobs. However, we must recognise that moving to a system that rewarded these jobs would mean that a proportion of those working above the current WTC threshold would likely reduce their hours – which would decrease their earnings and increase their benefits. So long as this cost is accounted for in a dynamic model, and compared against the impact of those entering the workforce on low hours, then the overall gains to society can be judged accurately.

The goal of maximising the number of households with work will, in the long term, secure a more favourable earnings and hence income distribution; one that is much more sustainable, as it is driven by earnings rather than income transfers. The practical implication of this is that, in the short term and at the margin, this involves 'paying' for jobs. This we consider to be a worthwhile investment.

> "Getting claimants in inner-city areas back to work is highly desirable on its own grounds, and will only be achieved by operating on both the demand as well as the supply sides of labour..."
>
> Frank Field MP

9.4 What is our work objective?

This review of the types of social objectives that have been used historically allows us to make some initial observations about what should be our preferences for a reformed benefits system.

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17 Robert Moffitt, 'Welfare Work Requirements with Paternalistic Government Preferences', *Economic Journal 116*, (November 2006), F441-F458.

18 Kate Bell, Mike Brewer and David Phillips, *Lone parents and 'mini jobs'* (Joseph Rowntree Foundation, 2007).

We do not underestimate the importance of addressing broader income distribution per se: effective poverty fighting means committing to an income floor below which no household should fall. However, in not making the important distinction between the social utility of a pound earned and the reduced social utility of a pound received in benefits, previous models have recommended tax and benefit structures which have risked deepening dependency and worklessness.

The desire for a more equitable income distribution, which has been pre-eminent in policy discussions, should be balanced with the need to underpin it through increases in earnings and jobs, rather than simple income transfers. At the margin, we can and should use the resources of society to support and encourage the earnings potential of its most vulnerable members.

Therefore, at the heart of our model is a characterisation of utility in which the number of households in work is the most important factor. The objective at the heart of our model is to maximise the number of households with work, over and above simply the number of jobs, or earnings. This final qualification is an important one, as some employment-based reforms are more likely to cause couples to move between one and two earners than households to move in and out of work.

In effect, we are advocating a broad Rawlsian distribution, seeking to maximise a combination of income and employment opportunity for those with the lowest earnings potential in society.

9.5 Limits and constraints on objectives

The preceding section has underlined the need to be very clear about what our objectives are. We turn now to discuss the constraints on distribution objectives.

There are two types of constraints on our objectives:

1. Conflicts with other objectives and policies. It may be necessary to limit our objectives to avoid conflict with other policies.
2. Logical conclusions and inherent limits. The most satisfactory social function, when pushed to its logical conclusion, can often lead to situations that are regarded by policy-makers as unsatisfactory. The mechanics of a tax and benefits system will also impose necessary constraints on how many objectives we can achieve.

In addition, there are implementation constraints, which account for the transition from the existing benefits regime to a new structure. For example, large changes in the income of certain groups, or in tax rates, might appear to deliver desired outcomes, but in practice be too drastic to be socially acceptable. At this stage, we will concentrate on the logical limits and opportunity costs of various systems; we will consider implementation constraints in Chapter 18.

Given our list of broader objectives from Chapter 6, there will be conflicts between optimising our employment objectives and achieving some of the other objectives relating to fairness and behaviour incentives.

In this section we will review some inherent limits in the setting of objectives, as well as two types of constraint that often impinge on the implementation of specific benefits objectives. These are conflicts with housing and family policy, and the impact on broader fairness and equality objectives.

9.5.1 CONFLICTING OBJECTIVES

One of the biggest challenges in setting objectives is to make sure they are consistent with other policies, such as housing and family policies. More specifically, it is necessary to understand the trade-offs needed to achieve the objective. As it was one of the Government's most clearly articulated welfare policies, we use the example of ending child poverty. How child poverty is tackled is as important as the desire to tackle it. Like many other social goals, achieving it is a complex challenge, with many dependencies. Two examples serve to illustrate the conflicts with other policies:

1. In order for the Child Poverty objective to be realised, the out-of-work benefits for all families with children will need to meet or exceed the 60% poverty threshold target (because otherwise out-of-work families with children will not be lifted above the poverty threshold). This creates a choice: either the out-of-work benefits for childless households will also need to be set at levels close to 60% of the equivalised income, or else there will need to be an increased differential between the benefits paid for those households with and without children. Setting the out-of-work benefits for all households (including those without children) at 60% of median earnings would be very expensive – and will not become more affordable over time. On the other hand, increasing the comparative generosity of out-of-work benefits for those with children will distort further the relative financial impact on those out of work from having children compared to entering work.
2. If the child-poverty objective is to hold, then either the poverty measure will have to be recast on an after housing cost (AHC) basis, or else Housing Benefit will also need to be given to out-of-work / low-earning homeowners and mortgagors, as well as being more generous than today for those with low social housing rents.[19] Before-housing-cost poverty will never be eliminated without addressing the fact that many of those who are below the poverty threshold do not receive Housing Benefit because they own their own home or have a mortgage. On the other hand, doing so would be very costly. It could be criticised as an inefficient way of spending scarce resources on homeowners (who do not have housing costs) just to

19 Given that poverty is measured on a before housing cost basis, the only way for the target to be met by those out-of-work households not currently receiving generous housing benefit will be to increase overall benefits. This will mean that those households in subsidised council housing or with mortgages (and not receiving any HB) will need to receive more.

hit a statistical target.[20]

These trade-offs lead us to a set of questions: What are the broader consequences of these trade-offs? Are they socially desirable? Who will be disproportionately helped? Which objectives/policies should take priority? These questions are crucial for policy makers, as unintended consequences inevitably arise – and these often require choices that might have been anticipated.

We have argued for the need to be very clear about objectives. It follows that the consequences and trade-offs with other policies need to be considered in design, and if necessary the objective should be modified. An analytical approach is essential to ensuring the consequences of any trade-off are well understood.

9.5.2 EQUALITY AND OPPORTUNITY CONFLICTING

Another significant trade-off, which we will analyse more closely in the next chapter, is between equality and opportunity. Objectives that seek to maximise the tax take (so that the Government can redistribute more wealth) will require tax systems that have very high MTRs for low-earners. Others have made the argument that, even if it is not necessarily economically efficient, there are a priori fairness and social mobility-based arguments to have an objective of lower withdrawal rates for low-earners. As Chapter 3 and Appendix A show, many low earners currently experience withdrawal rates in excess of 75%. The Work and Pensions Select Committee have raised the fairness point in a recent report:

> *If [41 per cent] is the highest tax rate that it is right to expect a high-income earner to pay, how much worse it is that the government effectively charges low income earners more than twice that rate.*[21]

Writing about the US welfare system, Daniel Shaviro has also made the social mobility argument:

> *Excessive marginal tax rates ought to be objectionable across the ideological spectrum whether one is liberal or conservative, favors increasing or reducing aid to the poor, and supports or opposes work requirements in transfer programs.*[22]

There are significant moral and social implications to the decision to keep marginal tax rates high for low earners, as it deepens the employment trap.

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20 One of the most efficient ways to rapidly reduce the child poverty numbers is to raise council rents to market level, and increase HB to cover the cost, and use the resulting fiscal benefit to provide HB for low earning families with mortgages. Some of this is financial engineering; the other is a genuine transfer of income to some needy groups. It involves a significant shift of resources between different low-earning groups. It also serves to show how inefficiencies can be locked in by preferential treatment of one group (council tenants) over another (mortgagors).

21 Work and Pensions Select Committee, *Benefit Simplification: Seventh Report of Session* (HC, 2007) 463-I.

22 Daniel Shaviro, *Effective Marginal Tax Rates on Low-Income Households,* (Employment Policies Institute, 1999).

Recognition of this necessary trade-off is one reason why our objectives in the first instance are not income-based, but employment-based, so as to create as many opportunities as possible for those who can to enter the workforce. We believe this to be the most sustainable way of encouraging opportunity and alleviating poverty, even if it means that the Government has less income available to redistribute.

9.5.3 INHERENT LIMITS

In addition to conflicts between particular objectives, or objectives and a general sense of fairness, there are certain fundamental constraints on what can be achieved with a tax and benefit system. For example, the need to have a tax base large enough to fund general expenditure and also the specified income transfers places limits on the proportion of society that should be net recipients of benefits as against net payers of tax.

As we explain in the next chapter, for any conceivable tax and benefits system, there will be a trade-off between PTR, initial generosity and the proportion of people who are net benefit recipients. We call this the iron triangle.

Continuing with the example of the Child Poverty objective, we have already noted that the out-of-work benefits for all families with children will need to meet or exceed the 60% poverty threshold target. The benefits payment to workless households with children must then be at least 60% of median income. This means one of two unavoidable consequences must hold. For a household with children at median income, either:

- Their benefits have been completely withdrawn –which would mean a 60%+ average participation tax rate for families with children, or
- They have not – which would mean more than half of all families with children are net benefits recipients (i.e. receive more in benefits than pay in Income Tax and NI).

Once these unavoidable consequences are made explicit, we must decide which of these scenarios is preferable. Is it right that so many would face a high withdrawal rate, or is it preferable to have such a high proportion being net recipients of benefits? To date these choices have not been part of the public debate.

9.6 Greater clarity, greater discipline

Clear objectives about what we are trying to achieve through a tax and benefits system are essential. The preceding discussion should demonstrate that merely setting a target is not enough: we need to be aware of conflicts with other objectives, to acknowledge the consequences of our choices, and be ready to modify them if necessary. What is needed is clarity with discipline. Again we use Child Poverty as an example:

- **Start with an objective that is attainable in the medium term.**
  The Government has chosen to target slices of the population incrementally to bring them up to the level of 60% of median income. The problem with this type of target is that it skews priorities. A situation arises where the incomes of those just below 60% are raised to just above, without addressing others who are in much deeper poverty. As a result, helping slices of the population in deeper-rooted poverty is increasingly expensive.

  A better and more even-handed approach would be to target eliminating severe poverty first, rather than monolithically halving the number below 60% of median income. This should then be reviewed on an ongoing basis, with an aspiration to raise all families above increasingly higher thresholds, as each previous target is met.
- **Be careful about targeting too narrowly who is to gain.**
  Is it socially preferable, or more just, to raise the income of a family with children at 59% of median income up to 60%, compared to helping a childless couple with income at 45% of median?
- **Details and definition need to be aligned with other objectives and policies.**
  There needs to be coordination across benefit structures. For example, policy on Housing Benefit and the approach to housing costs in the poverty target should be aligned.
- **Account for the resulting design of the tax and benefit system.**
  A welfare state that places one or more particular objective at its heart will require its own, very specific, attuned tax and benefit schedule, if this objective is to be realised. We also need to appreciate how the nature of responses to taxes and benefits affect the chosen tax and benefit programme: how those subject to the regime will respond, and what the profile of society will look like one two or ten years in the future.

  The elasticities induced from the decisions taken by claimants are a matter of ongoing empirical measurement. We have no real say in what they look like. However, the choice of objective; the opportunity to produce socially just welfare – or not – is a process, the responsibility for which lies solely with government.

9.7 Conclusion

The great advantage of dynamic modelling is that, if you ask of your model the right question, by setting the right objective, the optimal tax and benefit 'answer' – in other words, the schedule for that objective – will emerge.

Based upon the values that have informed our review, we propose the following objective to form the heart of our dynamic model:

Maximise the number of working-age households with at least one member in work, while ensuring all households receive a fair minimum income.

This objective is subject to three constraints:

1. A reformed system should minimise the tax and benefit withdrawal burden on low earners, and move toward a progressive schedule for PTR.
2. A reformed system should cost no more than the current system over the medium term.
3. The number of losers in any transition should be kept to a minimum.

In Part III, we will further modify this as we incorporate some of the other aspects of our manifesto outlined in Chapter 6, in particular to promote objectives which we believe to be at the heart of reversing social breakdown. In the next chapter, we describe some of the fundamental and necessary constraints concerning the design of a benefits system.

Being clear about our objectives, and defining those objectives more precisely is the first step to better reform. As a consequence trade-offs become more transparent: between redistribution and effectiveness for example, or between cost and the strength of incentives. There are even broader questions, and at some point we need to refer to philosophical ideas about what kind of society we want to see:

> *While helping the poor is an important objective, how the poor are helped becomes crucial. Do the means of redistribution advanced underpin or undermine the likelihood of developing fully a person's talents, and does such a strategy simultaneously help strengthen the sense of civic culture?*
>
> Frank Field[23]

A benefits system will never be simply about who gets what, and how much: its structure will have consequences for other social objectives we may have, as people change their behaviour in response to the system.

Let analysts and politicians agree or disagree with the objectives promoted in this report on an informed and meaningful basis, and there will then be some chance that the choices that emerge will be informed choices that are genuinely transformative.

23 Frank Field, 'What Then Was Unthinkable?' in *The State of Dependency - Welfare Under Labour* (SMF, 2000).

CHAPTER TEN
Framing the Benefits System

Key Conclusions

- The tax and benefits system is constrained by certain logical and arithmetical relationships, which determine what the benefits system can and cannot achieve.
- The 'iron triangle of benefit reform' dictates that setting the level of out-of-work benefits and the rate at which they will be withdrawn, absolutely determines the proportion of households who will be net recipients of benefits
- Optimum tax theory has historically suggested setting high marginal tax rates for low earners.
- This is because it aims to maximise personal 'welfare', assuming only earnings changes (but not employment changes) as a result of different tax and benefits regimes – it implies that sometimes, the benefits system should 'pay people not to work'.
- Once employment elasticities are accounted for, and we seek to optimise for household employment and income together, we suggest that the benefits system should subsidise low-paid work.
- We demonstrate that we should seek to minimise the participation tax rate for low earners, in order to maximise employment.

Creating an optimal tax and benefit schedule is an exercise of both academic and political import, with serious practical difficulties. How do we translate objectives into entire tax and benefit schedules? Having considered the consequences of various objectives in the previous chapter, and having considered how those consequences can be modelled numerically in the one before, we now turn to examine some fundamental constraints on tax and benefits design. While a better model such as our Dynamic Benefits Model is essential, we need to know the limits on reform.

In this chapter we first review these fundamental constraints surrounding the tax and benefit system, regardless of objectives or indeed whether one wants to design it statically or dynamically. Dynamic models tell us about additional inherent constraints on what the tax and benefits system can achieve. Starting with a dynamic model that only accounts for earnings movements, then one which only accounts for employment movements, and finally moving to a combined model, we examine how the tax and benefits profile that would raise the most money for redistributive purposes enshrines poor employment incentives for low-wage jobs. The system itself requires us to make choices and at this point the clarity of our objectives will again be tested.

We will conclude by summarising how the 'optimal' tax and benefit structure differs depending on the social and financial objectives.

10.1 The iron triangle of benefit reform

In the 1960s, out-of-work benefits began to grow. It became increasingly clear to economists that high marginal tax rates were causing disincentives to get into work and to advance through work. Moreover, it also became clear that there were fundamental constraints around how tax and benefits systems could be designed, meaning that Governments have to make choices about particular social priorities. At the time, there was no real analysis of this effect, but it was intuitively felt by many.

These fundamental constraints hold irrespective of the social or financial objectives pursued, or the underlying economic structure of society. These constraints arise out of the interaction between three aspects of a benefits schedule:

- The first concerns the generosity of the system: the amount of benefit given, in particular for those out of work.
- The second concerns the work incentives enshrined within the benefit, i.e. the marginal and participation tax rates as earnings increase.
- The third concerns the break-even point of the system. At what earnings level should a household switch from being a net recipient of benefits to a net payer of taxes, and, consequently, what proportion of the population is it acceptable to be in receipt of benefits? This clearly has implications for the overall cost of a system and its viability relative to the tax base.

These three aspects combine to form the Iron Triangle of Benefit Reform, an absolute logical constraint on the possible shape of a benefits schedule. Having decided upon any two of these parameters, the other is automatically and necessarily determined by that decision - in other words:

> **The proportion of households who are net recipients of benefits is fixed by the generosity of out-of-work benefits, and the rate at which they are withdrawn with increasing earnings.**

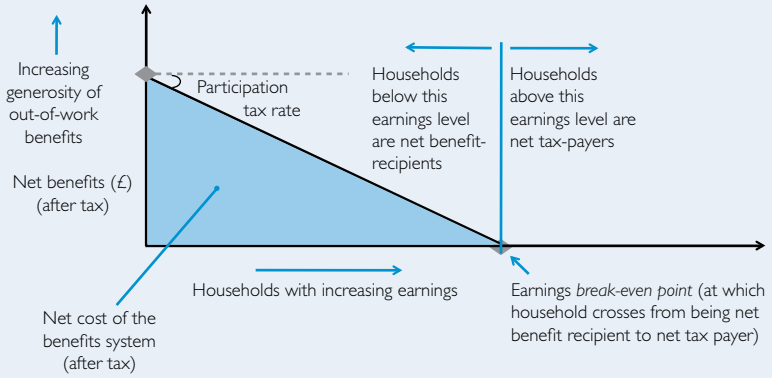
> "All radical welfare reform schemes have three basic parts that are politically sensitive to a high degree. The first is the basic benefit level provided, for example, to a family of four on welfare. The second is the degree to which the programme affects the incentive of a person on welfare to find work or to earn more. The third is the additional cost to the taxpayers … To become a political reality the plan must provide a decent level of support for those on welfare, it must contain strong incentives to work, and it must have a reasonable cost. And it must do all three at the same time."[1]

1 Milton Friedman and Rose Friedman, *Free to Choose: A Personal Statement* (Harvest Books, 1980), p. 12, reproduced in Katharine Hirst, Working Welfare (Adam Smith institute, 2007).

The importance of the three factors has long been understood, yet the inevitability of their relationship and the implication for public policy has often been overlooked.

The mathematical relationship that informs this principle is represented in the following graph.

Figure 10.1 The iron triangle of benefit reform



The starting point for the line, on the left of the graph, represents the level of out-of-work benefit. This is the value of the net benefit, post-tax, though because a person is out of work they are not paying any tax and so it is just the value of the out-of-work benefit. Where the line crosses the x-axis is the earnings break-even point: it shows what the income is of the household whose net benefit income is zero. (Depending on the particular design of the tax and benefits system, households after this point may still receive benefit but they will pay more tax.) The gradient of the line – how quickly the benefit is withdrawn – is determined by the average MTR over that range (i.e. the PTR at the earnings break-even point). The space under the graph represents the total cost of the system, though not directly: it tells us the net amount of benefit (after tax) that households at different earnings levels will receive – we would also need to know how many households of each type there were.

The iron triangle places a lower limit on the combined benefit and tax withdrawal rate for low earners.[2] This can be modelled as a mathematical relationship. The average marginal tax rate (PTR) for low earners can never be lower than the ratio of the level of out-of-work benefits (G) to the income of those at the earnings break-even point (M), where the balance of tax and benefits is neutral.

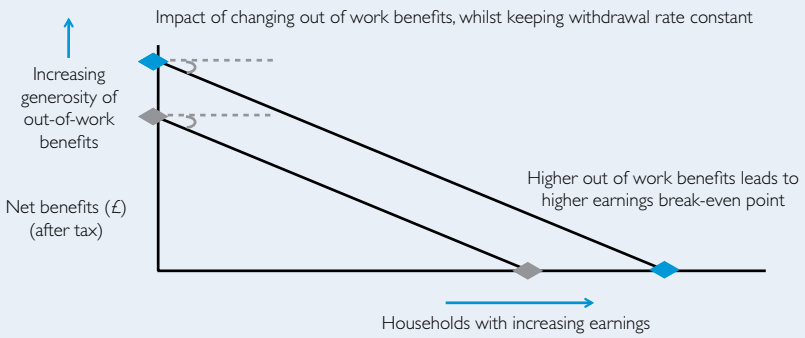
$$PTR = G/M$$

2 It is mathematically forced to be the ratio of the out-of-work benefits to the earnings break-even point. So, if break-even earnings are £16,000 p.a., and out of work benefits are £12,000 p.a., then the average withdrawal rate is necessarily 75% (i.e. £12,000 ÷ £16,000).

Put another way:

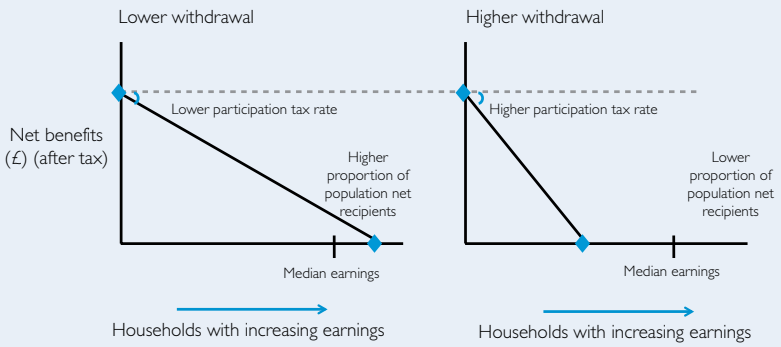
For any given withdrawal rate, the greater the level of out-of-work benefits, the higher the earnings break-even point needs to be. Increasing the amount of out of work benefit means that for a constant withdrawal rate, more households will become part of the benefits system. This is illustrated in Figure 10.2 below: keeping the gradient of the line the same (which represents the withdrawal rate and hence work incentives), if we increase the initial generosity of benefits, the total initial award will be depleted later and so the break-even point will move higher up the household earnings scale, meaning that more people will be entitled to claim benefits.

Figure 10.2 The iron triangle: impact of changing the level of out-of-work benefits, while keeping withdrawal rate constant



For a given level of out-of-work-benefits, the lower the withdrawal rate (PTR), the higher the resulting earnings break-even point. This is illustrated in Figure 10.3 below. If a generous out-of-work benefit system is desired, together with low withdrawal rates that reward work, it is likely that a large proportion of the population will be net recipients of benefits. As explained by Moffitt, the higher the out-of-work benefits, the more costly it is to reduce withdrawal rates, because not only does the level of in-work benefits need to be higher, but it is also more likely to stretch up into the point of the population where there is much higher earnings density – making many more people net recipients of benefits.[3]

Figure 10.3 The iron triangle: impact of changing the withdrawal rate



3 For more on this, see Robert Moffitt, 'Welfare Work Requirements with Paternalistic Government Preferences', *Economic Journal 116,* (November 2006), F441-F458.

In this way, having established high out-of-work benefits, a society may never be able to afford low withdrawal rates, economically or politically.[4]

Consequences of the 'iron triangle'

If income poverty is to be eliminated for any household grouping, and if it is expected that the median earner will be a net payer of taxes, there are two immediate implications:

- Out-of-work benefits for that group must be universally available at a level on or above the targeted poverty threshold, such as 60% of median net income.
- To ensure members of this group become net taxpayers by the time they reach median earnings, the minimum possible withdrawal rate for this group is that same percentage of net income, in this case 60%.

The only way to reduce the combined withdrawal rates of tax and benefits below 60% for low earners would be either to have the majority of the population in net receipt of benefits, or to accept that out-of-work benefits would not aim to help people move, in income terms, beyond an internationally defined poverty level of 60% of median income.

One way to alleviate poverty is to galvanise and structure the system to encourage families off welfare and make work pay. An alternative is to reduce income poverty directly by increasing the use of income transfer from the rich. The Government has focused on the latter, and has poured money into the system to realise that vision. It is worth recapitulating the statement we quoted in Chapter 1:

> The primary reason the Treasury has led on Child Poverty is that we control the levers which are critical for meeting the 2010 target, as we set the levels of financial support for families. Employment will have an important impact on achieving our goal of halving child poverty, **but financial support is the most important lever …**

Sir Nicholas Macpherson, submission to the Treasury Select Committee, 2007

The iron triangle holds whether one assumes that people respond to financial incentives or not, and places limits on any benefit system design. Even if we ignore behavioural change, and adopt a static world-view, there are mathematical constraints on the design of the benefits system. These mean

4 Ironically, it is only in societies with highly skewed earnings distributions that it is possible to fund generous benefit systems without employment traps. This is because, when the proportion of overall earnings above the median is very high, the tax raising potential from high earners is therefore very high. So it is possible to fund benefits to those at or above the median level.

that simply pouring money in will make little difference – and indeed is massively inefficient – and that we must make a normative choice based upon a societal vision: a society mostly on benefits or off benefits. This choice will determine the trade-offs we make within the constraints of the iron triangle.

10.2 Constraints from earnings-only elasticity models

If we accept that people do respond to marginal tax rates, and start to incorporate these responses into designing our system, we find that additional constraints become apparent which were not visible in the static world-view. This section identifies that there will be necessary, and uncomfortable, trade-offs between the objective of maximising the tax take and keeping MTRs low for low-earners.

It will also highlight the shortcomings of using a model which only takes account of changes in earnings levels, and not the movement of households into and out of work. In Chapter 9, we criticised the use of income- and personal-welfare-based objectives; to some extent these objectives were maintained by models which only took earnings elasticities into account.

In the 1970s, James Mirrlees was the first to build an economic model to determine the best tax rates to balance social objectives with the Government's need to generate revenue for other purposes. In doing so, he explicitly introduced the concept of earnings elasticity.

The seminal Mirrlees model assumes that people vary in their earnings potential, that is to say, what they would earn if there were no taxes or transfers, and that everyone always works, but chooses how much effort to supply. This is a very effective simplification when looking at the optimal tax rate for high earners, because, as we will recall, their employment elasticity is low.

Furthermore, this earnings-only elasticity paradigm meant that the most meaningful type of objective to model was one that was focused on income distribution. Examples include: maximise the level of affordable out-of-work benefit, maximise average earnings, for a given level of out-of-work benefits, and minimise the Gini coefficient (i.e. maximising income equality). Alternative objectives, for example those that sought to get people into work, could not be considered in this paradigm.

This work became an authority on the subject, and resulted in the academic and policy debate focusing for many years primarily on income distribution, rather than considering other objectives. We still see this legacy reflected throughout the poverty debate; from the Government's poverty strategy that focuses on income-based factors alone, to their indicators on social mobility, that are inadequate and almost wholly income-based.

However, this simplification is less effective when looking at the optimal benefits withdrawal rate for low earners. While it charts the variation in earnings caused by different tax schedules, it does not consider the possibility that someone who is in work would decide, as a result, to leave work. This is more likely for someone at the margin than one who was naturally the

principal object of the Mirrlees model. The reason for this is that he did not refer to employment elasticity.

By focusing merely on earnings, rather than employment, the Mirrlees model did not account for the fact that high PTRs for low earners results in a disincentive to work. As a result, the Mirrlees tax model provided academic support for schedules that had high withdrawal rates for benefits and only moderate tax for high earners. In this paradigm, income redistribution would be effective, because the modest tax of high earners encouraged them to earn more (and hence raise tax revenues), while the high withdrawal rates of benefits ensured that benefits were focused on the most needy, even if it did not encourage them to earn more.

We contend that this narrow perspective, while being a significant academic advance, has limited the welfare debate; it has, unfortunately, been detrimental to achieving social justice in this country.

Consequences of an earnings-only elasticity paradigm

The conclusions from the Mirrlees tax model all pointed towards high MTRs for lower earners:

1) **Income Redistribution**: MTR should be higher overall when the Government is keen to redistribute income from rich to poor.
2) **Earnings Elasticity**: MTR should be higher when earnings elasticities are low: i.e. for low earners, who are less responsive to MTR than high earners.
3) **Earnings distribution**: As noted by Brewer, Saez and Shephard, MTR should be higher at points in the earnings distribution where the number of individuals is small relative to the number of taxpayers with earnings exceeding this amount.[5] (This is because the revenue gained from increasing MTR at a given earnings level will be proportional to the number of individuals who have earnings greater than this level).[6] This creates another financial efficiency argument to taper away benefits in so far as it is possible to do so before the point at which earnings density increases.[7] Once again, lower earners are negatively impacted. (See Appendix for explanation of this challenge.)
4) **MTR floor**: A negative MTR will never make sense in a world of earnings-only elasticities, because the act of increasing taxes rates from negative to zero would raise tax take which could then be used for redistribution.[8]

A tax schedule that sought to maximise the tax take (and so the income of the poorest in society) would require high benefit withdrawal rates and lower top

5 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings,* (IFS, 2008).

6 In the example above, if there were twice as many higher earners, then the low-earnings tax rate that maximised tax take would be 96%, rather than 93%

7 This pattern is less applicable when work participation elasticities are considered. Nonetheless, when we review different proposals for benefits reform, the impact of the distribution of earnings on the outcomes can be counter-intuitive.

8 Tax take would increase both from the direct effect and also the behavioural effect (because they would earn less, and hence have less negative tax).

rates of tax. Even those schedules that sought a less aggressive form of income redistribution would have higher marginal tax rates for lower earners.

The original Mirrlees assumption, that changes in benefits and taxes result only in changes to earnings levels (and not in movement into and out of the workforce), has the consequence that that the effect on employment of high MTRs (which translate to high PTRs) is not acknowledged.

Under these earnings-only elasticity assumptions, we describe the tax schedules that would result from a range of social objectives. Here we will analyse three such social objectives: (1) redistributing income towards lower earners, (2) maximising the level of out-of-work benefits, and (3) minimising the Gini coefficient – constrained only by the need to raise revenue for other purposes.

10.2.1 OBJECTIVE 1: INCOME REDISTRIBUTION TOWARDS LOWER EARNERS

Brewer, Saez and Shephard have derived an optimal income tax schedule to achieve a moderate redistribution of income, assuming a constant earnings elasticity of 0.25 (This is in the middle of the range for observed earnings-elasticity measures – see Appendix D).

It shows that for very low levels of earnings, individuals would face a MTR of around 70%;[9] the MTR would then decrease relatively quickly with income, reaching 36% as incomes approach £30,000 per year. As incomes increase further, so too would the MTR, eventually settling at around 64% for incomes above £200,000.[10]

This U-shape pattern of optimal marginal tax rates results primarily from the earnings distribution in the population. At the point of maximum population density on the earnings scale, it would be worth having comparatively low MTR, so as to encourage additional earnings from this group.

If the elasticity were higher, at 0.5, so that people were more responsive to marginal tax rates, this would produce lower MTRs across the earnings distribution, falling as low as 20%, with a top rate of 45% (below the proposed 50% rate). The intuition for the difference here is simple: when individuals are more responsive to tax changes, they will react more to a given MTR (reducing their labour supply by more), and this places a limit on how high MTRs can go.

10.2.2 OBJECTIVE 2: MAXIMISING OUT OF WORK BENEFITS

A Rawlsian social objective seeks to maximise the benefit income for those out of work (who are the worst-off in society).

With such an objective, any change in MTRs that increases tax take will enhance social welfare – as this fiscal gain can be used to increase benefit levels. Therefore, with such an objective, the optimal tax schedule would maximise the overall tax take from the working population.

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9 Exclusive of consumption tax.

10 This data is taken from Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings,* (IFS, 2008).

Under this criterion, we would want a higher level of out of work benefits financed by higher MTRs across the entire distribution of earnings. The optimal shape becomes closer to an L than U-shape. Remember that having high MTRs at a low point on the income scale does not affect the MTR of those higher up on a different tax band (and so not affecting their work incentive) – but it will capture more of their overall earnings as tax. The particularly high MTRs for the lowest earners are driven by the desire to capture a larger tax take from mid-to-higher earners, without jeopardising their work incentives.

10.2.3 OBJECTIVE 3: MINIMISING THE GINI-COEFFICIENT

If one's objective was to seek a type of income equality, one would compare the social value of incomes rising for the lower earners with the social cost of the reduction in income for higher earners. The Gini coefficient is a measure of how widely incomes are distributed, with the minimum Gini coefficient of 0 occurring when every individual has exactly the same income. This indicator is often used for cross-country comparisons; and has been cited by commentators as evidence that inequality has increased in this country.[11]

With the objective of reducing the Gini coefficient, taxes for higher earners should be raised (beyond the point where tax take is maximised). In this scenario the net income of high earners falls, and the tax take is reduced. The resulting level of out-of-work benefits also drops, but the reduction in income for the lowest earners is less than the reduction in income for the high earners. There is greater income equality, albeit at a lower level of overall income.

10.2.4 EARNINGS-ONLY ELASTICITY: SUMMARY

All the tax models outlined in this section based on earnings-only elasticity suggest that the optimum schedule concentrates high MTRs on low earners. There is certainly an important lesson to take from the Mirrlees model, that maximising the redistributive power of a benefits system will have the effect of reducing social mobility through relatively higher MTRs for those on low earnings and those out of work.

However, the underlying assumptions of the model ignore the impact that tax and benefit withdrawal has on employment (as opposed to earnings): for low earners, this is the dominant effect.

Until recently, these earnings-only models have been the primary basis of academic understanding. This application of an appropriate model of the behaviour of high earners to low earners has held back the debate about welfare. As a result, the high benefit withdrawal rates in the UK and many other European countries have rarely been challenged.

More recently, however, the Brewer, Saez and Shephard model has begun to demonstrate the need to augment these models to include the effect of people moving into and out of the workforce as a result of changes to the tax and

11 See, for example, Polly Toynbee, 'The Public Worry More about Spanish Donkeys than Child Poverty' *The Guardian*, (January 2007).

benefit system.[12] It is to this we now turn.

10.3 Employment-elasticity models

The model described in the previous section assumes that individuals respond to the tax and benefit system only by varying their earnings as a function of the MTR they face. However, changes in whether people participate in the labour market at all, the employment elasticities, are not captured within such a framework.[13]

More recently, Saez and others have introduced 'work participation elasticities' into models.[14] At this point it is meaningful to consider reducing worklessness as a social welfare objective, in addition to income distribution. That is why we also look at jobs maximisation as a welfare objective.

Given the intrinsic value of a job, we believe that an employment metric is worth incorporating into any social objective underpinning a tax and benefit schedule; and that it will necessarily provide an optimal tax and benefit solution that is better suited to combating poverty in the long term.

In this section, we consider a paradigm in which moving into or out of employment is the only response to taxes and benefits, that is to say an 'employment-only elasticity' model. In this field, early work by Diamond (1980) has recently been built upon by Saez (2002), and Heim and Meyer (2004). We will use this work as the basis of our approach.

Under the employment-only elasticity model, the optimal structure of marginal rates changes dramatically towards reducing the MTR for lower earners.

Let us now explore the implications of two different social objectives: maximising tax-take to increase out of work benefit; and ensuring a more even income-distribution. Depending on which objective we pick, the shape of an optimal tax schedule will look quite different.[15]

10.3.1 OBJECTIVE 1: (RAWLSIAN) MAXIMISING TAX TAKE

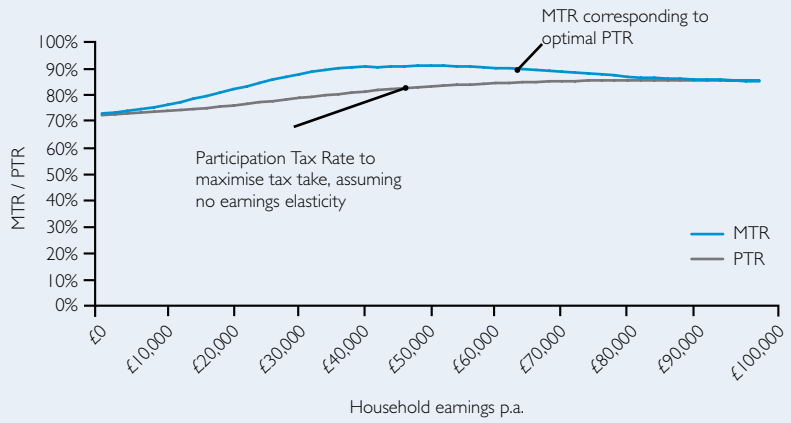
This particular objective places value only on the income of those out of work, and does not place any value on the lost income of those potential low earners deterred from employment due to high PTR. As before, this is the equivalent of a tax take-maximising objective.

The graph below shows what would be the tax maximising PTR for each earnings level.[16] The MTR schedule that corresponds to that PTR is also shown. The most notable difference between this schedule and those that are designed on earnings-only elasticity is that the MTR for low earners is lower, because of their higher employment elasticity.

In this example, at each earnings level, we are trading off tax-take from those

12 Mike Brewer, Emmanuel Saez and Andrew Shephard, Means-testing and tax rates on earnings, (IFS, 2008).
13 Richard Blundell and Thomas Macurdy, 'Labor supply: A review of alternative approaches', *Handbook of Labor Economics* (1999).
14 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings,* (IFS, 2008).
15 For a more detailed discussion, see in Appendix E.
16 Based on the employment elasticities given in Appendix D.

Figure 10.4 Employment-only models: tax schedule for maximising the tax take



in work with the number in work. The higher the PTR for any particular earnings level, the more tax per worker, but the fewer workers. This is because the objective is to maximise the tax take (and hence out-of-work benefits), so the tax rates are still relatively high.

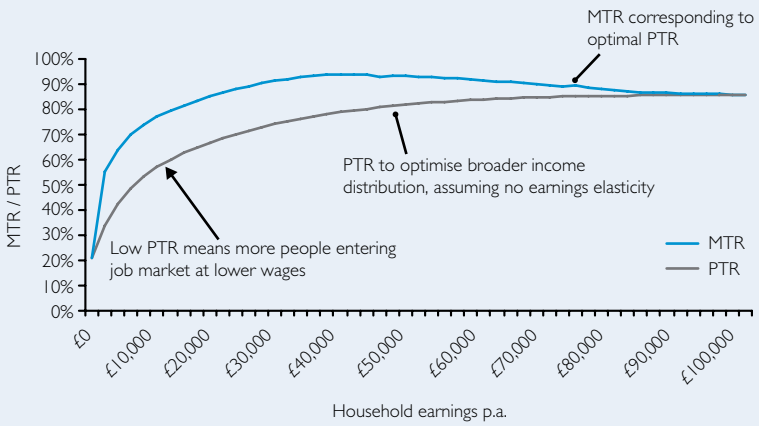
10.3.2 OBJECTIVE 2: BROADER DISTRIBUTION OF INCOME

An objective that sought a broader distribution of income would place value on the income of low-earners, as well as that of those out of work. As a result it would effectively place value on low-earners participating in the labour market and having earnings of their own.

If we say that the marginal income of low earners is nearly as valuable[17] as that of those out of work, then the optimal tax schedule has a dramatic drop in PTRs for low earners compared to the schedule for the Rawlsian objective.

With this objective, the participation tax rate is highly progressive. That is why the MTR for low earners starts very low, although it rises for middle earners.

Figure 10.5 Employment-only models: tax schedule for more equal income distribution



17 In this case, the marginal social value of income declines by 5% for each incremental £1,000 p.a. of earnings potential.

10.3.3 EMPLOYMENT-ELASTICITY: SUMMARY

The employment-only elasticity model and the earnings-only elasticity model point in opposite directions as regards the best withdrawal rates for low-earners. Looking only at employment responses tells us that PTRs should be low for low-earners, which is inconsistent with the high MTRs suggested by the earnings-only models.[18] Furthermore, to support the low PTRs for low earners, the MTRs suggested by employment-only models increase with earnings, and are actually damaging to earnings around median income, compared to the earnings-only model.

We cannot just look at the recommendations of the two models separately and strike an arbitrary balance. We need to have a model which simultaneously accounts for employment and earnings responses. This is what the Dynamic Benefits Model does.

Nonetheless, the unavoidable lesson from employment-only elasticity models is that most desirable objectives will require higher MTRs on middle-earners than on low-earners. It is at this point that our choice of objectives becomes very important.

10.4 Combined (earnings and employment) models

A combined model can accommodate social objectives that consider both employment rates and income distribution. We will show that any social objective that gives weight to the number of households in work will result in a tax schedule that has lower MTRs for low-earners than the earnings-only model, but higher than the employment-only model. The reverse is true for those with higher earnings.

Objective	Shape of tax-benefit schedule
Maximising out-of-work benefits *Or* Seeking broad income equality (10.4.1)	**Regressive** Higher marginal rates for low earners and relatively lower rates for high earners
Maximise national earnings / income (10.4.2)	**Flat** Broadly similar rates across the earnings spectrum
Maximise number of jobs / minimise the number of workless households (10.4.3)	**Progressive PTR** Low participation tax rates for low earners, and higher participation tax rates for higher earners

18 This conflict is ultimately resolved by having generous disregards and relatively high MTRs for low earners.

We are now able to develop our optimal model even further. We are in a position to combine into one model the two types of decision: the decision taken by people to move into and out of the workforce (quantified through employment elasticity), and the decision taken by people to change their level of earnings (quantified through earnings elasticity).

The shape of the optimal tax-benefit schedule will be dependent on the social objective. Some examples are set out in the table above.

We will review each of these different types of schedule.

10.4.1 MAXIMISING OUT-OF-WORK BENEFITS: REGRESSIVE SCHEDULES

If the objective is either to maximise out-of-work benefits or to seek broad income equality, the optimal tax/benefits schedule is a regressive one.

Meeting these objectives effectively translates into needing to maximise the overall net-tax take, so that it can be used to provide an increased income for those households out of work.

The most effective way to achieve this is by taxing high earners such that they pay higher marginal tax rates on lower earnings, and lower rates on higher. (See section 10.2.4 above.)

As the dominant criterion is raising tax, the earnings effect on high earners has a greater impact than the employment effect on low earners. As a result, these schedules are not significantly different from those generated under the earnings-only elasticity paradigm – where we were assuming that no one moved into or out of work. For more details see Appendix E.

10.4.2 MAXIMISING NATIONAL EARNINGS: FLAT SCHEDULES

If our objective is to maximise total national income, with no particular regard for income distribution, we will tend to want lower marginal tax rates on lower earnings, which will lead to flatter tax schedules.

Income maximisation is subject to certain constraints, such as the general expenditure on health, education, defence and so on. We also need to raise sufficient tax to provide for those out of work, or on low earnings.

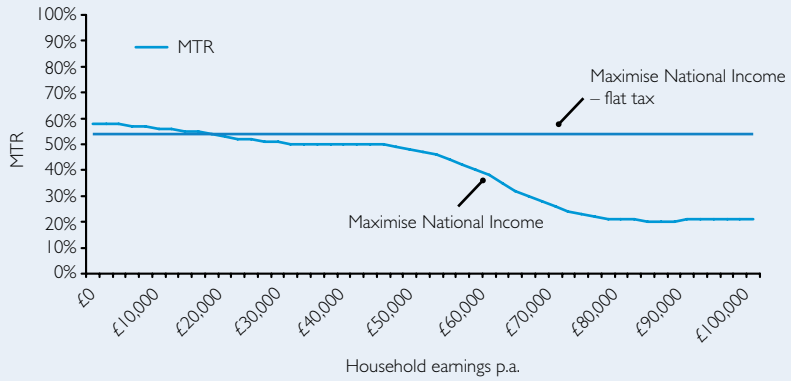
For example, in our simplified model of the UK working population, if the tax required to cover general expenditure were set at £5,000 per household, and the benefits paid to those out of work were set at 50% of median income, then the optimum flat tax would be at 54%.

This would result in a median net income of £21,000 p.a., and a 13% higher national income than the regressive tax schedule. It would also lead to lower levels of worklessness - approximately 50% of the induced worklessness compared to that under more redistributive tax/benefit schedules.[19] However, this is at the expense of lower levels of income equality. (For a discussion on

19 We estimate that the impact of high MTRs for low earners causes an additional 2m households to be workless vs. minimal taxation.

the trade-off between out-of-work benefit levels and marginal tax rates see the Appendicies E and H).

Figure 10.6 Combined elasticity model: 'flat' tax schedules, with out-of-work benefit at 50% of median income



The flat tax rate is virtually identical to the national-income-maximising MTR schedule for the majority of households. However, in order to raise the requisite taxes to support a given level of expenditure on out-of-work benefits, it would be more effective to lower tax rates on higher earnings to further raise national income (and thus tax-take). See figure 10.6 above. On the other hand, if further national income gains merely accrue to higher earners, we may choose to sacrifice some of these overall gains, so as to focus them on low earners instead.

10.4.3 MAXIMISING JOBS: PROGRESSIVE SCHEDULES

As the PTR is reduced for low earners, there is a reduction in worklessness, because low earners in particular are increasingly rewarded for entering the workforce.

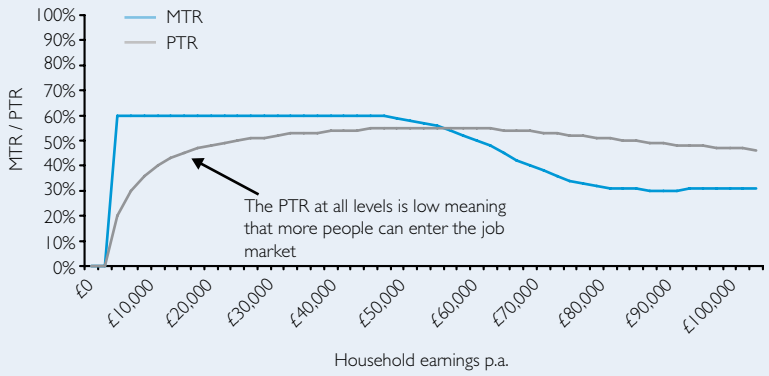
We can further exploit the high employment elasticity among low earners. When we looked at the employment-only elasticity model, we saw that a progressive PTR was the most efficient way for extra jobs to generate tax revenue.

This observation suggests that a tax schedule that is progressive in PTR terms would maximise the number of households in work. By keeping PTRs low for low-earners we can create the maximum incentive/reward for work for those who are most sensitive to this incentive. At the same time, we also wish to maximize the tax base from higher earnings, to fund the benefits that are mechanistically required to keep PTRs low for lower earners. Hence MTRs need to be kept moderately low for higher earners.

The resulting schedule creates a progressive PTR schedule by providing a generous tax and benefit allowance before any withdrawal. As a result, moderately high MTRs can be levied without significant impact on the employment incentive. This schedule follows the principles set out in the proposals of Brewer, Saez and Shephard (2008).

If we continue to target out-of-work benefits at 50% of median income, then the tax rate plateau under this scenario is 60%. If we were to target out-of-work benefits to be 60% of median income, then the tax rate plateau would need to be as much as 75%. Again, we see that meeting the Government's poverty target would come at a large social cost. It will take more understanding of the social consequences of reform – rather than blind adherence to these targets – if we are to help more low earners out of poverty.

Figure 10.7 Combined elasticity model: progressive tax schedules



Our calculations suggest this approach can yield 300,000-500,000 extra jobs when compared to the flat tax, income maximisation approach (See Appendix E for calculation). The main reason for this is that the PTR for those below median earnings is lower. There is a greater incentive to work for those who will be driven by such incentives.

The higher MTR for many of those just above median earnings means that the total national income is depressed slightly. It is 17% greater than the national income of the regressive schedule (against 21% for the income maximisation schedule). It does however result in a slightly more equal income distribution than the scenario above.

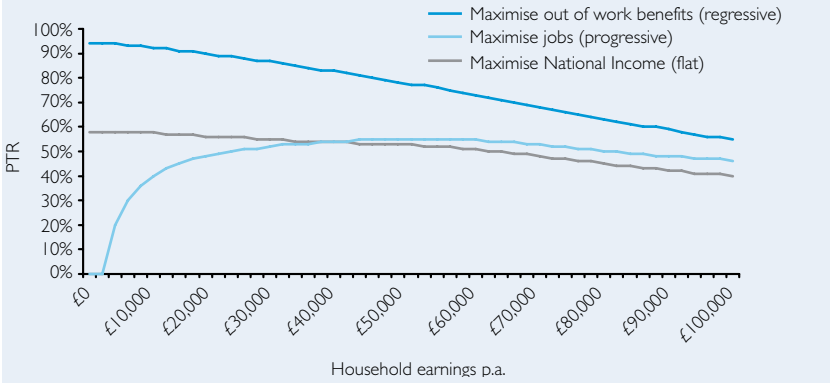
10.4.4 COMBINED-ELASTICITY: SUMMARY

Once we combine the two major behavioural responses to tax and benefits, we have created the core of a model that can help identify the optimal tax and benefit schedule, given a desired social and financial objective.

We have shown above that the approach that most closely matches the objectives identified in Chapter 9 is one where the PTR is progressive. In this way the incentive for low earners to enter the workforce is the greatest, aligning with their higher elasticities (efficient) and also with the benefits of securing better earnings (and income distribution).

The PTR profiles of the different objectives are shown in the graph below.

Figure 10.8 PTR profiles resulting from different tax schedules on a combined elasticity model



It should be noted that the shape of the 'maximise jobs' profile is the opposite to that suggested by the 'classical' optimal tax theory that was based on earnings-only elasticities and income distribution objectives, but ignored employment effects.

It should also be noted that this approach is the opposite of what we have today in the UK, where a regressive combined tax/benefits withdrawal schedule is hidden behind the veil of a progressive tax regime. Unfortunately today, the impact of benefits withdrawal dominates the decisions of the weakest in society, denying them the opportunities afforded to others.

10.5 Optimal tax conclusions

The patterns discussed in the earlier sections are based on a highly simplified model of the UK population, and therefore cannot be translated immediately into specific policy recommendations. However, they provide a sound basis for understanding the overall patterns underlying a practical and optimal tax and benefits schedule, given our objectives.

If the objective is to maximise out-of-work benefits, the practical answer is to maximise the tax take from all earners. This means having high marginal rates for low to middle earners, not just to raise taxes from them, but also to ensure maximum tax take from higher earners. High earners are sensitive to marginal tax rates at their earnings level, but not below. Hence, taxing their first earnings at a high rate, while keeping the MTR low on their highest earnings, is an efficient way of increasing the overall tax take while still encouraging them to earn more.

If the goal is to maximise national income (while protecting the least fortunate in society), then we need to lower the marginal tax rates for lower earners, because this will encourage low to middle earners to enter the workforce. This will have a greater impact on national income than encouraging high earners to earn yet more. Practically speaking this means maximising the tax raised from above-average earnings (as distinct from above-average earners); and using it to fund tax cuts for below average earnings. This will maximise the income of low earners (and also increase the

income of above average earners as their initial earnings will be taxed less). This will increase overall income and reduce worklessness, but will also reduce income equality, as benefits would be reduced.

If the goal is to maximise jobs, the same principle applies: maximising tax raised from high earnings, and using it to reduce the tax burden on lower earnings. However, the shape of the tax schedule on low earnings would be different. Jobs will be maximised when the PTR schedule is progressive. Low earners are less sensitive to MTRs (because they tend not to have the same level of choice of earnings-level as high earners), so the most effective way to create a progressive PTR schedule is to have a significant tax and benefit-withdrawal free allowance, and then a higher MTR through which to raise taxes.

Our objectives involve reducing economic dependency, and increasing the number of households with work. Hence we will need to explore tax and benefit schedules that have much more progressive participation tax rates, so as to stimulate the low-earner economy.

In all of these cases, we see that the optimal schedule still has lower MTRs for those with higher earnings, than for those below median. This is a prime reason for the political requirement to have separate withdrawal schedules for benefits and tax. However, the cost of allowing these combined MTRs to rise excessively has been grave for the most vulnerable members of society.

10.5.1 SECOND EARNERS

Secondary earners are more responsive to taxes than primary earners; therefore (all other things being equal) the earnings of secondary earners should be taxed at a lower rate than the earnings of primary earners for efficiency reasons.

However, an important question is whether all other things should be equal. In addition to efficiency considerations, we must also refer back to our objectives. If our objective includes valuing the first job in each low-earning household, there is a countervailing argument to have lower tax rates on the first earner than the second – or at the very least not to over-invest in tax rates below the tax-raising optimal.

A system of progressive PTRs at a household level already means that second earners generally have an increasing PTR. Given their elasticity, an optimal tax schedule will need to be careful not to price them out of work inefficiently. But, again, this would be quite different from today's position, where second earners tend to have significantly lower PTRs than first earners in a household.

10.5.2 OPTIMAL TAX IMPLICATIONS

This chapter, and the two that preceded it, have served to illuminate the theories and concepts underpinning our proposal, and to explain our thinking in devising it. In Part III we will use these concepts to create an optimal benefit schedule fit for today's society.

The concepts that have been outlined here are very much alive and implementable. Our discussion has been conceptual in nature and deliberately simplified in order to draw out the key principles: the real world is, of course, much more complicated, but the lessons we have outlined in this chapter will hold true in practice as well as theory.

CHAPTER ELEVEN

Why We Need the Dynamic Welfare State

Reviewing the benefits system with a dynamic perspective forces us to ask tough questions of our social and economic governance, questions that could not be more timely. We have a moral obligation not only to support the most vulnerable in society, but to ensure that in doing so we do not stifle opportunity and reward. Therefore, the basic question of whom society wants to help, as well as how the help is to be delivered, cannot be avoided. Is it right to divert resources to those who are able to work significant numbers of hours, or to those slightly lower in the earnings distribution?

A Government that wants to get more people moving from welfare into work, that wants to erode the barriers to social mobility among the most poor, and that is committed to a principle of equal opportunity for all, needs to answer those questions. And so Government must get to grips with the dynamic modelling process. The economic theory and practice that have evolved through years of research cannot be ignored. In times of economic austerity, dynamic modelling is a valuable tool that will help gauge the kick-starting effect of job-creation and will help harness that effect to its fullest. It is an aid to moving smoothly and quickly out of recession.

It is time to consider the distribution of employment as well as the distribution of income. In doing so, one is drawn to a progressive PTR, to end the barrier against work for the most vulnerable. It is our contention that, at the margin, mobilising the workforce will provide the greatest long-term security for the economy, and for society as a whole.

Dynamic modelling has a crucial role in accelerating economic recovery and ensuring that the base level of worklessness does not rise after the recession, in the same way it has done following previous economic turmoil.

To eliminate excessive marginal tax rates on low-income households, part of what is needed is simply the adoption of a better way of thinking about design issues — one that emphasises overall marginal rates in the tax-benefit system, rather than the use of phase-outs to target distinct benefits. Given that the combined elasticity to earnings and work is greater for lower earners, an optimal tax schedule will seek to maximise the affordable tax take from higher earnings and then reinvest it into lower earners.

The gains will be manifold. This buttressing of our country's 'fundamentals' – its labour supply – is the surest path to economic stability.

Making the optimal schedule a reality

The patterns outlined in this chapter are based on an illustrative model of the labour market, and have used more flexible tax schedules than would be available to a policy-maker in a practical situation.[1] However the direction is the right one. A progressive PTR can maximise jobs, while also maintaining a good level of national income without gross inequality of income. This should be our lodestone as we evaluate the current system and design a new one.

In this exercise we have looked at the population as a homogenous set of households. The differences in household composition will have an impact on their elasticities. As such, there are slight variations required in the tax schedule by household group to achieve an optimal result. However, it is unlikely to be as large (or have the same character) as the differences in today's schedules by household type. As we saw in Part I (further explored in Appendicies A and B), there is certainly very little fairness or rationality in the distribution of benefits across various household groupings. Simply producing a more consistent schedule averaged around a more progressive profile would yield great returns, even before a root-and-branch reform is carried out.

Closed System

As the argument is made to acknowledge dynamic effects, we must make sure the evaluation of any proposal is clear about the true costs involved. For example, there is no point claiming that an investment of £1 billion in benefit reform can reduce worklessness and increase national income, unless we also count the costs in jobs and national income of raising the £1 billion of funds necessary through taxes.

We must recognise that the world of income transfer is a closed system. By definition, any revenue-neutral policy will have to increase MTRs for some groups and ranges and decrease MTRs for other groups or ranges.

To take an example: as we increase the levels of in-work support for low-earners relative to those out of work, we will encourage more people to enter work. To start with, reducing very high participation tax rates will mean that the fiscal effects will be positive. Those entering work will require less benefits than out-of-work, and more than cover the cost of the benefit transfer to existing workers.

However, as the benefit levels are increased, there are diminishing returns. It costs the Treasury to pay extra in-work benefits to those who take up jobs, and this means raising taxes (or reducing non-welfare expenditure). These taxes result in a fiscal and employment drag – which mean that they are less effective than they might appear.

Both options may be politically unpopular; however, there is no sense in disregarding these institutional constraints, and engraining the dynamic perspective across society will make it harder for all future Governments to do

1 There would need to be fewer discrete tax bands. In particular, a flat tax at the upper end is needed even though raising tax rates at the upper end does not raise the tax take.

so. Welfare reform is vital. It is vital then, that we take the limitations of the entire system into account if we are to be successful.

Vision: A connected society

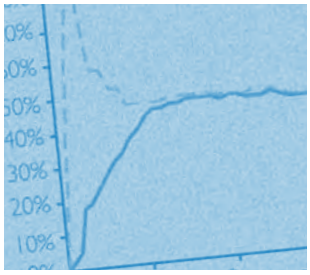
Our work connects the work of many economists and experts and, we believe, presents hitherto unparalleled opportunities for Government to understand the way their decisions affect the lives of the most poor and ought to inform government policy.

There is no social or economic sense in using static modelling, when economic research has evolved to the extent that welfare can be managed using dynamic economic methods.

It will take rigour and a Government committed to the principles of sound economics and social responsibility, to ensure that that the benefits system becomes a smarter, more effective system. This means finding a way to dramatically reduce the PTRs for low earners, in an affordable way.

We urge any Government serious about social responsibility and sound economics to take the work reported here, and use it to build further the knowledge-base around dynamic modelling. The potential is enormous. A new way of thinking about benefits offers the hope of a wider role for social thinking on welfare. In Part III, we will demonstrate the power of our model by using it to craft policies which we believe should be at the heart of a reformed benefits system.

PART III
Dynamic Benefits in Action



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CHAPTER TWELVE

Policy Design Using a Dynamic Benefits Model

"...a time for revolutions, not for patching"

Sir William Beveridge[1]

From principle to practice

In Part III, we will apply the principles outlined in the first two parts to design a series of alterations to the current scheme of benefits, and a new welfare settlement for our society. Given our objectives of reducing worklessness and increasing fairness, this would be the most effective way of spending the welfare budget. In Part I, we highlighted the aspects of the current benefits system that need reform, and discussed the objectives that a better system should try to achieve.

In Part II, we made the case for a new way of thinking about benefits: dynamic modelling. This is a way of evaluating the true costs and benefits of any proposed change to the tax or benefit system, including the financial impact of the earnings and employment decisions people make as a result of those changes. Our Dynamic Benefits Model also makes it clearer what kinds of systems will result if we make different decisions about trade-offs between objectives.

In this final Part III, we assess existing proposals for reform, and present our own proposals for a reformed benefits system – the Universal Credits scheme. We show how it achieves our fundamental objective, to relieve poverty, while supporting work and independence, in a fair and affordable way.

We begin by reviewing the spectrum of reforms which have been suggested by others. While we do not, finally, endorse any particular one of these options, we believe valuable lessons can be learned by analysing them, and our final proposal is a selected 'blend' of the most effective of these measures. We first consider reform options designed to reduce worklessness and poverty directly, then those which aim to increase fairness towards couples, and finally those which aim to reduce the complexity of the system. Our own proposal also addresses other inequities identified in Part I, such as the lower benefits claimable by mortgage holders and those with savings.

We have used our Dynamic Benefits Model to assess and compare the outcomes of all reform options discussed: how many households move into employment, the dynamic cost to Government, and the reduction in child poverty, and the effect on national earnings. A comparison of the efficiency of the different proposals is included in section 13.4.

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1 William Beveridge, *Social Insurance and Allied Services* (1942)

While the analysis undertaken in Part II helped identify optimal marginal tax rates for work incentives, and identified necessary trade-offs and constraints on benefits policy, we did not show how such an optimal scheme could be achieved from the specific starting point of the existing benefits system. After considering other people's proposals, we describe the Universal Credits scheme, before assessing its performance on the various measures we have identified. In this way it can be clearly compared to the options that others have proposed (and that we have analysed). We also compare the cost and efficiency of different versions of our own proposal.

As well as providing an insight into the likely effects of different policies, we hope that our comparisons will demonstrate the practical power of a dynamic model such as we have developed, in allowing comparisons of very different reforms and giving policy-makers clear points of reference for a more informed discussion of such reforms. It will also show that there is no 'silver bullet' for reform, and that priorities will need to be stressed and compromised made: in aiming for the best possible benefits system we must acknowledge the limits of possibility.

The Universal Credits proposals have been developed through just such a thorough and careful review; we believe their effect would be truly transformational, leading to sustained reductions in worklessness and poverty, greater fairness for couples families, and ultimately a stronger society.

CHAPTER THIRTEEN

Promoting Work, Reducing Poverty: Options

Key Conclusions

- Changes in benefit withdrawal rates help the poorest far more effectively than changes in tax rates;
- Small, targeted changes have a weak overall effect, while adding complexity;
- Increasing benefits disregards produces stronger gains in employment than reducing benefit withdrawal rates, but weaker gains in earnings.

It is clear that the most efficient way to increase overall employment and earnings is to reduce the (currently very high) marginal and participation tax rates faced by low earners.

A wide range of proposals for improving work incentives have been made in the past, including changes to benefit withdrawal rates, tax rates, earnings disregards, and tax allowances. This chapter and the two that follow are a compendium of potential reform options, mostly proposed explicitly by others, or inferred from what they have written. Where others have estimated the impact of their reforms, they have done so from a static, rather than a dynamic perspective: in contrast, the following dynamic analysis of reform options through our Dynamic Benefits Model is new. The analysis of these other options will lead us towards our own final scheme.

This chapter focuses particularly on those reforms which aim to improve work incentives across household groupings. We look at three categories of changes:

- Reducing withdrawal rates (either by reducing tax or reducing benefit withdrawal rates);
- Increasing disregards (either by increasing the personal tax allowance, or increasing the earning disregard prior to benefit withdrawal);
- Changing benefit levels.

There is a formal pattern to the review of each proposal:

- **The situation today** describes a particular feature of the tax and benefits system.

- **The case for reform** explains the arguments for why it produces undesirable outcomes, with reference to the key proponents of such arguments.
- **Specific proposals** describes which of the proposed changes we have analysed.
- **Winners and Losers** describes the direct, static effect of the income transfer: 'winners' are those groups (defined by earnings level or household type) who receive more benefit income, or lose less in tax, than they do under the existing system; 'losers' are those who would lose out in this sense from the changes.
- **Changes in economic incentives** shows the effect of the reform on MTRs and PTRs for different groups – we will see that the 'winners' often face reduced incentives to enter work before the reform.
- **Dynamic outcomes** brings this analysis together, taking into account how people would change their behaviour in response to the different reform proposals. Here we estimate the change in national income; the dynamic cost (defined in section 13.1.1); the effectiveness of the reform at reducing poverty, especially child poverty; and how many households we could expect to move in and out of work, overall. Unless otherwise stated, each reform proposal is analysed as if it were the only change to the system.

We review proposals that change the benefits system and also those that change the tax system. Benefits and taxes are most certainly not the same thing, however as we have argued in section 8.3.2, there are significant analogies when it comes to their disincentive effects. For example, benefits can be used to support work in three ways:

- Reducing the withdrawal rate (taper) of a benefit received by a household in work;
- Increasing the earnings disregard, before benefits are withdrawn;
- Increasing the amount of benefit given in-work, for example increasing the Working Tax Credit.

Similarly, there are three ways of changing the regime of personal taxation:

- Reducing the tax rate;
- Increasing the personal allowance;
- Providing a tax rebate.

Using the tax system to increase work incentives has been a popular policy choice in the past. The administration of Income Tax and National Insurance is more developed, and more efficient than most benefits: it has therefore been simpler to change. There are lessons to be learnt for the benefits system from such an approach.

13.1 Reducing withdrawal rates

Lower withdrawal rates for low earners make work more attractive, as they directly reduce marginal tax rates (MTR) and participation tax rates (PTR). Moreover, as we demonstrated earlier, the greatest penalty to work comes at the lower- to middle-end of the income scale. The key economic motivator to work for individuals who find themselves in this situation is not the tax rate alone, but the combination of tax and benefit withdrawal.

The complex dynamics of reducing withdrawal rates, and the 'More Workers-Less Work' paradox

The dynamics of reducing tax rates are relatively simple:

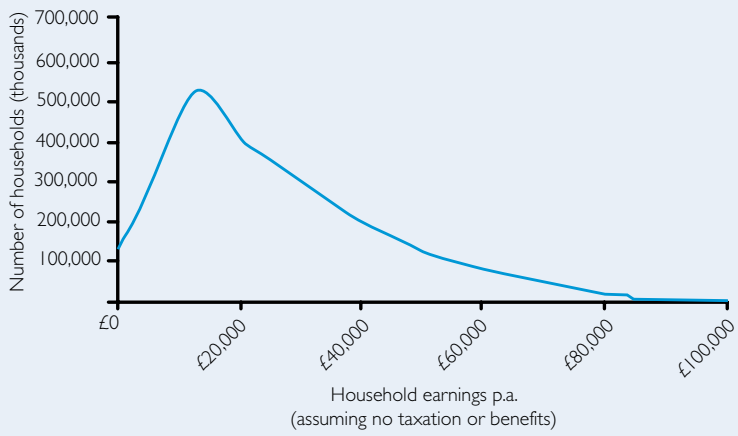
When tax rates are reduced, every earner on the tax rate experiences a reduced MTR, and every earner above the tax rate experiences a reduced PTR. Reducing tax rates will generally increase earnings and employment, and have few counterintuitive effects.

For changes to benefit withdrawal rates, things are much less straight-forward. This is because two groups are affected:

1) Those who currently receive the benefit experience lower marginal and participation tax rates; and
2) A second group whose earnings were above the previous threshold for receiving the benefit, but who now receive a tapered version of it, owing to its reduced withdrawal rate. This benefit will now be withdrawn in response to increasing earnings, so the marginal tax rate for this group will increase, encouraging them to reduce their earnings.

The behaviour of this second group is very important, and can lead to a highly counterintuitive effect: if the second group is very large compared to the first, reducing benefit withdrawal rates might actually decrease national earnings, even though it will always lead to more people working.

Figure 13.1 Household earnings distribution



We call this the 'More Workers – Less Work' paradox. It results from the skewed profile of the earnings distribution, which can be seen from the diagram below: if the withdrawal rate is lowered, the proportion of those in net receipt of benefits increases, as we discussed in Chapter 10 (the iron triangle of benefits reform). In technical terms, this can increase the mean marginal tax rate, even though the participation tax rate for the poorest falls.

In practice, this effect is rarely strong enough to mean that national earnings actually *fall* in response to a cut in withdrawal rates. However, it does explain why certain reforms promise to be very successful in increasing the number in employment, but produce much weaker gains in earnings

This is discussed in more detail in Chapter 10 and Appendix E.

We will consider four mechanisms for reducing disincentives to work:

1. Reducing the withdrawal rates for Jobseeker's Allowance and Income Support;
2. Reducing the withdrawal rate for Housing Benefit;
3. Reducing the withdrawal rate for Working Tax Credit;
4. Reducing the Income Tax rate.

13.1.1 REDUCE THE WITHDRAWAL RATES FOR JOBSEEKER'S ALLOWANCE AND INCOME SUPPORT

The situation today

Those receiving Income Support and Jobseeker's Allowance currently have a withdrawal rate of 100% above the small (typically £5 p.w.) earnings disregard: there is *zero* financial incentive for an individual in this situation to earn an extra £1.

The case for reform

There is a growing consensus on the need to reduce these marginal withdrawal rates for the lowest earners. This was commented on in a recent Treasury working paper by Mulheirn and Pisani:

> *The reduction of the 100% effective tax rate for benefit recipients facing a pound-for-pound reduction in their entitlement unambiguously improves the work incentives faced by this group.*[1]

Specific proposals

We have evaluated the impact of reducing the JSA taper rate to 80%, 70%, 60% or 50%. To ensure this makes a material difference to low earners, we have also adjusted the point at which Housing Benefit and Council Tax Benefit start to

1 Ian Mulheirn and Mario Pisani, *Working Tax Credit and labour supply: Treasury Economic Working Paper No.3,* (HM Treasury, March 2008), p. 10.

be withdrawn, so that this only happens once JSA is completely exhausted (as a result of it completely tapering away, or because of eligibility for WTC).[2]

Winners and Losers

All those currently working and in receipt of JSA/IS would benefit, because it would be tapered away more slowly. The value of both JSA and IS in 2009/10 is £64.30 p.w. (£50.95 for singles under-25 and £100.95 for couple households), so it would benefit most those earning less than this per week – the very lowest earners.

Worked Example

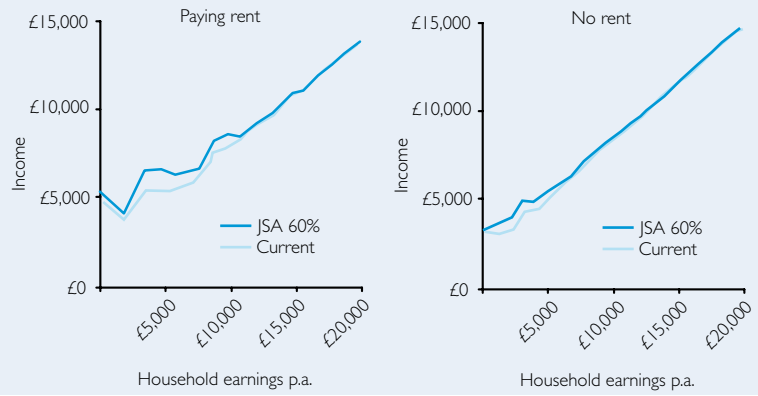
John, a single adult who works 10 hours per week at £6 per hour (just above the minimum wage), currently has nearly all his JSA tapered away. He is currently entitled to a £5 p.w. disregard, which means that £55 p.w. of his wages are offset against JSA. As a result his increase in take-home pay from working is £5 p.w.

As a result of the taper rate for JSA reducing to 60%, he would keep £27 p.w. of his wages (£5 disregard + 40% of the remaining £55 of his earnings). This is a gain of £22 p.w. or £1,144 p.a. compared to the situation today.

The impact of delaying the withdrawal of Housing Benefit in this scenario means some individuals higher up the earnings scale (not currently in receipt of JSA) would also benefit from reduced MTRs, because they would face withdrawal rates of 60%, rather than 65%, on their first £100 p.w. (after the £5 disregard). Figure 13.2 below shows how different groups would benefit from JSA being withdrawn at 60%. It shows how total household income (Y-axis) varies as earnings increase (X-axis), comparing the JSA at 60% scheme (red line) with current 100% withdrawal (blue line). The two scenarios chosen (a single person with no children paying rent, and no rent) are chosen because they are the most likely groups to be receiving Income Support and JSA and no other benefits, and so the simplest scenarios to illustrate.

Figure 13.2 Option: Set JSA withdrawal rate at 60% of earnings

Average household income for single households with no children, paying rent and no rent



2 These upward adjustments to the HB disregard are needed when reducing the taper rate of JSA, as otherwise the combined withdrawal rates would reach close to 100% - defeating the purpose of reducing MTRs.

As a result of this option, there would be 1.6m 'winners'. Figure 13.3 demonstrates who gains from a reduction in taper rate for JSA/IS to 60%, for those working fewer than 30 hours. The gain for couples will generally be higher, because as a household they have a higher combined JSA level that is currently tapered away at 100%.

Figure 13.3: Impact on population working fewer than 30 hours p.w. of withdrawing JSA at 60%

Family Type	Earnings of main earner	Tenure	Population	% Winners	Average household gain (p.a., 2005-06 prices)
No Children	£1 - £4,000	Couple	44,520	100%	£976
		Single	182,006	100%	£909
	£4,001 - £7,000	Couple	116,911	94%	£1,690
		Single	501,101	86%	£527
	£7,001 - £15,000	Couple	196,592	56%	£795
		Single	254,708	40%	£376
Children	£1 - £4,000	Couple	50,674	100%	£926
		Single	42,841	90%	£593
	£4,001 - £7,000	Couple	155,663	16%	£865
		Single	211,821	7%	£966
	£7,001 - £15,000	Couple	111,476	40%	£264
		Single	164,687	9%	£115
Total			**2,032,999**	**57%**	**£743**

The net impact is that the incomes of 134,000 households are lifted above the poverty threshold of 60% equivalised median income. The gains for those with children are less because of the current availability of Working Tax Credit at 16 hours. For these families, Working Tax Credits already provide a work incentive at low earnings.

Changes in economic incentives

In Part II, we explained that reducing a very high marginal tax rate has a much bigger proportional effect for recipients than reducing a lower marginal tax rate by a commensurate amount. It follows that reducing the 100% withdrawal rate for JSA / IS could be very cost-effective at encouraging people into work.

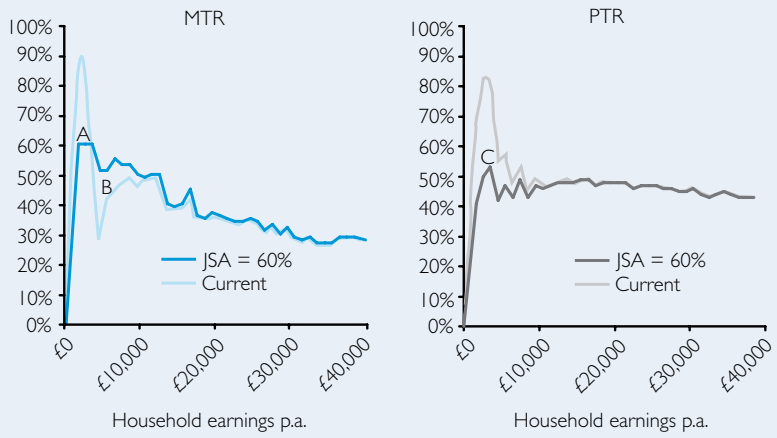
Figure 13.4 shows how reducing the withdrawal rate of JSA to 60% would establish lower MTRs for the lowest earners (A).It should also be noted there is a group (B) earning between £4,000 and £10,000 who would experience a higher MTR, because they are now receiving JSA, which is still being tapered away. Some of them will reduce their earnings as a result.

For nearly all those earning less than £10,000 per year, there would be a meaningful reduction in PTR (point C on the graph), thus providing greater reward for entering work at low earnings.

The most significant impact of such a reform would be that the spike in both MTR and PTR at low earnings is dramatically reduced. It is this alteration that would drive the most significant changes in behaviour.

Figure 13.4 Option: Set JSA withdrawal rate at 60% of earnings

Average MTR and PTR profiles for all households



Dynamic outcomes

Measuring dynamic costs

We use the same definition of dynamic cost throughout our analysis. Dynamic cost is the net annual cost to the Government of the proposal, once households' level of employment (both in terms of number of jobs, and hours worked) has adjusted fully to the incentives they face. It occurs as a result of changed payments to households, changed work and earnings levels, and also changed spending levels from the difference in net income, as VAT and other taxes are clawed back on these expenditures. However, it assumes no reductions in benefit administration costs, and no other indirect financial gains resulting from increased employment levels – so for proposals that increase employment, it should be somewhat pessimistic compared to the actual, long-term financial cost to the Government.

We also measure the change in the number of households with at least one member in work.[3] There will be a change in earnings as a function of people entering (or leaving) work and also increasing their hours.

Finally, as a check, we also quantify the number of children in households that have been lifted over the poverty threshold, as a function of employment, earnings increase, and income changes[4]

Table 13.5 below highlights the impact of such a reduction in taper rates. Reducing the withdrawal rate from 100% to 80% actually *saves* the government money because the employment effect of increased incentive for individuals to seek work outweighs the cost of decreased withdrawal rate. This is the

3 This is not the same as employment: a single earner household in which the other adult started working would increase the employment rate but not the number of households in work. The overall employment increase is captured in our model, but for clarity we have chosen to focus on what we regard as the most important social measures.

4 We have assumed that the poverty threshold remains unchanged by the movements created by our system. In fact, some of these proposals will have an effect on the poverty threshold, as they may change the median income – but we do not address this impact in poverty metrics.

equivalent in the benefits system of the phenomenon described by Laffer: that when taxes are very high, the overall tax take can often be increased by reducing taxes.[5]

Figure 13.5 Dynamic outcomes: Reducing the JSA withdrawal rate

Reducing JSA/IS taper rate from 100% to:	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)	Reduction in BHC child poverty (60%) ('000s)
80%	-£29	138	£387	64
70%	£81	207	£607	65
60%	£296	279	£831	119
50%	£910	363	£866	149

Where the taper rate is reduced to 60%, 145,000 of the 279,000 households entering work would escape poverty as a result of the reduction; the remainder would still benefit from a direct increase in income. The reduction in child poverty is more modest, as most of those households pushed over the poverty line are childless.

Decreasing the withdrawal rate further becomes increasingly costly: although the employment and poverty-reduction benefits continue to accrue, reducing taper rates below 60% is a much less efficient way of increasing employment and earnings, owing to the distribution of earnings across society. This results from the More Workers-Less Work paradox: moving from a 60% to 50% taper rate increases employment, but the effect on overall earnings is much smaller than we might have expected.

This reform is an important starting point for any effort to improve work incentives. It addresses some of the most extreme penalties in the current system. However, given that low earners have high employment elasticity to PTR, there is still a greater barrier to them entering the workforce than there is for higher earners. We will review alternative proposals for addressing this.

13.1.2 REDUCING WITHDRAWAL RATES FOR HOUSING BENEFIT

The situation today

Those currently receiving Housing Benefit also tend to have low income and high MTRs, though their MTR is not as punitive as for those in receipt of JSA/IS.

To understand this, we need to understand the interaction between Housing Benefit and Council Tax Benefit. Housing Benefit is withdrawn at 65% of net earnings, but those in receipt of HB will tend also to receive Council Tax Benefit which is withdrawn at 20% of net earnings. This results in a total withdrawal rate at this level of 85% of net earnings and around 70% of gross earnings for those paying Income Tax and National Insurance.

5 In economics, the Laffer curve is used to illustrate the idea that increases in the rate of taxation do not necessarily increase tax revenue.

The case for the reform

Some have proposed reducing Housing Benefit withdrawal rates in order to reduce overall MTR.[6] As with JSA/IS we would expect reductions in HB withdrawal rate to have a positive behavioural impact.

Specific proposals

We have estimated the impact of reducing the Housing Benefit taper rate to 35%, leaving Council Tax Benefit unchanged. This analysis is based on a JSA withdrawal rate of 100%, and HB/CTB disregards set as they are today.

Winners and Losers

Reducing Housing Benefit withdrawal rates to 35% net would help 821,000 working households who currently receive Housing Benefit to support their rent payments. For those households that experience a financial gain, the average net increase in HB (or reduction in withdrawal) would be £778 p.a.

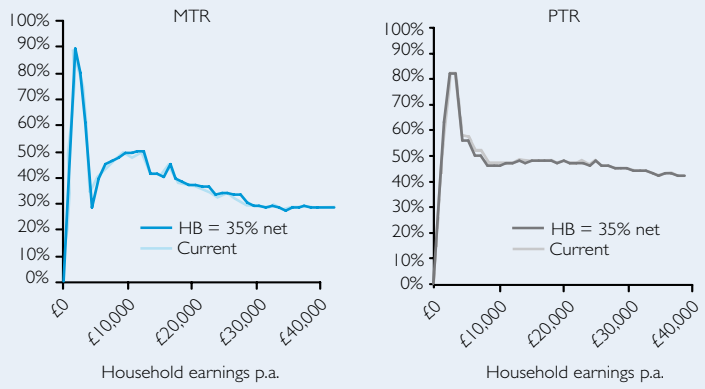
The majority of those who would gain are renters with household earnings between £4,000 and £15,000 per year. The gains are also concentrated in households with larger HB entitlements: privately-renting, large families in more expensive areas. As a result, reducing the taper rate for housing benefit lifts virtually no households out of poverty directly, as those in receipt of tapered HB are usually already above the poverty line.

Those with very low earnings do not experience any HB withdrawal, as they are paying back their JSA/ESA. Those with earnings above £15,000 have mostly had their housing benefit tapered. Low earners with mortgages would not be helped by this reform, as they are not eligible for Housing Benefit.

Changes in economic incentives

Figure 13.6 Option: Set HB withdrawal rate at 35% of net income

Average MTR and PTR profiles for all households



6 Nicholas Boys Smith, *Reforming Welfare*, (Reform, November 2006), p. 11.

Housing Benefit is withdrawn on the basis of net earnings, so changes in its withdrawal rate have a diminished impact on MTR and PTR. As can be seen from the graphs above, the average marginal and participation tax rates are hardly affected by a change in withdrawal rate. This is because the overall amounts are relatively low; and also the benefit accrues to a small proportion of low earners. The reduction in MTR for one group in receipt is counteracted by an increase in MTR for those earning slightly more. Between £5,000 and £10,000 there is a small reduction in average PTR.

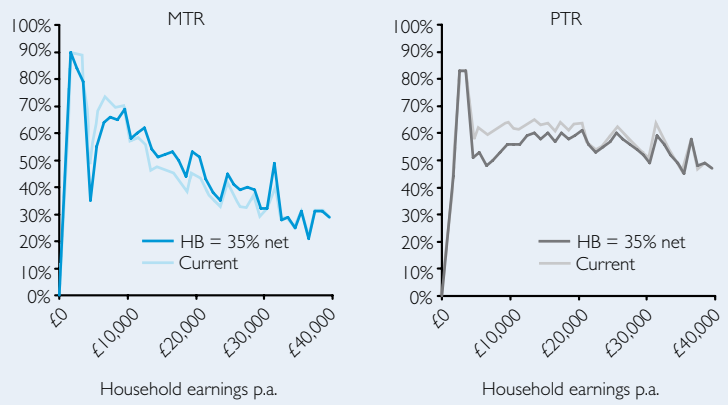
As a result we would expect to see very little behavioural change across the population from a reduction in Housing Benefit withdrawal rates.

However, with regard to the subset of households in the private rented sector, where the levels of Housing Benefit are highest, the effects are greater (see Figure 13.7 below). Among this group, a more noticeable reduction in MTR can be seen among lower earners, with a slight increase among higher earners as they face later withdrawal of HB.

A more sustained reduction in PTR is present, as a result of lower HB withdrawal rates. This reduction has a greater impact on incentives, as this group has far higher PTR than others, itself a function of the high level of benefits withdrawn.

Figure 13.7 Option: Set HB withdrawal rate at 35% of net income

Average MTR and PTR profiles for private renting households



Reducing Housing Benefit helps those entering work at around £6,000, but for lower earners, the highest PTR still remains, owing to JSA withdrawal at 100% in this model.

Dynamic outcomes

The table below shows the impact of changing the housing benefit withdrawal rate.

Figure 13.8 Dynamic outcomes: Reducing the JSA withdrawal rate

Reducing HB taper rate from 65% net to:	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)
35%	£231	61	£386

The effect is not as dramatic as for reducing the withdrawal rate of JSA/IS, as people receiving HB occupy a range of situations. While some today have withdrawal rates of 95%, others start at 65%. Similarly, some have a PTR of 90%; others only 25%. That is why the bulk of the positive impact is concentrated in a subset of the recipients.

Hence, this proposal – on its own – is not particularly efficient.

Clearly, help given through specific benefits (in this case Housing Benefit) will only help a particular group (in this case, those who rent). This limits the scope of change to a single benefit to address the wide-ranging work incentives problem.

13.1.3 REDUCING WITHDRAWAL RATES OF THE WORKING TAX CREDIT

The situation today

Currently, tax credits are withdrawn at a taper rate of 39% of gross earnings. As a result, most recipients of Tax Credits experience an MTR of 70%,[7] which is a significant disincentive to increasing earnings. On the other hand, many recipients of tax credits have comparatively low PTRs compared to other low earners.

The case for the reform

A recent IFS report for the Mirrlees review specifically suggested reducing the withdrawal rate of tax credits (both Working Tax Credit and Child Tax Credit) from 39% to 34%.[8]

Specific proposals

We consider different levels of taper rate for Working and Child Tax Credits. We do not make any change[9] to the disregards levels or to the Family Element of CTC, which is tapered at household earnings above £50,000.

Winners and Losers

Reducing the tax credit withdrawal rate to 30% (from 39%) would help up to 4 million households by an average of close to £800 per year. Reducing the Working Tax Credit withdrawal rate helps only those who are eligible to claim the benefit – those who fulfil the hours criteria (see section 2.6.6).

Those families with more children, receiving the largest combined tax credit awards, will gain the most. The biggest beneficiaries are families with annual earnings between £15,000 and £30,000. The income gains from reducing

7 Income Tax at 20%, National Insurance at 11%, and Tax Credit withdrawal at 39%. Some large families will keep HB when eligible for WTC.

8 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings*, (IFS, 2008), p. 52.

9 The childcare elements of the WTC are assumed to operate unchanged to today.

withdrawal rates of tax credits would not reduce poverty, as all recipients experiencing withdrawal have incomes above the poverty thresholds.

Changes in economic incentives

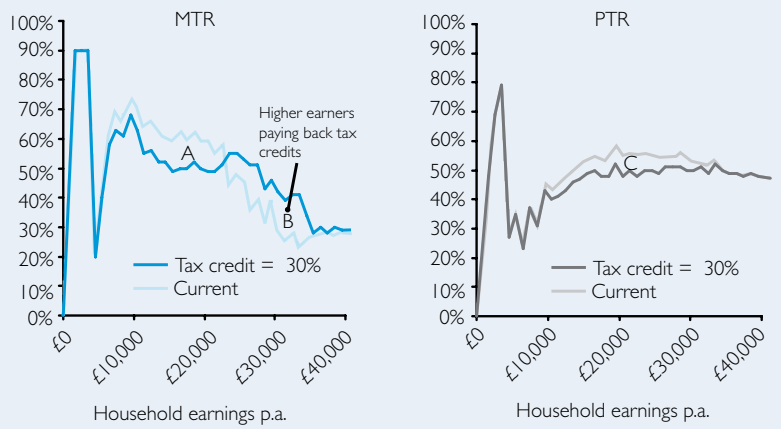
Those receiving WTC tend to have higher earnings and lower MTR and PTR than those in receipt of IS/JSA and Housing benefit.

The impact of changing the taper rates is most pronounced for households with children, who experience the sequential withdrawal of both Child Tax Credit and Working Tax Credit. As a result, they currently experience higher MTRs further up the income scale.

As can be seen from the graphs in Figure 13.9 below, the average family with earnings from £9,000-£22,000 (A) has a lower MTR due to reduced tax credit withdrawal rates, whereas those higher up the earnings scale (B) will have higher MTR because they now receive tax credits and are experiencing their withdrawal. As a result, for many households around the median earnings, there will be an earnings disincentive.

Figure 13.9 Option: Set tax credit withdrawal at 30% of gross earnings

Average MTR and PTR profiles for all households with children

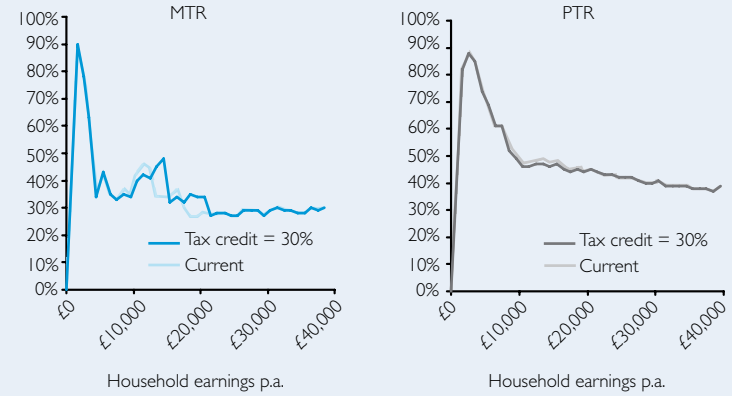


The PTR graph shows that there is a slightly reduced PTR for all those households earning above £9,000 p.a., up to ~£30,000 (C). As a result, there will be a positive employment incentive among mid-to-higher earners.

For single adults and couples without children, a reduction in tax credit withdrawal rates has very little impact (Figure 13.10 below). A slight delay in paying back Working Tax Credit reduces the PTR marginally, but compared to families with children, this group already has lower PTRs above £10,000 per year.

Figure 13.10 Option: Set tax credit withdrawal at 30% of gross earnings

Average MTR and PTR profiles for all households with no children



Dynamic outcomes

The reduced household participation tax rate from a lower WTC taper rate helps to increase the number of households in work, and as a result reduce the number of households experiencing child poverty. However, it does so at a cost to national earnings. The higher number of people facing increased MTRs outweighs the earnings increase of the greater employment level (another example of the More Workers-Less Work paradox). This is true for reducing the taper rate to either 34% or 30%.

The table below shows the impact of changing the tax credit withdrawal rate.

Figure 13.11 Dynamic outcomes: Reducing tax credit withdrawal rate from 39% income

Reducing tax credit taper rate from 39% to:	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)	Reduction in child poverty (60%) ('000s)
34%	£1,245	47	-£60	42
30%	£2,542	94	-£39	85

The cost of reducing the withdrawal rate of tax credits is high for three reasons:

1. The beneficiaries of this reform currently experience relatively low MTR/PTR.
2. In the case of a 30% tax credit taper rate, the increased MTR for those now entitled to WTC means that many new beneficiaries have an incentive to reduce their earnings. This is an example of how the underlying earnings distribution can have an impact on the optimal MTR schedule, especially when we are reducing the MTR through slower benefit withdrawals (as opposed to tax reductions). Slower withdrawals means that people with higher earnings will receive a tapered benefit. Reducing the withdrawal rate for a relatively small group of earnings below a concentrated group of high earners can mean that the earnings impact of higher MTRs for many overwhelms the employment and earnings impact for a small number of lower-earners (More Workers-Less Work).
3. Furthermore, there is the effect of an increased PTR for many second-earners: this means there is no overall increase in jobs. As many higher

elasticity second earners leave work as do workless households gain employment.

In comparison to the previous two options we have considered, the costs of reducing the taper rate for Tax Credits are relatively high for the extra households in work. On the other hand the large total number of winners (albeit those who are already above the poverty threshold) does have a certain appeal.

13.1.4 REDUCING TAX RATES

The situation today

In the 2007 Budget, the former Chancellor, Gordon Brown, cut the rate of tax from 22p to 20p. This was financed by the abolition of the 10p tax band, which came into effect in April 2008. Today there are only two tax bands: a basic rate of 20p and a top rate of 40p (though a third, higher rate of 50p is to be introduced shortly).

The case for reform

The case for a reduction in the basic rate of income tax is that it provides some relief for hard-working families, and that its benefits are felt broadly across the working population. On the other hand, it does not help the very lowest paid people, and also reduces the tax receipts from all higher-rate taxpayers.

Cutting the rate of tax across the board is a less effective measure than many others from the point of view of a progressive taxation schedule, as the winners from such a policy tend to be concentrated at the higher end of the income scale. With most reforms of this type, little benefit accrues to those who pay little or no tax.

Specific proposals

The specific reform we have evaluated using the model is to reduce the standard rate by 2 points, from 20% to 18%. At the same time we leave National Insurance and Income Tax thresholds unchanged.

Winners and Losers

Lowering the tax rate helps all those who pay tax in the band which is lowered. If the standard 20p band were reduced by 2 pence, all those paying income tax would gain: over fourteen million households would gain by an average of £423 p.a.

For many low earners, this effect is muted because Housing Benefit is withdrawn from net earnings. If the tax rate is reduced, those in receipt of Housing Benefit will find it is withdrawn faster, thus negating the benefit.

For example, for a 2p cut in basic income tax, someone earning £7,000 would benefit by £32 p.a., whereas someone earning £70,000 would benefit by £750 p.a.

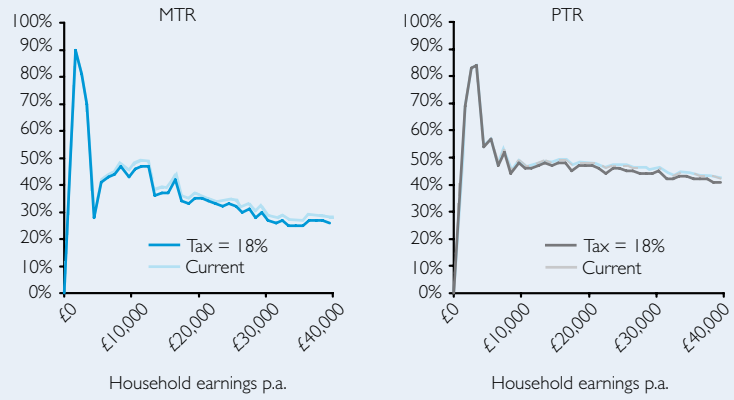
Reducing the tax rate will not directly (in a static manner) push a significant number of poor households above the poverty threshold.

Changes in economic incentives

Reducing the basic rate of tax means that all basic rate tax payers will see a reduction in their MTR, thus encouraging them to increase their earnings (Figure 13.12 below). There is also a reduction in PTR for those at the upper end of the basic tax band.

Figure 13.12 Option: Set standard rate of Income Tax at 18%

Average MTR and PTR profiles for all households



For lower earning households, there is a small decrease in MTRs (from those earning approximately £9,000 and above). PTRs are only very slightly affected.

Higher rate tax payers (not shown on the graph)[10] will not experience a change in MTR, which will be 40 per cent, but will have a modest reduction in PTR. The combination of these effects will increase employment and also earnings.

Because those who gain have higher earnings and lower MTRs and PTRs than average, reducing tax rates will not have the same positive behavioural effect as those we have seen for the benefit options. Moreover, as we saw in Chapter 8.3, higher earners are less responsive to PTRs than lower earners.

Dynamic outcomes

When the rate of taxation is reduced, all those paying tax at that reduced rate receive a greater reward for earning more, and so some choose to work more. This leads to an overall increase in earnings. However, this reward is spread diffusely.

Using our dynamic model, we can demonstrate the impact of cuts to either rate of tax in more detail:

10 Since this model was constructed, the higher rate tax band decreased to £37,400.

Figure 13.13 Dynamic outcomes: Reducing basic tax rate

Reduce basic tax rate	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)	Reduction in child poverty ('000s)
2p (20% > 18%)	£4,140	+80	£3,610	41

This reform is very costly, and results in only a small number of households escaping poverty. On the other hand, it does result in a significantly increased GDP as a result of the increased earnings.

13.1.5 SUMMARY: OPTIONS FOR REDUCING WITHDRAWAL RATES

Comparing the different examples above, some lessons can be learned about how to reduce marginal tax rates in a way that has a large-scale impact. They are as follows:

1. **Help those with the highest MTR/PTR:** In order to be effective, reductions in tax and in benefit withdrawal rates should be focused on those with the highest MTRs and PTRs. This is the group that will gain most from the reductions. Hence, reducing the taper rate for JSA and IS is the most effective reform of this type.
2. **Avoid reducing withdrawal rates for those with low MTR:** Reducing withdrawal rates for tax credits or Income Tax can have a very broadly-based impact. However their impact is diluted because it is spread across those with both high and low MTRs.
3. **Target on most elastic, and most needy:** In order to have the greatest impact, we should aim to reduce PTRs for those with low earnings. If so targeted, the new schedules will have a meaningful impact on the choices facing those joining the workforce in entry-level jobs.
4. **Do not be overly narrow:** we should seek to help and reward low earners generally, not just specific groups. For example, reducing withdrawal rates on Housing Benefit is less effective because it does not help many people.
5. **Avoid spill-over effects:** As benefit withdrawal rates are reduced, the consequences of additional households facing high benefit withdrawal rates is that earnings are reduced and some second earners leave the workforce. This is a problem with both reducing HB and tax credits.

We believe the most appropriate route to reducing overall withdrawal rates is to focus on the groups with the highest combinations of MTRs and PTRs. An effective way to do so is to place a cap on the combined withdrawal rate that any individual can experience.

All but one of the proposed reforms analysed above fail some of these tests: reducing the withdrawal rates of JSA/IS is clearly an important part of any reform, but reducing the withdrawal rates of any other single benefit is a very costly exercise. The complexity of the benefits system means that benefits

such as HB and tax credits have a mixture of recipients with both high and moderate MTRs. This fact is one reason why cost-effective reform has been so difficult to design.

The solution is to focus on the overall withdrawal rate of benefits, rather than on any one in particular. Setting a cap on the benefit taper rate is an effective way of ensuring that the investment in lower MTRs is well-directed. This is also the approach partially taken by Brewer, Saez and Shephard (2008) – although they have two different withdrawal rates.[11] In our own proposal we recommend only one overall withdrawal rate (Chapter 16).

Our model suggests that capping benefit withdrawal rates at 55% of post-tax earnings is very efficient. It reduces disincentives to work, while avoiding increasing the MTRs at higher earning levels in a counterproductive way. This approach reduces the highest MTRs and also minimises the inevitable spill-over effects.

13.2 Increasing disregards

Increasing benefit disregards (the level of earnings at which benefits start to be withdrawn) and tax-free allowances is another way to reduce PTRs for many groups. It does so without fundamentally changing the MTR schedule, although the fact of a bigger disregard means that it is shifted up the earnings scale. So the lowest earners pay no tax, and/or do not have benefit withdrawn, whereas higher earners experience a greater MTR from delayed withdrawal of benefits.

Current benefit disregard levels are set in a way that attempts to minimise the risks of concurrent withdrawals from multiple benefits. However, the lack of alignment between benefits means that this is often inefficient and complex to administer. Consider this tangle of thorns:

- Housing Benefit and Council Tax Benefit are set such that they withdraw once IS/JSA has been completely withdrawn
- Working Tax Credit withdrawal only occurs once IS/JSA has been lost, and the household is paying tax.
- Child Tax Credit withdrawal only occurs once WTC has been withdrawn.

Nonetheless, it is still possible to face simultaneous withdrawals due to:

- Tax and National Insurance Contributions;
- Housing/Council Tax Benefits;
- Tax credits.

In this section we assess the impact of increasing benefits disregards and personal tax allowances. Increasing disregards is more effective at providing a material benefit to lower earners.

11 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings*, (IFS, 2008).

13.2.1 INCREASE BENEFIT DISREGARDS

Benefit support can be made more generous for low earners by increasing the 'disregard'. Like an increase in the personal allowance, increasing benefit disregards allows more earnings to be kept by those in entry-level jobs.

Increasing benefit disregards brings down participation tax rates by allowing more earnings to be kept, hence it improves work incentives. Furthermore, it also substantially reduces complexity, as earnings below the disregards do not have to be withdrawn by the relevant bodies.

The situation today

The current disregard for withdrawal of JSA is £5 p.w. of earnings for a single person and £20 p.w. for a lone parent.

In the 2007 budget then Chancellor Gordon Brown increased the WTC thresholds by £1,200 (though this generosity was offset by an increase in the withdrawal rate by 2%).

The case for reform

The main advocates of the general approach of increasing disregards have been Brewer, Saez and Shephard in a recent paper for the IFS. This suggested the first priority for any reform should be to:

> *Increase the level of earnings disregards (the amount of earnings a person is allowed to earn before benefits are withdrawn) in all of the means-tested benefits (in order of priority, HB/CTB -then JSA/IS) to reduce PTRs on earnings of less than £90 a week for all, and on higher earnings for individuals receiving HB/CTB: these groups currently face very weak incentives to work at all.*[12]

They also suggested introducing a disregard in Working Tax Credit for the second earner in order to increase the incentives for a second earner to work.

Specific proposals

Increasing disregards where PTR is highest will have the greatest employment impact. Hence, we analyse the impact of increasing the disregards for JSA/IS to the following:

- £10 for singles, £20 for couples, £25 for lone parents and £35 for parents with children (keeping the withdrawal rate at 100%).
- The disregards for Housing/Council Tax Benefit are increased to when these out of work benefits are fully withdrawn, or when WTC is awarded.

In this analysis we do not change the disregard for tax credits, Income Tax or National Insurance.

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12 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings*, (IFS, 2008), p. 52.

Winners and Losers

There are 900,000 winners from increasing these benefits disregards, gaining on average £188 p.a. from this modest change. They are predominantly those with household earnings below £6,000 p.a. who are currently in receipt of JSA/IS or HB. A couple with children with low earnings could be up to £780 better off. Many of those receiving HB or CTB will experience an increase in income, as these benefits are tapered away from a higher point. Nearly 40,000 working households are lifted directly out of poverty, as a result of postponing JSA withdrawal.

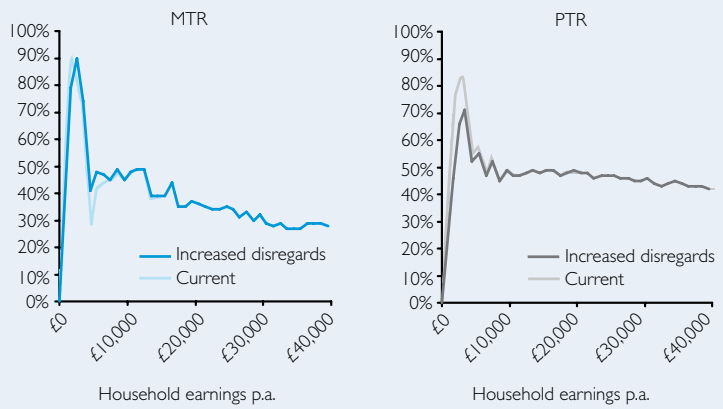
Changes in economic incentives

The result of increasing earnings disregards for out-of-work benefits is that the JSA withdrawal is shifted up the earnings scale until it interacts with Working Tax Credits. However, the MTR for many low earners is increased as their JSA now continues to be withdrawn at a higher earnings level.

The PTRs for the lowest earners are reduced significantly as they keep more of their initial earnings before having any benefit withdrawn. Figure 13.14 shows how the peak in PTR for the lowest earners has been reduced somewhat.

Figure 13.14 Option: Increase the benefit disregard

Average MTR and PTR profiles for all households



Increased disregards create significantly greater work incentives. On its own, however, an increase in benefit disregards can also cause earnings to reduce for many of those currently not in receipt of any benefits because of the higher MTR they experience. Hence, a truly effective reform will need to combine increased disregards with a reduction in the punitive MTR for the lowest earners.

Dynamic outcomes

The virtue of this reform is that the winning section of the population is focused on those who receive benefits, and those with the lowest end earnings. As a result, there is a significant increase in the numbers of households in

work, and also increased earnings – although this is reduced by the loss of earnings of those in work facing a higher MTR.

Figure 13.15 Dynamic outcomes: Increase benefit disregards

Increase benefit disregards:	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)	Reduction in child poverty (60%) ('000s)
New levels at £10, £20, £25, £35 for different groups (see above)	£32	113	£237	75

The net effect is that for a small dynamic cost of £32 million, it is possible to increase the number in work by over 100,000: this reform comes very close to paying for itself in the short-term, and we would expect it to produce net gains for the Treasury over the long-term.

13.2.2 INCREASING TAX ALLOWANCES

The other mechanism for reducing PTRs is by increasing the personal income tax allowance, although this only helps those entering employment at earnings above the current tax threshold.

The situation today

The personal allowance in 2007-08 was set at £5,225. In 2008-09 it was adjusted with inflation to £5,435, before being increased by a further £600 to £6035 by Alistair Darling, and this further increase has been adjusted for inflation for 2009-10: it is now £6,475.[13]

The case for reform

As with decreasing the rate of tax, increasing personal allowances is a measure with broad appeal. There have been a number of commentators who have suggested increasing the personal tax allowance. Lord Blackwell, writing for the Centre for Policy Studies, urged a raise in personal allowances to £7,500.[14] This was supported by a member of our Working Group, Nicholas Boys Smith, who suggested raises to £7,900 and £10,000 in his 2006 paper Reforming Welfare.[15] More recently, in 2007, Katharine Hirst, writing for the Adam Smith Institute, advocated a starker raise to £12,000.[16]

The advantage of increasing the personal allowance is that it concentrates the benefits on the lowest earners. It also means that higher earners will also benefit.[17]

13 Our model uses the £5,453 figure. However, this has little impact on the comparison of reforms, as the change relative to the current situation is being measured.
14 Lord Norman Blackwell, *Take poor families out of tax!,* (Centre for Policy Studies, October 2005), p. 1.
15 Nicholas Boys Smith, *Reforming Welfare*, (Reform, November 2006), pp. 125-6.
16 Katharine Hirst, *Working Welfare,* (Adam Smith Institute, 2007), p. 27.
17 This effect is mitigated if it is structured as a rebate – see section 13.2.3.

Specific proposals

We have modelled an increase in the personal allowance to £10,000. However, we have left both National Insurance rates and the higher rate Income Tax threshold unchanged.

Winners and Losers

All taxpayers are winners from this reform. The total number of households who see a financial gain is 14.3 million. Those individuals earning above £10,000 receive the greatest benefit – and households with two earners see the greatest potential gain. The average household gain is over £1,000. As a result, 93,000 low-earning households would be lifted directly out of poverty as a result of having significantly reduced tax.

Those larger families who have greater Housing Benefit and Council Tax Benefit entitlement will see a smaller gain, as these benefits are withdrawn on income net of tax and tax credits. Hence, these two benefits will be withdrawn faster as a result of not having tax withheld. As a result, up to 85% of the gain from paying less tax is lost. Out of this group of large families, those who have already earned enough so that all their benefit entitlement has been tapered away will see a material gain.

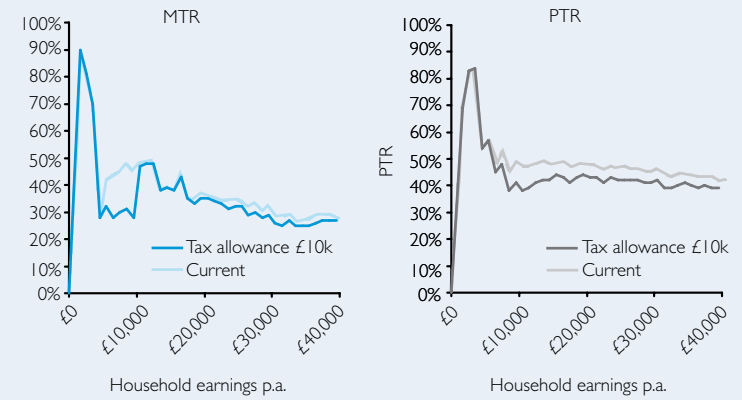
Those who are not paying tax - or who are earning just over the personal allowance – see zero or minimal gain.

Changes in economic incentives

This proposal reduces the high marginal rates that many lower earning households have to pay. As can be seen from Figure 13.16 below, households with earnings between £5,000-£10,000 experience much lower MTRs, and on average higher earnings households also experience a drop, where second earners benefit.

Figure 13.16 Option: Raise the individual tax allowance to £10,000

Average MTR and PTR profiles for all households



There is, moreover, a sustained reduction in the PTR for all households with earners above the tax threshold, increasing the rewards for employment at average or above average wages. However, this reform, on its own, does not materially increase the rewards for entry-level jobs. The high PTRs faced by low earners remain unchanged – unlike increasing benefit disregards.

Dynamic outcomes

Figure 13.17 analyses reforms which increase the personal allowance to £10,000 per year.

The increased reward for employment means that 326,000 households would move into work. As the tax threshold operates on an individual basis, there would be further incentives for second earners to also enter work: as a result the total number of increased jobs would be 460,000.

Figure 13.17 Dynamic outcomes: Raising the tax allowance

Increase personal allowance	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)	Reduction in child poverty ('000s)
+£10,000	£11,400	326	£8,701	136

As a result of the decreased MTRs for those on low earnings, they would be encouraged to earn more. Consequently, the total increase in earnings would be £8.7 billion. The net effect would be that a further 283,000 households would escape poverty through entering work and also earning more: and in total, 376,000 households would escape poverty (from both increased income and increased earning) if the annual tax threshold were raised to £10,000.

Personal allowance raises are slightly more effective at increasing employment than tax rate cuts. However, when compared to the other reforms we have considered, they remain an expensive and broadly inefficient measure, especially when accounting for the economic costs of raising another £11 billion to fund them. (See Figure 13.4 for a comparison of all the dynamic outcomes for options described in this Chapter.)

This proposal shares many characteristics of reducing the rate of tax. However, increasing the personal allowance means that more families do not just pay a *reduced amount* of tax, but pay *no* income tax. Despite the problems with using tax as a means to improving work incentives, there is an admirable aim in reducing the number of families both paying tax and receiving benefits at the same time. We conclude therefore, that some modification of the tax regime must occur in order to reduce 'churn' as far as possible, but it is clear that this must be balanced against affordability and efficiency, as money might be better spent elsewhere.

13.2.3 TAX REBATE FOR PEOPLE ON LOW PAY

The situation today

Recently the Government, in increasing the personal allowance, also decreased the threshold for the top band of tax, so that most of those paying at the top band of tax would not benefit from the increased generosity. A tax rebate achieves a similar purpose: once an earner earns above a certain threshold the 'unpaid' tax is claimed back.

The case for reform

Increasing the personal tax allowance has many attractive features. It is, however, expensive as it reduces the PTR of higher earners (without inducing much additional employment). A rebate represents a far more targeted approach, as the rebate is paid back more quickly.

Specific proposals

Rather than simply increasing the personal allowance, this option aims to provide a rebate against tax and National Insurance that is paid back once a person's earnings rise above a certain threshold. We analyse a proposal that provides a rebate for the first £1,000 of income tax paid, then paid back from annual earnings over £12,000 at a rate of 10%.

Winners and Losers

Under this option, all low-paid workers benefit from paying less tax. Ten million households gain by an average of £708 p.a. The greatest winners are those earning between £10,500 and £12,000 per year, who benefit by £1,000. Those with earnings between £12,000 and £22,000 will see this benefit taper to zero as it is paid back at 10%. At higher individual earnings (once the rebate has been paid back), there are no winners or losers. Hence, this helps focus support on those who need it. As a result 123,000 low-earning households would be lifted directly out of poverty.

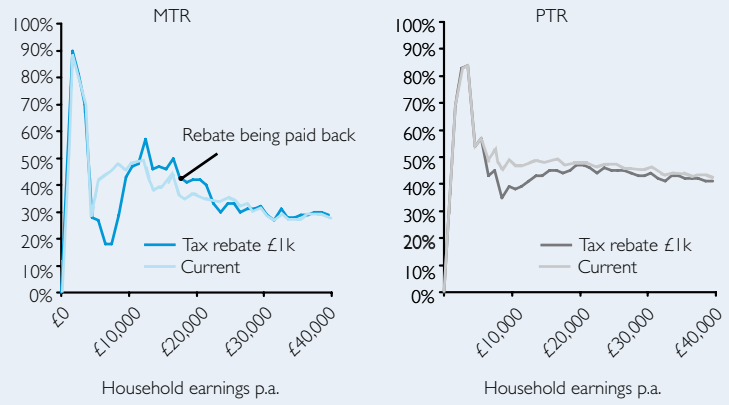
A weakness, in terms of precisely fulfilling our objectives, is that being individual-based (as with all tax-based reforms), the result is that two-worker households with one low-earning and one high-earning member will benefit. The investment is not as targeted as it could be. That said, this mechanism offers a more efficient mechanism for reducing 'churn' of tax and benefits than increasing personal allowances.

Changes in economic incentives

This rebate reduces the high marginal rates that many lower earning households have to pay. As can be seen from Figure 13.18 below, households with earnings between £5,000 and £12,000 experience much significantly lower MTRs. Significantly lower PTRs are experienced between £5,000 and £22,000.

Figure 13.18 Option: Give individuals a tax rebate of £1,000

Average MTR and PTR profiles for all households



This option has the disadvantage of increasing the MTR for those at the point on the earnings scale where they are paying back the rebate. That is why, while this option provides a greater employment incentive, it also provides an earnings disincentive for those we are paying back the rebate at an increased marginal rate.

Dynamic outcomes

The increased reward for employment from providing a tax rebate means that 312,000 households would move into work. Because the tax rebate operates on an individual basis, there would be further incentives for second earners to also enter work. As a result the total number of increased jobs would be 453,000. The net effect would be that a further 267,000 households would escape poverty through entering work and also earning more. This would mean that 390,000 households would escape poverty as a result of the rebate.

Figure 13.19 Dynamic outcomes: Providing a tax rebate

Tax rebate	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)	Reduction in child poverty ('000s)
£1,000 paid back from earnings over £12.000 at a rate of 10%	£3,897	312	£6,225	136

The model suggests that a rebate is a much better option than raising the personal allowance (see Figure 13.19), as it ensures that the beneficiaries are concentrated among low earners, making it a better poverty fighting measure. As a result, the increase in households with work is comparable, but the cost is significantly less (£3.9bn against £11.4bn). On the other hand, when compared to a policy of increasing benefit disregards, it is far more expensive, even if it has a bigger employment impact.

13.2.4 SUMMARY: OPTIONS FOR INCREASING DISREGARDS

Increasing benefit disregards creates a powerful incentive to enter work: moreover, it disproportionately helps those in the lowest-earning jobs, and the gains do not continue up the income scale.

Increasing tax allowances has less impact. Such a move has no effect on the income of those earning less than the tax allowance, and also costs significantly more as it provides gains for many others further up the earnings scale. A tax rebate would be somewhat more focused, but still not as effective as a benefits disregard.

Raising the disregard on its own is not satisfactory as it leaves many more earners facing very high MTRs. However, a combination of capping MTRs and raising the benefits disregard is likely to be the most cost-effective way of reducing PTRs for low earners and also containing MTRs for the majority of earners. Such a combination will form the basis of our proposed reforms in the next chapter.

13.3 Change benefit levels

Changing the generosity of benefits is often proposed as a way of reducing poverty and worklessness. It is argued that raising out-of-work benefit levels will reduce income poverty, and increasing in-work benefit levels will reduce worklessness.

13.3.1 CHANGE OUT-OF-WORK BENEFITS LEVELS

The case for reform

Currently, out-of-work benefits are increased annually in line with inflation. For most groups, out-of-work benefits are paid at £60.50 p.w. for single people, or £94.95 p.w. for couples. In addition, those with children can receive Child Tax Credits and Child Benefit worth roughly £60 p.w. per child.[18]

Specific proposals

Some commentators have suggested increasing the amount spent on the child element of CTCs in a drive to combat child poverty. Under such a scheme, every family claiming CTCs would see an increased income, and a few families would find themselves newly eligible for CTCs.

Winners and Losers

The financial winners from such a scheme would be those currently out of work, and those on low earnings. The greatest gains would go to those out of work. It is not clear that this move would help those in deepest poverty. It is more likely to continue to shift those just below 60% of median income to just above.

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18 Some approximations around the 'first child' distinction in Child Benefit and the family element in CTCs, alongside taking the 2009-10 levels where possible.

Changes in economic incentives

Increasing the out-of-work benefits in this way would weaken work incentives.[19] Even when PTR remains constant, there would be an incentive for those in work to leave. Those who are not eligible to claim the child element of CTCs in work would actually see their PTR rise, as the out-of-work position becomes more attractive. (See Appendix C for a fuller discussion of 'income effects' on work incentives.)

Dynamic outcomes

The unambiguous result of increasing out-of-work benefits would be increased levels of worklessness. Mulheirn and Pisani have shown that increasing out-of-work benefits with constant participation rates will lead to a reduction in employment. That is why we do not propose to explore this option. Such an option would lead to some decrease in income poverty: however, it would be a very expensive way of achieving this, and completely fails to meet our objective of increasing earnings.

13.3.2 INCREASING WORKING TAX CREDIT

The situation today

The Working Tax Credit has been the cornerstone of the Government's approach to encouraging work. Working Tax Credits are currently worth a maximum of approximately £80 p.w..[20] Given that the Government has introduced a measure by which to support working families, it seems appropriate to examine the effects of extending their programme.

The case for reform

Increasing the level of the Working Tax Credit might be a way of rewarding those who enter work at the thresholds of 16 or 30 hours per week. This would directly address the work incentive, but in a limited way. It makes employment more attractive only at, or just above, the hours thresholds.

Specific proposals

The proposal we have modelled is to increase the value of the Working Tax Credit to £2,500 p.a.

Winners and Losers

All those eligible to claim the Working Tax Credit would gain from this proposal. In addition, some low-middle earners who were previously ineligible on the basis of earnings would now qualify, as the award would be more

19 Ian Mulheirn and Mario Pisani, *Working Tax Credit and labour supply: Treasury Economic Working Paper No.3,* (HM Treasury, March 2008).

20 Basic element, couple/lone parent element and thirty hour element.

generous – because at a similar taper rate it would be available to those on higher earnings than today.

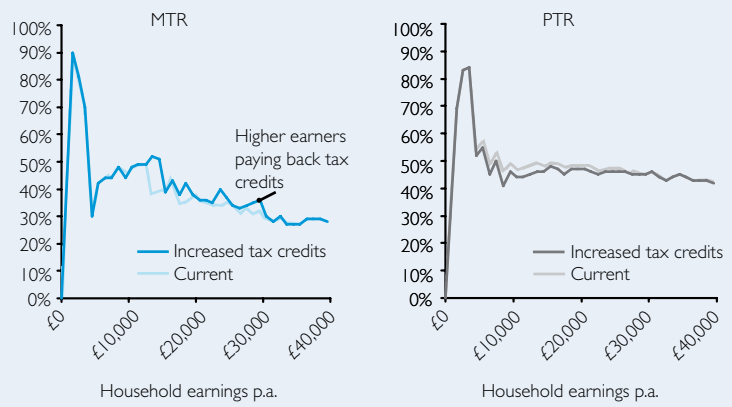
On the other hand, WTC support will only help those who are already eligible, meaning that many who do not fulfil the hours requirements will not be eligible.

Changes in economic incentives

If the value of WTC were increased, then those who qualify would find they have a greater gain from working. Some households higher up the earnings scale would face higher MTRs as a result of now receiving WTC (and having it tapered away).

Figure 13.20 Option: Increase value of WTC to £2,500

Average MTR and PTR profiles for all households



This proposal creates a limited increase in incentives to work, primarily because it reduces participation tax rates for those who have currently some of the lowest PTR levels.

Dynamic outcomes

There would be an increase of employment around the 16/30 hour points where the awards would be greatest, with increased employment across the range of earnings where households are eligible for the working tax credit. However, it would be a very inefficient way of increasing rewards from employment.

Figure 13.21 Dynamic outcomes: Increase working tax credit

Increase working tax credit	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)
£2,500 p.a.	£2,256	91	-£483

The beneficiaries would be those claimants who today have some of the lowest PTRs. The group of workers for whom it would be most efficient to increase in-work benefits would be those who are working just below the thresholds.

There would also be an overall reduction in earnings: this is a clear example of the More Workers-Less Work paradox. A very high number of households would face higher MTRs and would therefore decrease their earnings, far outweighing the additional earnings of those households entering work.

13.3.3 TAPERING IN WORKING TAX CREDIT – 'NEGATIVE TAX RATES'

The situation today

Tax credits are available to parents who work 16 hours or more per week, and those without children from 30 hours per week. Those who do not reach these hours thresholds are ineligible for Working Tax Credits.

The case for reform

Several commentators have expressed a wish to adopt a more American-style Earned-Income Tax Credit (EITC). This model differs from the UK approach in that it *tapers-in* as well as tapering out. It therefore replaces the hours rules with a purely income based assessment.

Both Boys Smith and Darwall have proposed adapting tax credits to taper in, in this fashion. However they also both suggested abolishing both Child and Working Tax Credits to pay for it (see below). The abolition of the Child Tax Credit would leave many worse off, as the EITC does not give any income to those who do not work. It seems quite politically difficult to scrap this support, but the in-work EITC could well replace WTCs.

The US Earned Income Tax Credit

The EITC works by paying an increasing amount as the claimant earns more, up to a maximum amount. After this, the maximum amount continues to be paid until the 'phase-out' threshold is exceeded. From this point, the EITC tapers away at a given rate.

It follows that an EITC that tapers in is just like a tax rebate, except that a negative tax rate can occur when it is tapered in faster than the underlying tax (&NI) rate.

In *Reforming Welfare*, Nick Boys Smith suggests a variant of the EITC,[21] with a phase-in of 100%, a maximum amount of £5,000 and a phase-out after earnings of £8,000 such that the total marginal rate never exceeds 50%. Couples with children would have a maximum amount of £7,000 and a phase-out threshold of £10,000.[22]

21 Nicholas Boys Smith, *Reforming Welfare,* (Reform, November 2006), pp. 127-30.
22 Less support is given to those with children.

In *A better way to help the low paid*, Rupert Darwall suggests a 35% phase-in, to a maximum of £10,000, which is then phased out at a rate of 25%. In his proposal, those who are exactly on the 16/30 hour working tax credit eligibility points are those who lose the most. Previously, they received near to the full entitlement, but due to the new 'phase-in', they receive much less with the EITC. The largest winners are those who have the maximum credit phased-in, but none withdrawn. This proposal is far more generous than tax credits, and so we would expect many more people to be claiming welfare.

Bell, Brewer and Phillips have also suggested that those who work eight hours per week should be eligible for Working Tax Credit, as a way of incentivising 'mini jobs'.[23]

Specific proposals

Given the high MTR and PTR faced by those who do not meet the hours thresholds, there is an opportunity to phase in WTC. As a proxy, we evaluate a reform that sets the JSA withdrawal rate to 55% and WTC eligible to all over-25s at 16 hours. This proposal does not quite provide a perfect match for tapering-in, as there is still a step-change at the WTC threshold. However, it is a close proxy.

Winners and Losers

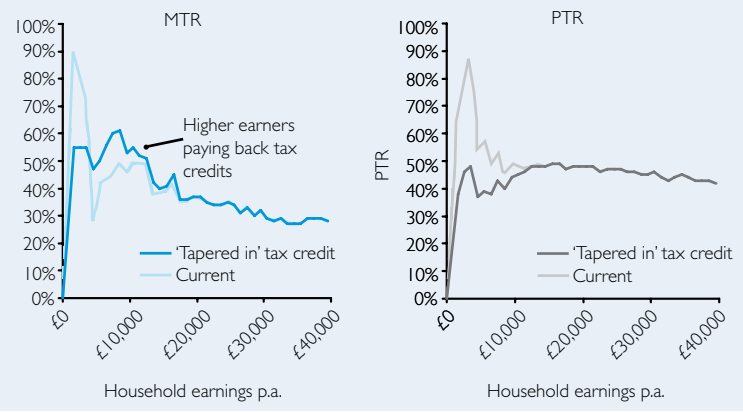
There are approximately two million winners from this reform, gaining on average £860 p.a.. They would be all those working below the hours thresholds, especially childless adults who currently receive no WTC until they work 30 hours. Over 300,000 households would be lifted directly out of poverty – the vast majority of which would be single adults or childless couples.

Changes in economic incentives

This approach to providing a proxy for tapering-in WTC would provide a significant increase in work incentives for all low earners. The high marginal tax rates at low earnings would be reduced, though there would be higher MTRs for those childless households who received WTC at 16 rather than 30 hours.

Figure 13.22 Option:Taper in tax credits

Average MTR and PTR profiles for all households



23 Kate Bell, Mike Brewer and David Phillips, *Lone parents and 'mini jobs'*, (Joseph Rowntree Foundation, 2007).

The net result would be a much reduced PTR profile across all low earning households, thus substantially reducing the barriers to entering work.

Dynamic outcomes

Figure 13.23 Dynamic outcomes: Taper in tax credits

Taper in tax credits	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)	Reduction in child poverty (60%) ('000s)
JSA withdrawn at 55% and WTC available to all over-25s at 16 hours	£929	+366	£976	93

We would expect those facing much reduced marginal rates to increase their earnings. However, some of those who lose would drop out of work. This effect, however, would be offset by many more who would return to work due to the much larger incentives. It has a dramatic impact on poverty reduction, resulting in 458,000 fewer households in poverty, from reduced withdrawal and the positive employment and earnings impact. The down-side to this is that such generosity comes at a large cost.

The combined effect of 60% JSA taper and 16 hour rule for WTC is slightly more attractive than simply a 50% taper rate for JSA. As we will see later, it allows us to use it as a staging post for other reforms later on (Chapter 18).

While the implementation of a tapered Working Tax Credit (in its current form) would be fiendishly complicated, this analysis shows that this is a powerful idea, because it tackles the highest MTRs faced by low earners. As a result it would provide some of the greatest returns on investment.

Summary

A tapered-in Working Tax Credit – or the proxy of a lower JSA withdrawal rate – will reduce the participation tax rate for those on low earnings and give people more reason to take a job. More generally, increasing the generosity of in-work benefits (which effectively subsidises work) will make work more attractive. However, it is difficult to achieve this using the existing benefits system because of the eligibility criteria which means that is hard to create the incentives to those who need them without creating greater complexity. This means that only people with certain types of work are eligible for help, and all the others are left behind. Reform must ensure that the wide ranging effects of high marginal rates are dealt with, such that those who need the help most are supported.

13.3.4 INCREASING THE MINIMUM WAGE

The situation today

The high MTR for low earners has been a strong influence on the need for, and a strong influence on the impact of, a minimum wage. Where MTRs are higher,

the minimum wage is greatly depleted by withdrawal of benefits, and yields far less to the marginal worker than many of us would see as a meaningful reward from work (see section 13.1.1 for a worked example of this).

If the marginal worker can get by on a net income of £2 per hour, and the MTR rate is 67%, the required gross wage to deliver that £2 per hour is £6. However, if the MTR is 75%, the required gross wage to make it worthwhile working would be £8 per hour.

For many workers, the high withdrawal rate of benefits sets a floor on gross wages at a level above the minimum wage on which one can practically survive. This is bad enough from a social justice perspective, but it is moreover one of the reasons that, to date, there has been little observed lowering of employment levels from the introduction of the minimum wage.[24]

The case for reform

Nonetheless, for many commentators, increasing the minimum wage is an attractive policy. It increases the take-home pay of those in low wage employment (regardless of its effect on increasing household net income), increases labour supply (rather than demand), and makes a positive statement about the value of work.

Do Working Tax Credits allow employers to avoid fair wages?

In evidence to the Working Group, it was argued by some that Working Tax Credits (WTC) allowed employers to pay lower wages than they otherwise would. Perhaps, went the reasoning, this might justify further increasing the minimum wage, to ensure that employers are paying fairly.

The answer to this question depends on the starting point.

Rather than providing a net subsidy to employers, the WTC effectively removes the floor on acceptable incomes (discussed above) that results from the high withdrawal rates for other benefits.

The effect of Working Tax Credit is to reduce the PTR by between 20-50 percentage points. As a result it creates a net withdrawal rate that is nearly as low as that experienced by higher earners.

For the vast majority of low earners working just above the WTC hours threshold, therefore, the Working Tax Credit actually does reduce the hourly wage required to make it worth working.

Raising the minimum wage is not a response to unfairnesses imposed by the Working Tax Credit, but to the biases of the benefits system as a whole.

24 Although the opinion-forming US study of entry-level restaurant workers has now been challenged. See Deirdre McCloskey and Stephen Thomas Ziliak, *The Cult of Statistical Significance*, pp. 101-103.

Winners and Losers

Overall, the very high marginal tax rates today mean that increasing the minimum wage suffers from three major disadvantages:

- It would not materially help those whose working hours are below the threshold for WTC as virtually all gains in wages would be lost in earlier withdrawal of benefits.
- Even for those eligible for Working Tax Credits, the high MTRs mean that they would receive only 20%-40% of the increased wage. The remaining 60-80% of the increased wage paid by the employer would actually go back to the government.
- Increasing the cost of labour is likely to reduce the demand for it at the margin (and this is likely to be faster than the increase in supply, because the changes in incentives experienced by employers can be 3-4 times those experienced by workers due to the high marginal tax rates).

Dynamic outcomes

In an environment of high MTRs, raising the minimum wage has all the hallmarks of an exercise in political positioning. It is a declarative policy. It is far less effective than a simple MTR reduction at increasing the income of the lowest earners. It would mostly ask employers to pay for more of the benefits bill, with nothing in return.

Increasing minimum wage versus decreasing MTR: which is the most cost effective?

Joan works just under 17 hours per week at a minimum wage of £6 per hour, and so earns £100 per week. However, she faces a PTR of 70% and so has a net income of only £30.

Suppose a Government wanted to implement a socially just policy; one that increased her net income from the same number of hours of work from £30 to £50, it could either increase the minimum wage or reduce her PTR.

If the Government decided to reduce Joan's PTR, it would have to spend £20 reducing the PTR from 70% to 50%.

However, if it kept the PTR at 70%, to achieve the new net income for Joan of £50, it would have to increase the minimum wage to £10 per hour.

Over Joan's week, this would mean that Joan's employer would have to pay her an extra £67, of which £47 would go to the Government in taxes and reduced benefits.

If marginal tax rates were significantly lower than they are today, increasing the minimum wage would have a much more positive impact on employees. Given the level of current MTRs, it would be more effective to invest in reducing MTRs than in increasing the minimum wage.

13.3.5 CONCLUSION

In this section 13.3, we have assessed various options to increase the level of benefits: raising out-of-work benefits, raising in-work benefits (WTC), tapering in WTC, and increasing the minimum wage. An increase in the out-of-work benefit for those able to work will serve only to exacerbate the problem of economic dependency, whereas increasing the in-work income will provide an improved incentive to enter and progress in work. Changing the Working Tax Credit to allow it to taper in for those working below the hours threshold can be a very effective way of supporting employment of low-earners; while changing the minimum wage has little effect on the income or incentives for low-earners in a context of very high marginal tax rates.

13.4 Improving work incentives: conclusion

No single set of proposed reforms has convincingly tackled the problems of the current benefits arrangements. The complexity of the benefits regime means that small changes to the tax and structure of individual benefits do not go far enough towards improving work incentives. The changes need to focus on reducing overall withdrawal levels. Changes to benefits have a much bigger impact on the poorest and low-earners than changes to the tax regime. Increasing disregards has more of an employment impact than reducing withdrawal rates. However, reducing withdrawal rates also encourages increases in earnings.

Figure 13.23 below shows that the most efficient changes to the benefits system come from addressing the very high MTRs and PTRs experienced by the lowest earners. Efficiency is measured as the increase in the number of working households for every £1000 p.a. invested in the system. Reducing the JSA/IS taper rate and increasing benefits disregards are all much more effective than those proposals in the bottom half of the table below:

Figure 13.24 How efficient are the different options at reducing worklessness?

Proposal	Annual dynamic cost (million)	Increased households with work ('000s)	Efficiency
Reducing JSA/IS taper to 80%	-£29 (saving)	138	self-financing
Increasing benefit disregards	£32	113	3.53
Reducing JSA/IS taper to 70%	£81	207	2.59
Reducing JSA/IS taper to 60%	£296	279	0.94
Reducing JSA/IS taper to 50%	£910	363	0.40
Tapering tax credits	£929	366	0.39
Reducing HB taper to 35%	£231	61	0.26
£1,000 tax rebate	£3,897	312	0.08
Reducing tax credit taper to %30	£2,542	94	0.04
Increasing personal tax allowance to £10,000	£11,400	326	0.03
Reduce basic tax rate by 2p (20% >18%)	£4,140	80	0.02

The challenge in developing a proposal for reform is to achieve a significant improvement in the number of working households at acceptable cost. This will require a combination of selected proposals above (recognising that they cannot be simply added together), together with a more holistic reduction of the highest MTR and PTRs without too much spill-over expenditure. The resulting reforms will also have to meet other objectives too if benefits system is truly to sustain improvement in the lives of the poorest households and families. We turn in the next chapter to assess proposals that address the couple penalty.

CHAPTER FOURTEEN
Reducing the Couple Penalty: Options

Key Conclusions

Adjusting the earnings disregard and value of Working Tax Credits is the most effective way of reducing the couple penalty for low-earning households within the current system.

Individualising benefits and transferable tax allowances are less effective because of their expense.

The "couple penalty" was discussed in Chapter 4. It manifests itself in the relative generosity of the tax and benefits system to singles rather than couples. It is not just a financial penalty, but a material penalty – couples receive much less than singles even after accounting for their savings from living together.

The Working Tax Credit highlights this issue particularly acutely as it pays out equal amounts to both couples and lone parents. A number of options have been proposed to deal with this issue.

This chapter analyses four options aimed at reducing the couple penalty:

- Individualising benefits that are currently given and withdrawn on a household basis;
- Increasing the award value of Working Tax Credits for couples;
- Increasing the earnings disregard on Working Tax Credits for couples;
- Introducing a transferable tax allowance.

The latter three apply only to households that already have at least one member in full-time or part-time work. It is apposite to note that the options for reform in this chapter are not, primarily, aimed at decreasing worklessness or generally decreasing poverty; but bringing the treatment of couples more into line with the treatment of individuals. Nonetheless we have described the dynamic outcomes for the Working Tax Credit proposals in the same way as in the previous chapter.

There are other groups, such as mortgagors and savers, whom the system also treats unfairly; but we are not aware of any concrete proposals that have been made to assist them, and so do not review them here. We will nonetheless address these groups in our final proposal (see section 16.8).

14.1 Individualisation of benefits

The situation today

Presently, all benefits are paid on a household level, with all means-tested benefits being withdrawn on the basis of household earnings.

The case for the reform

Paying benefits at an individual level is attractive to those who wish to simplify the tax and transfer regime. Tax is administered on an individual level, and proponents of 'individualisation' hope that eventually benefits could be administered through PAYE.

In David Freud's independent report for the Department for Work and Pensions, he referenced the debate around individualisation, calling complete individualisation 'attractive'.[1] Despite this, he felt unable to recommend it, as he feared it would add costs and complexity to the existing system and may reduce work incentives for some partners.

The House of Commons Work and Pensions Select Committee report on benefit simplification argued for individualisation of its proposed Single Working Age Benefit (see section 5.2.2.2).[2] In a recent IPPR report by Sainsbury and Stanley, individualisation was proposed alongside a range of simplification measures.[3] Discussing a single working age benefit, they commented that it should be awarded "on an individual rather than a household basis." Further, there is a broad fiscal point about individualising benefits: if, as suggested in the Pensions Select Committee and IPPR papers, the same amount of benefit is paid to an individual regardless of whether they are in a couple or not, there can be large cost implications.

In order to individualise benefits, either the amount that singles receive must go down, with consequences for the financial position of lone parents and singles, or the level of support given to couples out-of-work would go up. There are three possible ways of achieving this:

1. Raising the couple value of benefits to twice that of singles – which would dramatically increase the overall benefit bill. There are quite negative employment incentives as the out-of-work position is considerably strengthened. Furthermore, there is a large static cost associated with increasing the amount given in support by so much.
2. Rebalancing the value of couple and single benefits by reducing single benefits and simultaneously raising couple benefits – without increasing the overall benefit bill. This would be very difficult to implement, given the likely opposition to decreasing out-of-work benefits.

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1 David Freud, *Reducing dependency, increasing opportunity: options for the future of welfare to work - An independent report to the Department for Work and Pensions*, (2007), pp. 103.

2 Work and Pensions Select Committee, *Benefit Simplification: Seventh Report of Session*, HC (2006-07) 463-I p. 111.

3 Roy Sainsbury and Kate Stanley, 'One for all: active welfare and the single working-age benefit', *It's All About You - Citizen-centred welfare*, (IPPR, September 2007), pp. 46-55.

3. Using the inflationary up-rating process to fund all increases of couple benefits. This approach somewhat reduces the cost and the political pressure, but it would take a long time to fully implement.

Individualisation is an attractive prospect, but work incentives and fiscal prudence are more important than the simplification of administration. If a way can be found to avoid or mitigate these trade-offs, then individualisation could be considered more seriously.

Even if benefits are *awarded* to individuals, there are those who argue they should be *withdrawn* on the basis of household circumstance. Complete individualisation would award and reduce benefit based on individual circumstance. However, this may mean that in some couples where one partner earns large sums, the spouse may still receive benefit due to inactivity or low earnings.

John Penrose MP has written that the costs of both full and partial individualisation must be assessed before a conclusion is reached on what can be achieved.[4] The continuation of a regime that withdraws benefits on the basis of household income would make integration with PAYE harder.

Our approach will be to focus on eliminating the couple penalty for in-work couples first, and thereafter workless couples. If benefits were to be individualised, the focus should again start with those received in-work, so as to take advantage of the dynamic effects.

We now turn to those proposals which aim directly to reduce the working-couple penalty.

14.2 Rebalance the Working Tax Credit award level

The situation today

Chapter 4 highlighted the penalties faced by working couples. Today the value of the WTC paid to a household in which a couple both work above the thresholds does not reflect the fact that they have higher living costs.

The case for reform

In 2007, this Working Group recommended a range of options to increase the Working Tax Credit 'couple element'.[5] The most logical option was to raise the couple element by 1.6 times the amount that a lone parent received, as this ratio would be consistent with other benefit rates.

In 2008, analysts at the Institute for Fiscal Studies suggested a similar move: raising the level of tax credits for all other groups than lone parents. Specifically, they proposed raising the couple element in WTC by 1.6 times in

4 John Penrose MP, private communication of the working group.
5 Social Justice Policy Group, *Breakthrough Britain*, (CSJ, July 2007).

order to equivalise it with regards to other benefit rules.[6]

A report by the Institute for Public Policy Research in 2008 also suggested raising the amount that couples could receive through the Working Tax Credit by a third – a similar generosity to the two reforms detailed above.[7] A recent Policy Exchange report argued for the introduction of a "non-working spouse" element into the tax credits system worth 50% more than the tax credits paid to sole parents, but reduced to take account of a Married Couples Allowance to be simultaneously introduced into the income tax system.[8] It is clear that a political consensus is emerging.

Specific proposals

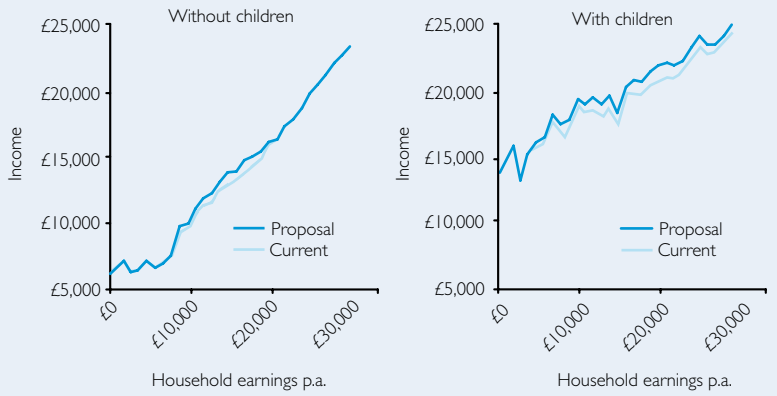
We have modelled the impact of raising the Working Tax Credit amount for couples to 1.6 times the amount for single adults.

Winners and Losers

This reform will help around 1.5m couples by an average of £900 per year. As a result, the in-work couple penalty is reduced. However it will not directly reduce the numbers in in-work poverty by much, as all beneficiaries are on incomes above the poverty thresholds. Among childless couples, those with earnings between £10,000 and £20,000 are the main gainers, whereas, among those with children, the gainers range from those with earnings from £5,000 to £30,000 on average.

Figure 14.1 Option: Raise the Working Tax Credit disregard

Net income for couple households without children and with children



Economic incentives

By increasing the pay-outs to couples through the Working Tax Credit, the incentive to work is strengthened for two-adult families. However, for

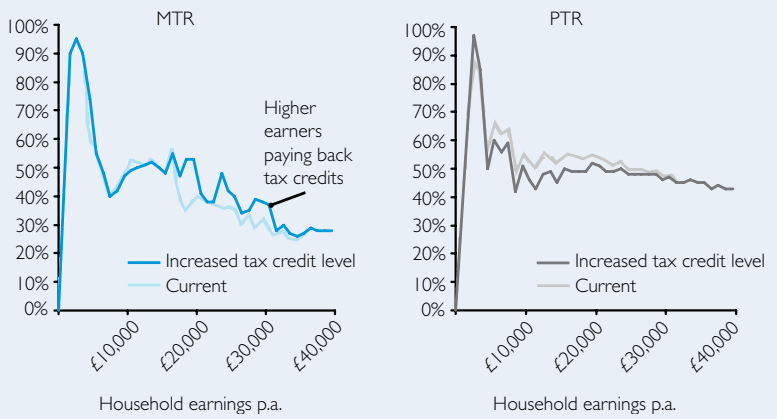
6 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings*, (IFS, 2008), p. 52.

7 Graeme Cooke and Kayte Lawton, *Working out of poverty,* (IPPR, January 2008).

8 Peter Saunders and Natalie Evans (ed.) *Reforming the UK Family Tax and Benefits System* (Policy Exchange, 2009), p.100. Eligibility for the "non-working spouse" element would be restricted to couples who are married or in civil partnerships with dependent children.

many couples above £15,000, the marginal tax rate is increased due to more extensive withdrawal of tax credits. As a result there is a reduced incentive to work among a large portion of the working population.

Figure 14.2 Option: Set tax credit amount for couples at 1.6x singles' award, Average MTR and PTR profiles for couple households



At the same time there is a reduction in the PTR as a result of more generous in-work benefits. This shows the limitation of tax credits as a mechanism. The employment benefits of providing higher levels of in-work support need to be balanced against the reduction in earnings caused by the higher MTRs that follow.

Dynamic outcomes

Figure 14.3 Dynamic outcomes: Set couple WTC award to 1.6 times the single award

Working couple penalty	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)	Reduction in child poverty (60%) ('000s)
Set couple WTC award to 1.6 times the single award	£2,308	80	-£854	81

This reform helps the first earner in couples. However, some (higher elasticity) second earners choose to leave work due to the increased reward for being a one-earner. As a result, there is an overall loss of jobs, even though there is an increase in the number of households in work (the More Workers-Less Work effect).

As a result of changes in employment, 64,000 households escape poverty, leading to 81,000 children escaping poverty.

14.3 Rebalance the Working Tax Credit earning disregard

The situation today

The earning disregards for WTC are currently the same for couple households as single adult households. As a result many couple families face another penalty, as their WTC award begins to be tapered away at a level of earnings that is lower relative to the poverty threshold than for singles.

The case for reform

Both the IFS[9] and IPPR[10] papers mentioned above also suggested introducing a WTC disregard for the second earner. This would essentially increase the amount that a two-earner couple could earn before tax credits were withdrawn, increasing the reward for the second earner. The current WTC disregard of £6,420 p.a. could be doubled for couples.

Specific proposals

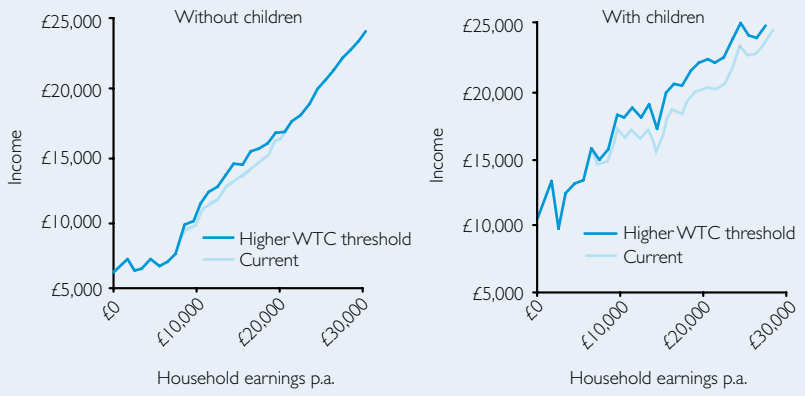
We have modelled a more modest change to the WTC disregard for couples, by setting it to be 1.6 times that of a single person. The 2009-10 level is £6,420, so the couple disregard would be £10,270. As with the current system, it is evaluated at a household level, thus making it transferable.

Winners and Losers

Among couples, the gains are experienced mainly by families with children with household earnings of between £10,000 and 20,000 p.a.. Couples without children gain little, as the increase in disregard has less of an impact for those who are only entitled to WTC at 30 rather than 16 hours.

Figure 14.4 Option: Set tax credit amount for couples at 1.6x singles' award

Average income for couple households without children and with children



9 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings*, (IFS, 2008)

10 Graeme Cooke and Kayte Lawton, *Working out of poverty*, (IPPR, January 2008)

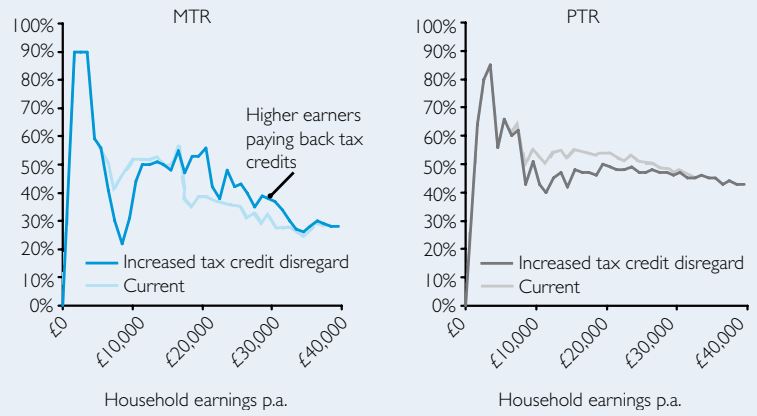
This proposal works as a form of benefits 'personal allowance' and similarities can be seen: higher earners benefit more (see section 13.2.2). While this proposal protects against this to some extent by limiting the gainers to those claiming tax credits, it is still quite loosely targeted.

Changes in economic incentives

By increasing the earnings threshold at which couples face withdrawal of tax credits, a much lower MTR is in effect for those earning between £6,000 and £11,000 p.a. This is compensated by having a higher MTR above this earnings level, as the tax credits are withdrawn further up the income scale.

Figure 14.5 Option: Raise the tax credit earnings allowance for couples to 1.6x for singles

Average MTR and PTR profiles for couple households



The net result is an increased incentive and reward for those entering work below median income, but for many there is a reduced marginal incentive to earn more, because of the higher MTRs faced by many couples.

Dynamic outcomes

Increasing the WTC threshold for couples is an expensive reform. It encourages close to 100,000 households to enter work, but at the same time many more second earners would leave work because of the higher marginal and participation tax rates they would face.

Figure 14.6 Dynamic outcomes: Set couple WTC disregard to 1.6 times single's disregard

Working couple penalty	Dynamic cost (million)	Increased households with work ('000s)	Increased earnings (million)
Set couple TC disregard to 1.6 times single	£3,235	99	-£1,262

14.4 Transferable Tax Allowance (TTA)

The situation today

Today, all taxation operates at an individual level. Couples with one earner are entitled to only one personal allowance. As couple PTRs tend to be generally higher, support targeted around couple families is quite effective.

The case for reform

The TTA allows couples to share their personal allowances. If one person in the couple is earning, but the other is not, the first can use all the second's personal allowance. This idea was supported by this Working Group in *Breakthrough Britain*, and by the Centre for Policy Studies' report *Take poor families out of tax*. A recent Policy Exchange report has argued for married couples (and couples in civil partnerships) with dependent children to be given the option of retaining their two single allowances or of either spouse transferring half their personal allowance to the other spouse. This proposal would be restricted to married couples (and couples in civil partnerships) with dependent children, at a projected cost of £750 million per year.[11]

Winners and Losers

The TTA broadly benefits those couples with one person in work, but not two, by increasing the personal allowance of the earner. Those who win most are one-earner couples who are earning more than the personal allowance. Two-earner couples where one partner is on a low income also see some gain.

Changes in economic incentives

The proposal would create an incentive for two-earner couples to respond by moving towards one-earner couples. Furthermore, some studies of increasing the personal allowance has shown this to be a less effective way to reducing the financial penalties to work faced by those on welfare.

Outcomes

After further discussion of the transferable tax allowance, and despite our earlier support for the idea of increasing the personal allowance, the Working Group does not regard them as a particularly effective way of helping the poorest couples, certainly compared to available alternatives. Rather, they concentrate the rewards on the high earners.

In addition, as is the case with increasing the Working Tax Credit, there are ambiguous incentives. There would be an incentive for a second earner to stop or reduce their work, in order that the first earner could use more of the TTA.

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11 Peter Saunders and Natalie Evans (ed.), *Reforming the UK Family Tax and Benefits System* (Policy Exchange, 2009), p.93.

14.5 Conclusion

Addressing the in-work couple penalty through the benefits (and tax credits) system rather than the tax system is the most cost-effective way of helping couples, particularly those with low earnings who face the most severe couple penalty. Addressing the penalty through a transferable tax allowance deals with the problem for couples at earnings levels where the penalty is smaller, and has less of an impact on behaviour. Although it is helpful, it does not address those most penalised. Increasing the benefit level for couples by individualising benefits, by contrast, will help couples on the lowest income; but it is costly and reduces work incentives.

The proposals to alter the earnings disregard for and value of the Working Tax Credit are more likely candidates for consideration, since they are relatively focused on low-earning households. While it may be equally unfair at all levels, the incentive effect on behaviour will be stronger for couples on lower earnings. Increasing the award would lead to a further 80,000 couple households in work; but the dynamic cost is high, at approximately £2.3 billion. Increasing the disregard would create an even greater work incentive, but at a significantly greater cost. In terms of getting households into work, these proposals are inefficient.

The cost of correcting the penalty also shows us just how much the Government saves by penalising couples in this way. It also tells us that we need to be careful about how we combine our proposals to achieve objectives, and suggests that the more expensive areas of unfairness will have to be dealt with more gradually.

CHAPTER FIFTEEN

Simplification: Options

Key Conclusions

- Standardising withdrawal rates and reducing the number of benefits provide opportunities for simplification without compromising economic efficiency.
- True simplification of benefit withdrawal mechanisms facilitates intergration of benefits with the tax system.

In Part I we mapped out the evolution of the welfare system, showing how piecemeal additions have led to the unwieldy arrangement that exists today. The complexity muddies incentives, makes people less willing to take risks, reduces take-up and is expensive to administer.

A number of commentators have made proposals for reducing complexity, and these fall into three broad categories:

- Streamlining the number of benefits and their interaction with each other;
- Standardising the withdrawal rate;
- Creating one point of contact for claimants;
- Integrated payment and withdrawal with the tax system for those in work.

In this chapter we also consider a flat tax as an extreme case of a standardised withdrawal rate.

15.1 Streamlining benefits

The situation today

The many different kinds of benefits are aligned very poorly with one another today. As a result there are many 'kinks': claimants may find themselves in situations where it is not clear which benefit to claim,[1] nor whether a change

1 David Martin Benefit Simplification: *How, and why, it must be done* (Centre for Policy Studies, 2009), p. 34.

in circumstances, such as earning more, or moving in with a partner, will adversely affect income. The number of benefits also adds to the volume of information required to process benefit claims, creating confusion and waste on the part of the administrators.

Specific proposals

There are growing calls for more unified systems with just a 'single benefit'. This idea has also been called the 'citizen's income'. It should be noted that none of the proposals call for merging of all existing benefits, but rather the merging of particular categories.

The Work and Pensions Select Committee's report on benefit simplification included a proposal for a Single Working Age Benefit or 'SWAB'.[2]

The SWAB would:

- Replace all benefits apart from HB, CTB and DLA;
- Be set at around same initial level of payment for those who do not work.

In addition to the Work and Pensions Select Committee report, an Institute for Fiscal Studies paper proposed a 'radical reform' called the 'Integrated Family Support' (IFS).[3]

This proposal:

- Replaces all family-related benefits (IS/JSA, HB, CTB, CTC, WTC and CB), but not IB/ESA;
- Is set at a lower level than current out-of-work benefits.

Most recently, Martin has proposed a situation which aligns the various benefits without scrapping them.[4] The first step is to align payment rules, and then get rid of premiums in different benefit similar circumstances. All child-related elements in IS, JSA, ESA, CB, HB and CTB would be folded into an enhanced Child Tax Credit (except for the childcare element of WTC), which would be withdrawn until it reached the current CB rate. Similarly, disability premiums from IS, JSA, and ESA would be folded into an enhanced DLA.[5] The mortgage interest payments available to those on IS, JSA and ESA would be folded into HB. So we are left with the following categories: out-of work benefits, a child-related benefit, a housing-related benefit, a disability-related benefit, and an in-work benefit.[6]

A claimant would then be entitled to only one of JSA, ESA, or IS, testing

2 Work and Pensions Select Committee, *Benefit Simplification: Seventh Report of Session HC* (2006-07) 463-I, Annex A.
3 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings* (IFS, 2008).
4 David Martin, *Benefit Simplification: How, and why, it must be done* (Centre for Policy Studies, 2009), p. 34.
5 Ibid, p. 33.
6 Martin also considers carers' allowance.

eligibility for each in that order through a 'cascade test'.[7] Eligibility for one of these would give access to the child benefit and the housing benefit, and the disability-related benefit for the severely disabled. There would be no more premiums in any of these benefits for a circumstance dealt with primarily by another.

Assessment

The attractiveness of systems like this is obvious: simple, transparent benefits, clearly related to specific purposes, will reduce complexity and make managing claims much simpler (though the different proposals suggest the authors have differing views of the number of purposes of the system).

The elimination of distinct in-work benefits in the single benefit schemes described above (though not in the Martin scheme) also means that the decision to work will no longer be affected by concerns about what will happen to one's benefit. The reward of work will be more transparent. Single benefit schemes would encourage greater take-up of benefits, especially among those working, since these will be paid regardless and withdrawn through PAYE system (see section 15.4 below). However, there is also a danger that the single benefit loses the connection to the job market for those out of work, as the benefit is principally income-focused, rather than work-focused.

Both the SWAB and the IFS proposals raise revenue by removing Child Benefit and the Child Tax Credit family element from families with higher incomes. However, they are both comparatively generous in that they offer much more in-work support than is currently available.

Single benefit systems will eradicate unnecessary premiums attached to different benefits aiming to deal with the same circumstances. But it is important to recognise that even a nominally single benefit will require different payment rates for people in different circumstances. Several witnesses to the House of Commons Work and Pensions Select Committee pointed this out:

> *If you took [disabled families] as an example, a single working age benefit would need a disabled child premium, the disabled child premium would probably have to be differentiated, perhaps into a higher, middle and lower rate, and then you have basically replicated Disability Living Allowance.*[8]

This is part of the attraction of Martin's scheme, aligning benefits rather than scrapping them. However, the disadvantage of his scheme is the continued presence of distinct in-work benefits.

If, as the Work and Pensions Select Committee propose, these measures are combined with a form of individualisation, then both the couple penalty and

7 Martin's scheme includes pension credits as well. David Martin *Benefit Simplification: How, and why, it must be done* (Centre for Policy Studies, 2009), p. 31.

8 Steve Broach, *Every Disabled Child Matters*, cited in Work and Pensions Committee, *Benefit Simplification: Seventh Report of Session HC* (2006-07) 463-I [334]

further administrative hurdles are overcome.[9]

15.2 Standardise the benefit withdrawal rate

The situation today

Currently those in receipt of benefits can face a multitude of different marginal tax rates, including 100%, 95.5%, 89.5%, 76%, 70%, and 65% etc., depending on the combination of benefits and taxes being withdrawn.

Specific proposals

Martin's scheme described above includes a combined 50% withdrawal rate for all benefits, down to a plateau for certain child-related benefits.[10] The IFS 'Integrated Family Support' benefit would be withdrawn at 30% of gross earnings, or 45% if the housing element is claimed (though the initial award is less generous than for existing out-of-work benefits).

The 'SWAB' suggests a single withdrawal rate, possibly of 40% (though the figure is presented as an example).

All proposals determine the benefit withdrawal rate and not the overall MTR, which would be higher for those paying tax.

Assessment

A single, lower, withdrawal rate would set a cap on the MTR for all benefit recipients: hence such a reform would be the most effective way of moving people back into jobs. Those in low-paying jobs, below the tax threshold, would find the withdrawal rate was their overall MTR, making working more hours extremely attractive. The proposals also targets those with the weakest work incentives – i.e. those currently facing MTRs of 80% and higher.

A single withdrawal rate would have the further virtue that it would be very clear to claimants how much better off they would be as a result of working or working more.

The principle of having a standard withdrawal rate is extremely attractive, as it represents one of the most effective ways of promoting work. However, the correct rates must be chosen to sure maximum efficiency in any welfare system. Our model suggests that a withdrawal rate of 55% (post tax) is optimal (see Appendix E).

15.3 Single agency to administer benefits

The situation today

To lodge and maintain a benefits claim, and to appeal against any decisions,

9 Work and Pensions Select Committee, *Benefit Simplification: Seventh Report of Session HC* (2006-07) 463-I, Annex A.

10 David Martin *Benefit Simplification: How, and why, it must be done* (Centre for Policy Studies, 2009), p. 37.

there are a myriad of agencies which the claimant must deal with. This is not just DWP for out-of-work benefits, the local council for housing benefits, and HMRC for tax credits, but the different sub-department and agencies within these organisations who are responsible for different benefits. Each department and sub-department has its own forms, requiring claimants to give the same information repeatedly.

Specific proposals

Martin's scheme is the most explicit of those we have reviewed on this point. He proposes that a single agency be responsible for the client-facing administration of all benefits, and that the point of contact be local.[11] The 'cascade test' would allow a single form to be used for all applications. Martin also proposes a single website with a better-off calculator, made easier because of the aligned rules described above.

Analysis

One administrator would be familiar with all claims and benefits made by a particular claimant, allowing for earlier identification of irregularities. This would also mean that single notification of change of circumstances would suffice, saving time on the part of the claimant and reducing the risk of being embroiled in bureaucracy. The work, in this context, would be transferred to the administrator, who would be required to contact and notify the relevant agencies.

This proposal is clearly dependent on a simplification of the system such that is possible for one person or team to be able to give informed guidance and make contact with all the relevant internal departments.

15.4 Integration with the tax system

Current situation

For many employees taxation is deducted through the automatic PAYE system. A person gets their post-tax earnings, and does generally not have to worry about paying back tax at the end of the year. By contrast, some benefits are claimed weekly, some monthly, and some yearly, with different reconciliation periods and unexpected recalls.

Specific proposals

The IFS 'radical reform' proposal suggested that welfare could be withdrawn through the PAYE mechanism.[12] So did the Work and Pensions Select Committee in their 2007 Report:

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11 David Martin *Benefit Simplification: How, and why, it must be done* (Centre for Policy Studies, 2009), p. 39.

12 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings* (IFS, 2008), p. 7.

> *The SWAB would also be an in-work benefit. Once someone had begun work the DWP would tell the tax office (HMRC) how much benefit they were receiving. HMRC would then reclaim the benefit from their wages at a constant Marginal Deduction Rate (e.g. 40p in the pound) through the tax system.*[13]

These proposals have two elements in common. First, they are based on a dramatic simplification of the benefits, with either only two (IFS) or one (DWP) withdrawal rates. Secondly, in each case employers would be asked only to withdraw benefits from the earnings of employees, not to pay benefits to them. In other words the claimants would receive the maximum amount applicable for any benefit, but their take-home pay would be reduced by the withdrawn amount.

Martin goes further and suggests that the benefits could be paid through the PAYE system.[14]

Assessment

Previous calls for greater integration of the tax and benefits system, so as to provide a simpler experience for the low-earning claimant, have been dismissed on the basis of the sheer complexity of the current benefits system. It would be very difficult for the PAYE systems to handle the complexity and dependencies in the rules. (As will be the case when the elimination of the personal tax allowance from higher earners is implemented – resulting in higher MTRs for a specific group of high earners).

A recent incarnation of this idea was implemented when Working Families Tax Credits were initially paid (and tapered) by employers. This approach was dropped when WTC was introduced in 2003. Employers had found the rules cumbersome, and the added complexity of paying benefits as well as withdrawing taxes created an unacceptable burden.

Integration with the tax system would:

> *...abolish the need for any notification of changes of circumstances for people moving in and out of work, or for linking rules to cover them either.*[15]

This would reduce the burden of complexity on the claimant, and also reduce the opportunity for fraud and error.

In the withdrawal-based schemes, the fact that the benefit would be continued to be paid in full (albeit withdrawn through PAYE) would create

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13 Work and Pensions Select Committee, *Benefit Simplification: Seventh Report of Session HC* (2006-07) 463-I, Annex A.

14 David Martin, *Benefit Simplification: How, and why, it must be done* (Centre for Policy Studies, 2009), p. 65.

15 Work and Pensions Select Committee, *Benefit Simplification: Seventh Report of Session HC* (2006-07) 463-I, Annex A.

a sense for claimants that their income stream is secure – they will know that they will either be claiming their full benefit, or be in work and receiving more than they received out of work. Martin's scheme would not have this structural advantage – on moving into work the source of the benefit would change; though it would reduce the administrative give-and-take associated with tax and benefit churn.

15.5 Flat Tax

Flat-tax proposals aim to dramatically simplify the tax system, attempting to remove different rates of tax. Whilst seemingly outside the remit of benefit reform, flat-tax proposals are complicated by any additional withdrawals that occur, such as those from benefits.

Flat-tax proposals can therefore in fact take a number of shapes:

1. Those that deal with tax and national insurance;
2. Those that deal with tax, national insurance and any personal allowances;
3. Those that also include all withdrawals, from tax, national insurance and benefits. This can be combined with a scrapping of any allowances.

The third proposal is the 'true' flat-tax: the rate of withdrawal that everybody would have to pay at a constant rate to raise the same revenue. This proposal would also cause the very high MTRs faced by low earners to be reduced and balanced against the MTRs of higher earners.

For this third option, the universal withdrawal rate would be need to be higher than today's top rate of Income Tax and National Insurance, and would also end up penalising those receiving Working Tax Credit close to the hours threshold (where their PTR today is below 40%).

Flat-tax proposals, however, ignore the impact of the distribution of earnings among the working population on the efficiency of tax and benefit schedules. Whilst lower taxation in general can produce a positive effect, a flat-tax raises tax rates for some, and reduces it for others. However, not all types of people respond in the same way, and therefore flat-taxes are inherently sub-optimal. In particular, raising the marginal rate on the richest by so much produces very negative dynamic effects.

The flat tax proposal is quite clearly an expensive option. It does, however, highlight the disparity between the high marginal rate on the poorest, and the lower rate for the richest.

15.6 Conclusion

The previous chapters have looked at others' proposals to increase work incentives and reduce unfairness. If the system is made simpler, the rewards from work are made much clearer to people; and it will also be clear to policy makers and others if the rewards are not strong enough, or the biases unfair, prompting swifter redress. A simpler system will also reduce the level of

involvement required by claimants to maintain and protect their income, in and of itself reducing benefit dependency.

People have congregated around the kinks in the system – both those caused by complex eligibility rules and also those caused by variations in MTRs, at points where the system is relatively more generous and less demanding. Simplification of both rates and administration either requires great generosity, bringing everyone up to the level of those at the sweet spots, or an acceptance that these people will lose out relative to others. Given the popularity of these points, there are likely to be a significant number of losers.

In seeking to reduce the number of benefits, we also need to be careful to maintain a link to the job-market.

CHAPTER SIXTEEN
The Universal Credits Scheme

Key recommendations: Universal Credits

Key Points

1. A dramatically **simpler**, streamlined system with harmonised eligibility rules, designed to reduce benefit dependency and to be simpler to administer:

- One primary benefit system with two components:
  - *Universal Work Credit*, for those out of work or on very low wages. This will combine JSA, IS, IB/ESA;
  - *Universal Life Credit*, to cover additional living expenses for all those on low incomes. This will combine HB, CTB, DLA, WTC, CTC (and potentially Child Benefit), without cutting the levels of these benefits for those who need them the most;
- All benefits administered through one agency (so only one point of contact);
- Tax and benefits withdrawal integrated into a single system, "PAYE+", making it more accurate and responsive to changes in earnings, with reduced risks involved in returning to work.

2. A more **work-focused** system that reduces in-work poverty for low earners:

- Introduce a standard withdrawal rate for all benefit payments of 55% of post-tax earnings;
- Significantly increase the earnings disregards for all benefits claimants;
- Treat 'passported benefits' as universal benefits-in-kind, and taper them away with increasing earnings rather than taking them away abruptly;
- Restructure Incapacity Benefit, replacing the permitted work regime with the increased earnings disregards, and separating the fit-for-work test from disability-based payments.

3. A **fairer** system that supports **positive behaviour**:

- Progressively reduce the size of the penalties for couples, savers, and those with mortgages.

This chapter presents our proposals for benefit reform, based on the principle that *benefits should relieve underlying poverty, while supporting work and independence, in a fair and affordable way*. We build on the survey of reform

options presented in the previous chapters, bringing together those options that withstood analysis and had the most efficient dynamic effects.

The Universal Credit system is one benefit, with a work-focused component and living costs component, withdrawn at a uniform rate above an earnings disregard, which is determined by household type. The generosity of the system to different households is governed solely by the size of the initial award, and the size of the earnings disregard before the benefit begins to be withdrawn – the rate of withdrawal does not vary. All households are eligible to receive the full available amount, regardless of their earnings; however as earnings increase, the value of the award is diminished by a corresponding withdrawal through the tax system in addition to Income Tax and National Insurance.

The proposed Universal Credit scheme has been designed to meet the following criteria:

- **Increase the rewards from work for low earners**. In order to increase employment, we must ensure low earners face low PTRs. However, since low earners are less responsive to MTRs than higher earners, it is more efficient to achieve low PTRs through generous earnings disregards, rather than low MTRs.
- **Dramatic simplification**. To end the current confusion and multiplicity of withdrawal rates, with their different conditions and constraints, we propose *one* universal withdrawal rate. To ensure continuity of income, the initial award will be received in full by all claimants, regardless of whether they are in-work or not; but those in work will find its value withdrawn through the PAYE.
- **Fairness**. In order to ensure larger families are more able to support themselves through working, we increase the earnings disregards based on family size. In addition, for equivalent households, those with more generous out-of-work benefits have lower earnings disregards.
- **Maintain current levels of out-of-work benefits.** We do not propose changes to the existing sizes of the initial awards for different households. This is a decision which requires significant broader political debate, and is outside the scope of this report. Moreover, our Universal Credits proposals will work without requiring changes to initial award generosity.
- Control costs, while minimising losers. The specific levels of the uniform withdrawal rate and the earnings disregards have been set so as to balance the need to control costs and avoid too many low earners losing income as a result of the reforms.

The key differentiating characteristic of this proposal to many others is the way in which the earnings disregard changes based on family size and out-of-work award entitlement. This allows us to balance fairness, control costs, and limit the number of losers. By having the variation in the disregard rather than the

withdrawal rate, the experience of the claimant with fluctuating earnings is much more stable. Changes in disregards are aligned with changes in benefit entitlement, at the major junctures in life such as moving property, or changes in family structure.

Under our proposals, the vast majority of low-earners will gain; and those who are currently workless will have a far greater reward from entering work than they do today. The number of workless households will reduce by 600,000 and child poverty will reduce by 210,000. Because the basic structure of our system can be applied in ways that are more or less generous, with greater or lesser dynamic effects and greater or lesser costs, we also describe, briefly, alternative scenarios which we have considered. We discuss the costs and dynamic outcomes of our main scenario in Chapter 17, and the alternatives in Appendix H.

In this chapter we will provide a detailed description of these proposals, detailing:

- The overall architecture of the Universal Credits system;
- The profile of withdrawal rates;
- The treatment of household earnings disregards;
- How passported benefits work;
- The application to couples compared to singles;
- The rebalancing of the mortgage and savings penalties;
- The treatment of disability;
- The place of childcare in the system.

This chapter will also summarise how this new benefits framework supports positive social behaviour. We will also explain the extent to which our objectives will be achieved. More detail can be found in Appendix C.

While our proposals comprise a unified whole, some of the important changes described herein would have a beneficial effect even if separated from the Universal Credit scheme. We urge readers who find the overall scope of our reform daunting, nonetheless to consider its parts. In Chapter 18 we will also suggest a possible implementation timetable, which would require some parts to be in place before others.

16.1 Universal Credits structure

The Universal Credits system maintains current initial awards for basic benefits. However, the scheme determines these awards under two new headings, which make up its two components: income for those who cannot work (or work-encouragement for those who can); and extra living costs to do with family size, housing support and the need for assistance with a disability. These are the major requirements of a working-age benefits system.

1. The benefits system for working age households should comprise one system of Universal Credits with two components:

i. Universal Work Credit (UWC)

ii. Universal Life Credit (ULC)

Under this proposal, we remove the distinction between contributory and non-contributory working-age benefits, and between in-work and out-of-work benefits.

This proposal dramatically simplifies the system. It ties in with our objective, stated in Part I, to *reduce the number of benefits.*

In the past, some have called for a "single benefit" solution to effect simplification (see Chapter 15). We have opted for two distinct components because this allows us to explicitly differentiate between work-focused benefits that are dependent on (for example) attending interviews, and benefits designed to cover costs such as rent. These benefits have very different eligibility criteria, and we believe that the distinction would become blurred if the two were treated together. While the assessment for each component depends on different factors, they will be received as one payment. Our analysis shows that this is the simplest approach that can comprise a practicable system.

16.1.1 UNIVERSAL WORK CREDIT

2. Universal Work Credit is a work-focused payment:

i. It is paid on the condition of enrolment into a welfare-to-work scheme.

ii. It is paid to those who are out of work or on very low wages.

iii. It replaces JSA, IS, ESA/IB.

The Universal Work Credit (UWC) would replace the existing out-of-work benefits (JSA, IS, IB/ESA). It would be "earned" through participation in welfare-to-work schemes for low-paying jobs, with exemptions for those not able to work,[1] and would be administered in the same way as today – paid locally, through welfare-to-work providers.

As this Working Group has previously recommended, we propose that the conditions for receipt of UWC should be robust. Responsibility for determining a claimant's eligibility should reside with Jobcentre Plus.

We propose to set the level of UWC for those out of work at a similar level to the equivalent benefits today.

1 See Social Justice Policy Group, *Breakthrough Britain,* Volume 2: Economic dependency and worklessness (CSJ, July 2007), p.32-38 for a more complete discussion of work expectations.

3. Universal Life Credit is paid in- or out-of-work to cover additional living costs. It replaces HB, CTB, DLA, CTC, and makes WTC unnecessary.

16.1.2 UNIVERSAL LIFE CREDIT

The Universal Life Credit (ULC) would be a simple means-tested benefit that provides additional income to those on low or no earnings. It would replace Housing Benefit, Council Tax Benefit, Child Tax Credit and Disability Living Allowance.

All households (whether in or out of work) would be entitled to receive ULC, subject to withdrawal based on earnings. The payment levels for those out of work would remain at the same level as today, set by the same criteria as the benefits it replaces: household composition, housing tenure, region and levels of incapacity (if any).

The payments for Housing Benefit and Council Tax Benefit would be transferred to ULC, using the current system of Local Reference Rent for both social and private tenants. (A distinct Local Reference Rent would also need to be set for social tenants.)

The payment for children in the household would remain as it is today, with the payment levels for Child Tax Credit transferred to ULC.

This system dramatically simplifies the distinction between the in-work and out-of-work benefit regimes. Put simply, there would be no separate 'in-work' benefits. The role of Working Tax Credits would be subsumed into the new Universal Credits. By reducing the benefit withdrawal rates (see section 16.3), there would be no financial need for a distinct additional benefit for those low-earners whose working hours reach a particular threshold. This achieves our objective to *eliminate distinct in-work benefits.*

The proposed system moreover augments the financial arrangements currently provided by Working Tax Credits. They now form part of the system, with their effects matched at their various thresholds.

16.2 Benefits Administration

16.2.1 ONE ADMINISTRATIVE AGENCY

The simplification of the benefits structure we have proposed makes it possible also to simplify dramatically the administrative arrangements. Claimants need only be in contact with one agency. Moreover, it would be possible to combine the administration of the tax and benefits systems, in a way that has previously been impossible, by using the PAYE system for the withdrawal of benefits.

4. There would be only one agency managing the payment of Universal Credits.

This ties in with our objective to reduce the number of agencies administering benefit. By simplifying the benefits system, there need only be one agency administering benefits, and only one payment to individuals.

It is important to ensure that any benefit change aids the roles of welfare-to-work providers. These providers connect claimants back to the labour market. In-work and out-of-work support have historically been managed as separate regimes, partly in deference to the role these providers play.

16.2.2 PAYMENTS MADE IN FULL

5. All Universal Credits would be paid directly to claimants in full, who would then be responsible for all household outgoings, including rent and Council Tax.

As has already been seen with the introduction of the Local Housing Allowance scheme, this approach creates an incentive for the individual to pay for housing more effectively than the state, because there would be a meaningful reward for claimants to economise on their housing. We also think it would encourage independence and personal responsibility. For the small number of people who are unable, because of physical or mental incapacity, to pay their bills, special arrangements can be made to have rent and council tax paid directly at source.

16.2.3 PAYMENTS WITHDRAWN BY PAYE

6. For those in work, the withdrawal of Universal Credits would be administered through the PAYE system, with employers withholding payments in a similar way to Tax and NI, but on an instantaneous (not cumulative) basis.

For self-employed workers, there would need to be a simplified system for them to pay back a proportion of their earnings as withdrawn benefits. This system should be simpler than the regime that exists today.

Those with multiple jobs can split their disregards across their different employers, but they would be liable for withdrawal of the total benefits from both employers. Hence, there would need to be a reconciliation process, so that any over-withdrawal can be returned to claimants. We would encourage the DWP to set up an easy-to-use benefits calculator to allow low earners to work out how far benefits should be withdrawn, and when they should claim back.

PAYE+: How would it work?

The withdrawal of benefits through the PAYE system can be managed as a bolt-on to the existing system. It would not involve a change in the tax code. The figures below illustrates how the system would operate.

The claimant would receive the full value of the Universal Credit (both the Work and Living components), paid directly into a nominated bank account.

DWP, or its agencies, would inform the employer of the amount of the earnings disregard, and total benefits to be withdrawn – supplementary information to the PAYE code.

Employers would need to make an additional calculation of a further deduction from employees' pay packets. For every post-tax pound earned above the earnings disregard, employees would withdraw at the standard benefit withdrawal rate, up to the total amount of benefits the employee receives. The employer would pay the employee the net amount, and transfer the deductions to HMRC as part of a new PAYE+ system.

Figure 16.1 Benefit payment for an out-of-work claimant

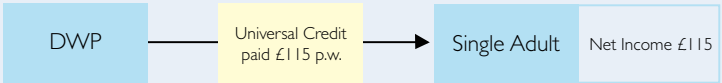
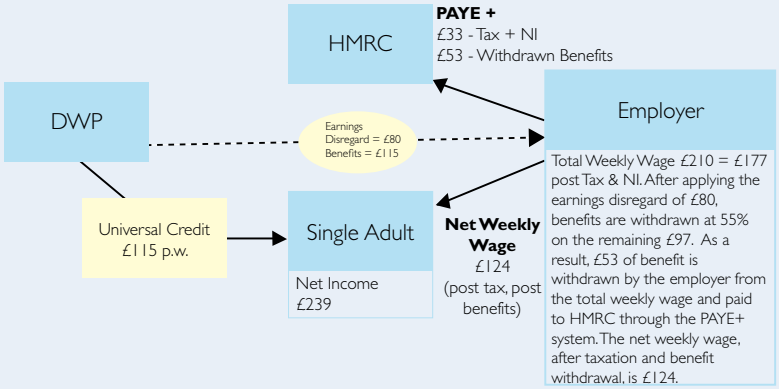


Figure 16.2 Benefit payment for an in-work claimant



By paying this withdrawal to HMRC together with Income Tax and National Insurance, employers will have a few weeks' working capital benefit, due to the lag in these payments.

We do not underestimate the nature of this change, and would expect that it would be best to allow two to three years to build the computer systems. Nonetheless it would be essential for a government to commit to a process for changing the details and publish it in advance. There can only be one transition.

16.2.4 MECHANICS OF PAYE+ WITHDRAWAL

The combined effects of these policies dramatically improve the claimant's experience at different stages of employment, as outlined below:

Entering Work

In order to achieve PAYE integration, each worker would be given a tax code that included the individual disregard, and also the total value of the household's withdrawable benefits level.

Claimants will know that, whatever happens, as long as they are seeking work or working, they will receive benefit income, which will be withdrawn only when they actually receive a wage from their employer. The claimant's income stream will be secure, no longer threatened by taking a job.

With the advent of PAYE+, there would be no need for a claimant on welfare to return to the employment office in the period when work is first being sought. This would give the job-seeker the flexibility and confidence needed to stay in the mindset of looking for work, even after the tribulations of the (often fraught) first few months out of work.

Changing Earnings

Withdrawing benefits through PAYE makes benefit levels more accurate and responsive to changes in earnings, and reduces the risks involved in returning to work.

Working through PAYE means that there is a naturally balanced system: as earnings decrease, so do withdrawals. Changes in withdrawal amounts are captured directly at source when earnings change. Given this direct connection between withdrawal and earnings, the likelihood of under- or over-withdrawal is minimised for individuals. This means that people need not fear being out of pocket at all from work. People can be more in control of their own finances and have more incentive to take control of their own lives.

This mechanism accommodates unstable earnings patterns that are prevalent among low earners. As household earnings increase, benefits would be withdrawn from a worker's pay packet, greatly reducing the risk that a claimant has too little to live on as a result of benefits stopping before the first pay packet has arrived.

In order to avoid any over-withdrawals, there can be a regular reconciliation. We propose an annual renewal of Universal Credits, at which point any over-payments can be reconciled and paid back to claimants – much like the successful US model of Earned Income Tax Credit. This would not be necessary for the lowest earners, as they would not have had their Universal Credits fully withdrawn. Hence, in stark contrast to today, they would be the ones least likely to experience any delays in payment, or over-withdrawal.

Leaving Work

On leaving a job, the claimant's P45 should be sent to the benefits office so that they can be invited in for a job-focused interview, with a notice that otherwise the UWC will be cut off after a time period. Those receiving a reduced rate of UWC have a strong incentive to contact the jobcentre directly, in order to re-qualify for the full payment.

These policies further provide the following advantages that address objectives set out in Chapter 6:

- Simplifying the administration needed for both Whitehall and claimants.
- Reducing the problems of delays and backdating in the transition to in-work benefits reduces the financial risks of entering work.

A simpler benefit system should inaugurate improved administration. The only determination needed would be to calculate the total amount of the award. This would provide a dramatic simplification for claimants who have to make only one application, and for whom there is just one set of rules to work to. There would be just one application form which would need only to record household characteristics, and asset levels. This approach eliminates up-front means-testing for benefits, and dramatically simplifies the reporting procedures.

The advantage of this approach is that the benefits agency need change the benefit payment only when there is a reason for a change in the standard amount due to changes in circumstances. This occurs less frequently than changes in the household earnings. Furthermore, by having only one work-related benefit it is necessary to inform and work with only one agency.

16.3 Withdrawal rates

A key objective of our reforms is to increase the rewards from work. To achieve this, we need a system in which benefit withdrawal rates do not exceed a specified maximum, to create the lowest possible marginal tax rates within the acceptable design constraints. In doing so, we also believe that benefit withdrawal rates should be made much more transparent and consistent. This will make it simpler for claimants to project how much better they would be if they take a job, or increase their working hours.

16.3.1 SINGLE WITHDRAWAL RATE

In broad terms, we have a choice. To achieve a more socially just withdrawal rate, we either have to reduce benefit levels at certain incomes, or we have to ensure more people are kept on benefits for longer. The former would have us disproportionately affect the poorest people. So we have to keep more people in receipt of benefits for longer. The advantage of a dynamic model is that it allows us to tailor the shape of this new benefit distribution, in a way that static models, which do not take changes in decision making into account, have not.

Hence, we propose setting a standard withdrawal rate for benefits, so that low earners retain much more of their earnings than today.

Under our proposals, there would be a standard benefit withdrawal rate for Universal Credits, set at 55% of net (post-tax) household earnings. This would be achieved in part by capping the withdrawal rate for benefits.

7. Set the withdrawal rate of all benefits at 55% of post-tax earnings, to reduce marginal tax rates for all low earners.

This new system of reduced withdrawal rates would increase work incentives for those who are currently hardest hit by the welfare system. The lower withdrawal rate would provide much more in-work financial support for low earners, and would be fairer and more transparent. **This proposal would benefit nearly everyone who wants to work.**

A post-tax withdrawal rate results in a progressive combined marginal tax rate, but in a moderated way. It rises from 55% for those below the personal allowance for Income Tax to ~70% for those paying tax at the standard rate (until the benefit is exhausted). This is equivalent to the MTR of those facing withdrawal of tax credits currently, and lower than that for those who have Housing Benefit withdrawn.

This proposal has the following advantages:

- **Those who want to work or work more are rewarded more transparently with a simplified benefits system, with just one type of withdrawal mechanism.** The proposed system means that households should experience the tapering of only one benefit rate, in addition to Income Tax and National Insurance withdrawal.

- **The incentives for low-earners to earn more are increased, by reducing the highest benefit withdrawal rates they face.** Setting the standard benefit withdrawal rate at 55% net of tax reduces the MTR for nearly all workers in receipt of benefits. This reform increases the returns for those who take the decision to go to work and then to progress through work. This is the best route out of long-term dependence and poverty.

A key objective of our proposal is to have a combined tax and benefit taper rate that is lower than today, yet also progressive with earnings. This would mean that those with lower and less secure earnings retain a greater proportion of their benefits than those with higher earnings.

16.3.2 WHY 55%?

We have identified 55% as the preferable withdrawal rate, based on the employment responses of our dynamic model. (See Appendix F for further discussion of this point.)

- Setting it higher than 55% would increase MTRs for those working households in receipt of benefits other than Housing Benefit (even if their net income was higher than today). As a result, there would be a negative impact on earnings, and on the number of second earners in employment.

Setting it lower than 55% would increase the number of higher earners receiving benefits, and hence facing higher withdrawal rates, which would also reduce earnings – and increase costs for the system as a whole.

Lowest earners

For those with earnings below the tax threshold, the MTR they experience from withdrawal of benefits will always be 55%.

Modest earners

For those earning above the tax threshold who pay Income Tax and National Insurance Contributions, the overall MTR increases. This ensures that marginal tax rates are progressive as earnings increase. However, by withdrawing benefits on the basis of post-tax earnings, benefits lost are proportionally less of the total income when a claimant is being taxed, than when they are not earning enough to be taxed.

Higher earners

In order to maximise the fairness and efficiency of the system, the 55% withdrawal rate applies to all benefits. Hence, the family element of the Child Tax Credit, which currently is withdrawn only from families on relatively high incomes, and then at a low rate, would be treated like all other benefits and be subsumed into the ULC and hence withdrawn earlier at 55% net of taxes.

As a consequence of this proposal, those currently experiencing the withdrawal of only one (remaining) benefit, such as CTB or the family element of CTC, would face a higher MTR than today. We believe that this is appropriate, given the need to focus our attention and resources on helping the poorest. It would apply to only those on the highest earnings and in receipt of the low levels of benefit. The best way to reduce the overall cap on benefit withdrawal rate is to make sure all benefits withdraw at the same rate.

16.4 Household earnings disregards

16.4.1 GENEROUS EARNINGS DISREGARDS

We are primarily concerned with encouraging workless households into work. While reducing the withdrawal rates to 55% provides a modest increase in incentives to increase earnings for the lowest earners, it does not address the comparative lack of incentives to enter work below the current hours thresholds for Working Tax Credit.[2] The earnings disregards are the key to how the system operates, and provides real incentive and reward for low earners.

We propose significantly more generous earnings disregards than are

2 Below 16 or 30 hours of work (depending on certain characteristics), workers are not eligible for Working Tax Credit. For further details, see Chapter 2.6.6.

currently available, so as to provide much greater incentives for those taking the first steps into employment. This means that households whose members are entering work will have no withdrawal of benefits – effectively a withdrawal rate of zero – until their earnings reach the disregard, thus retaining everything they earn. As noted in Chapter 8, it is those who are out of work that are most responsive to changes in the PTR, and therefore this move will provide a significant incentive to find employment. Once earnings exceed the earnings disregard, the withdrawal of Universal Credit commences at the standard benefit withdrawal rate (55% post tax).

16.4.2 PRINCIPLES UNDERPINNING EARNINGS DISREGARDS

Fundamentally, the level of the Universal Credits disregards follows the principle that larger families should have higher disregards. For example, the earnings disregard for a couple with one child is greater than for a childless couple. The larger family will keep more of their initial earnings, ensuring that they can better support themselves through work.[3] In setting these levels, there are a number of considerations.

- **Economics:** We will need to ask how many extra households enter work for each increase in the earnings thresholds. For example: will investing £1 million in increasing the earnings disregard for single adults reduce worklessness by as much as investing the same in increasing the disregards for couples with children?
- **Fairness:** We will need to ask whether it is fair that one household type should be given a much larger disregard than another. For example, is it fair that the earnings disregard for a young couple under 25 be significantly less than the earnings disregard for a single adult over 25?
- **Legacy:** We will need to ask how many low earners can be allowed to lose out, in order to divert investment towards increasing the rewards to work for others – even if the overall effect is a fairer system with more households in work. For example, is it appropriate that any reform should ever cause a single mother working 16 hours a week to have less income – no matter what the resulting benefit?

16.4.3 PROPOSED EARNINGS DISREGARDS

The trade-offs outlined above are fundamentally a combination of value judgments and politics. We have chosen to focus on schedules that do not increase costs, and have few losers. More radical options that change the income of many people in order to maximise the efficiency of incentives are, of course, possible. However, they are unlikely to be implementable. Hence, we have not pursued them in this report.

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3 Since the initial award has not been affected, out-of-work households with greater need will on the whole be receiving more benefit to start with.

We look at a number of disregard scenarios in Appendix H, but here we describe the disregards for three scenarios with significantly different cost implications:

- Minimise the number of direct losers ("Minimal Losers scenario"), albeit with a short-term fiscal cost, with longer-term break-even. This involves being more generous again to those currently at the WTC thresholds, so that there are very few low earners who lose out. The indirect losers in this case are the taxpayers who would have to pay for the extra costs.
- No extra direct fiscal cost. Inevitably some will find themselves financially worse off as a result of this reform, but there are many social benefits. This would include reduced administration cost and reduced health and crime bills. The key to this reform is to dramatically reduce the PTRs for under-25s, as this is where the social return on investment is highest. However, it comes at the cost of having losers among those currently working just on the WTC thresholds.
- Small extra direct fiscal cost, as well as limiting the number of losers[4] within the new simpler structure. This trade-off involves investing less in reducing the PTRs for under-25s, and preserving more of the rewards for those currently working at the WTC thresholds. This will mean fewer incremental households entering work, as we have traded economic efficiency for protecting legacy positions. There would still be the full set of social benefits.

These scenarios correspond to the following earnings disregards for benefit withdrawal:[5]

Figure 16.3 Earnings disregards scenarios

Household Earnings Disregards	**1. Minimal Losers *(The Proposal)***	**2. Break Even**	**3. Reduced Losers**
Households	£1,500	£3,000	£1,500
Over 25/ Parent Addition	£3,500	£0	£2,000
Lone Parent Addition	£3,000	£3,500	£3,000
Each of 2nd and 3rd children	£350	£350	£350
Rent	-1.8 x rent supplement[6]		
Council Tax	-1.3 x Council Tax supplement[7]		

With a 'disregard floor' of £260 per adult + £650 per child + £1,660 for lone parents, should the formula above suggest a lower disregard.

4 With household earnings below £30,000. We accept that there will be those among higher-earners who lose out from receiving less of the family part of the CTC. We do not seek to minimise these losses.

5 With minimum values of £260 per adult + £650 per child + £1,660 for lone parents, should the formula above suggest lower earnings disregards.

6 For every £1 provided in benefits to cover housing costs, £1.80 is reduced from the benefits disregards. In this way those households with large support for housing costs have a lower disregard than those with low or no housing support included in their Universal Credit.

7 The same reduction in allowance applies to the amount of Universal Credit provided to cover Council Tax. However, this deduction in the allowances is not applicable to those under 25 who have the youth penalty. There is also a floor for these allowances.

The table is additive – each increase in the disregard is added to the one above, if applicable. The rent reductions mean that for every £1 provided in benefits to cover housing costs, £1.80 is reduced from the full disregard. The Council Tax reduction works in the same way. For those with multiple jobs, the earnings disregard can be split across the employers. As necessary, there can be a reconciliation to ensure that any potential over-withdrawal is returned to the claimant.

8. Dramatically increase the earnings disregards for benefits, so as to reduce PTRs for the lowest earners, by setting the disregards for households as in the table above.

For the purposes of explanation, we have focused the rest of this chapter on the Minimal Losers scenario, where there are very few losers, but there is a short-term cost to the taxpayer. We believe that this approach sets a good template from which to develop policy – especially given the broader cost savings. Details of other scenarios are presented in Appendix H.

16.4.4 EXAMPLES OF DISREGARD CALCULATIONS

Let us take the Minimal Losers scenario to understand how to calculate the disregard. The standard household earnings disregard is £1,500, and this is what a single person under the age of 25 would get if they were not claiming any support for housing. If the household has a person over 25, or includes children, the household disregard (still not claiming any housing support) would be £5,000 (comprised of the household disregard of £1,500 plus the over 25/parent addition of £3,500). A lone parent with two children would have a disregard of £8,300 (basic household disregard, plus parent addition, plus the lone parent addition, plus a second child addition).[8]

So we see that bigger households have higher earnings disregards; and lone parent households, which require some additional generosity have larger disregards. (The additional generosity is explained more fully in section 16.4.5 below.) What about households of the same size, but which claim larger rent costs? The principle here is that, for a household of a given size, those claiming more benefit will have it withdrawn earlier. Those households with large support for housing costs have a lower disregard than those similar households with low or no housing support included in their Universal Credit.

Take a single adult, John, aged 30, whose presumptive disregard is £5,000. Let us assume that he claims housing support (i.e. currently Housing Benefit) worth £50 per month. His disregard would then be reduced by £1,080 (£50 x12 x1.8); so his overall disregard would be £3,920. Were John also receiving support for council tax, say at £20 per month, the disregard would reduce

8 Couple parents would not be eligible for the lone parent element of the disregard. See section 16.7.3 for details.

further by £312 (£20x12x1.3); so their overall disregard would be £3,608 – significantly higher than today.

Jane is the same age as John and also has no children, but has much higher rent costs: £300 per month. Her starting disregard is £5,000, but the reduction of her disregard due to rent costs would be £6,480 (£300 x 12 x 1.8), which is not possible. Instead she would claim the 'disregard floor' of £260 for a single adult.

It is worth noting that these are disregards are usually substantially more generous than under the current system, where withdrawal generally occurs much earlier, and at a higher rate. Jane, because of her high rent costs, has a disregard no higher than currently. However, beyond the earnings disregard she will face benefit withdrawal of only 55%, resulting in a lower MTR and PTR than currently.

Worked Example

John, 26, is single, and earns £100 p.w. in a part time job.

Today, John is not eligible for Working Tax Credit. His rent is £45 p.w and his council tax is £364 p.a. (or £7 p.w.). In order to determine his eligibility for benefits we need to account for his earnings disregard of £5 p.w. below which his Jobseeker's Allowance is not withdrawn. Given he earns £100 p.w. he is not entitled to any Jobseeker's Allowance. His Housing Benefit and Council Tax Benefit entitlements are withdrawn on net earnings. Since he does not earn enough to pay tax, net earnings are his wage of £100 p.w.. Hence, he is no longer entitled to Council Tax Benefit, but still receives tapered Housing Benefit of £19.33 p.w. His total income and its derivation is summarised in Figure 16.3 below, which compares it to the Universal Credits scheme (with minimal losers):

	2007-08		**Proposed**		
	Weekly	**Annual**	**Weekly**	**Annual**	
Out of Work Entitlements	£112.50	£5,850	£112.50	£5,850	
JSA	£60.50	£3,146	£60.50	£3,146	UWC
HB	£45.00	£2,340	£45.00	£2,340	ULC
CTB	£7.00	£364	£7.00	£364	
Earnings	£100.00	£5,200	£100.00	£5,200	
Earnings Disregard	£5.00	£260	£6.05	£315	
In Work Benefit Entitlements	£19.33	£1,005	£60.83	£3,163	
JSA	£0.00	£0.00	£8.83	£459	UWC
HB	£19.33	£1,005	£52.00	£2,704	ULC
CTB	£0.00	£0.00			
Income	£119.33	£6,205	£160.83	£8,363	

Figure 16.4 Income Derivation for single man, aged 26, working part-time, earning £100 p.w.

Under the proposed system, the level of out-of-work benefits that John would be entitled to is unchanged. His earnings disregard would be slightly higher. Given that the taper rate for benefits under the proposal is 55%, when earning £100 p.w., he would be entitled to £60.83 p.w. of benefits. This proposal results in a weekly increase in income of £41.40, or 35%, which represents a significantly increased reward from work for John.

16.4.5 RATIONALE FOR SPECIFIC EARNINGS DISREGARDS

In our central proposal, these disregards ensure that those working at the 16/30 WTC hours thresholds on low wages have the same net income as if they were receiving WTC, in as simple a way as is practicable. Those currently in receipt of WTC would therefore be no worse off under the new arrangements. These disregards and lower withdrawal rates provide the equivalent of tapering in WTC, hence those working below the hours thresholds would keep much more of their earnings, and thus have a higher income.

At this stage our aim is to provide the most cost-effective reform. Those under-25s who are not currently eligible for WTC would, under the Universal Credits scheme, be entitled to a lower earnings disregard than older households, replicating, to some extent, their current relative disadvantage. We would argue that over time this disregard should be equalised, as younger people need as much of an incentive and reward from working as do older households. Any differences in the level of justifiable financial support for younger people should ultimately come from the benefit levels, not in differential withdrawal rates or disregards.

The calculation of precise levels of disregards for different household types and rents, so as to provide the same level of work incentive as WTC, is very complex.[9] It also means that simplifying the system without creating many losers means increasing its generosity for certain household types in order to create simple rules that capture the fundamental shape of the policy proposals above: to ensure a simple system, we end up being somewhat more generous overall. We believe this is an acceptable cost of simplification while minimising the losers. Given that the generosity is predominantly for low-earning workers, it is also efficient, in that it increases work incentives.

Our approach to addressing the question of how to withdraw different levels of benefits in a fair and simple manner contrasts with the current approach, and also that suggested by Brewer et al.[10] By keeping one standard benefit withdrawal rate, we are required to change the disregard levels, lowering them for those in receipt of benefits for housing. The IFS paper took the opposite approach of setting higher MTRs for those receiving benefits for housing. Our approach has the advantage of being more flexible without added complexity: setting different disregards is much simpler than setting different taper rates, and easier for the claimant to understand.

This approach has an advantage over the current system, and this addresses one more of our objectives from Part I:

> *Increased rewards for entering work, especially for those doing so on low earnings and low hours. This proposal means that those working below the existing hours thresholds receive a significantly*

9 A reflection of the complexity of the interactions of today's different benefits: see section 5.1.

10 Mike Brewer, Emmanuel Saez and Andrew Shephard, *Means-testing and tax rates on earnings,* (IFS, 2009).

greater reward for work than today. As a result more of the poorest will be incentivised to find a job, without having to worry about the effects of different hours worked on their benefit level. We would expect many more occasional and part-time workers, because for the first time there would be a genuine financial reward for those earning up to ~£60 per week, and a greater reward for all those working below the current hours thresholds.

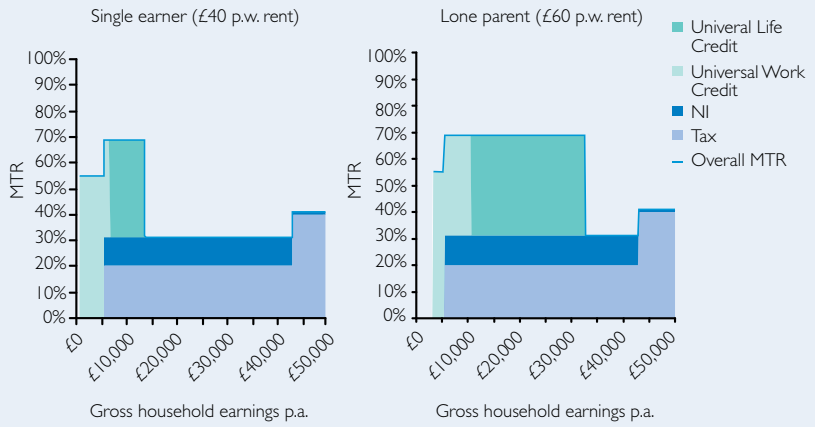
16.5 Discussion of the basic reforms

These proposals result in reduced withdrawal rates, and increased in-work income for all low earners. The work focus is improved by making UWC more of a payment for seeking work, and also separating the second person in the household, and linking their continued payment of UWC to engagement with JobcentrePlus (see section 16.8.4 below). Employment traps are reduced for those currently on ESA: a clear signal that work pays is sent at every point in the system.

16.5.1 ILLUSTRATION OF MTRs AND EARNINGS DISREGARDS

Figure 16.4 below illustrates how the earnings disregards and withdrawal rates operate. A single earner, receiving help with rent will receive only a modest earnings disregard of ~£15 p.w., and will face high MTRs until all Universal Credits have been withdrawn. The MTR rises to 69%, once Income Tax and National Insurance are withheld. For the lone parent with two children, the earnings disregard is significantly more generous, although the 69% MTR lasts for longer, as the total amount of benefit to be withdrawn is greater.

Figure 16.5 Universal Credit scheme: Interaction of earnings disregards and withdrawal rate

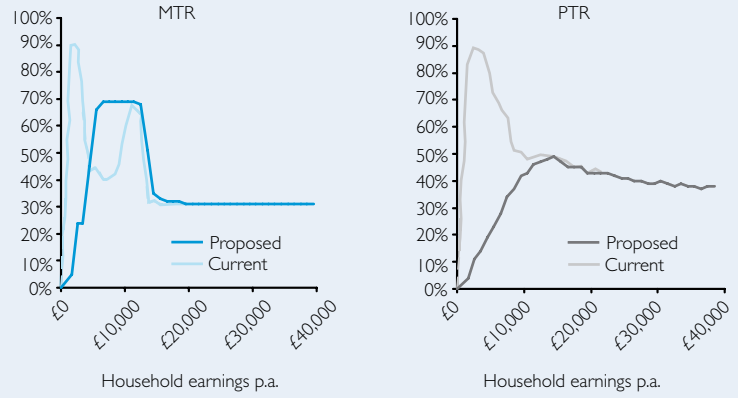


Compared to the analysis of MTRs for different households in Chapter 3 and Appendix A, these schedules can be seen to be much more straightforward, and contain fewer work penalties. (See Appendix F for a detailed comparison of household groupings under current and proposed arrangements.)

16.5.2 IMPACT ON AVERAGE WITHDRAWAL RATES

The average MTR would rise for those earning between £5,000 and £12,500 p.a., but the PTRs for those working fewer than 30 hours per week would be dramatically lower. The graphs below show how the average MTR and PTR would change for a single adult without children.

Figure 16.6 Universal Credit scheme: Average MTR and PTR for single adult (over 25) with no children



The overall impact of these policies is very positive. Our modelling shows that they would lead many more households into work (see Chapter 17 and Appendix F for more details). Their combined effect is to create significantly greater work incentives for those taking up employment at hours levels below the current thresholds: this is particularly attractive to lone parents for whom working fewer than 16 hours is a good option, or for childless people whose first attainable job requires fewer than 30 hours per week. For those working more than the current hours thresholds, the benefit withdrawal would be much fairer (and as a result more efficient).

The extra generosity required to create a simple system that does not overly penalise lower earning households also means that there is a greater work incentive for many. This reform can help dramatically reduce the number of workless households.

We should also add that the proposal helps achieve the objective to eliminate the hours rules in the benefit system, to reduce the thresholds and barriers to progression in work. As we have shown, these hours thresholds create unfair outcomes. They create a barrier to work on the one hand, while on the other, they remain unfair to those who do work just below the current hours thresholds. They simply do not reflect the parlous employment state of those who are taking the decision to get back into work and who can find themselves moving from job to job in those first few months up the job ladder, each of which have varying hours commitments. It is time for a more people-centred approach. From the first hour worked, the more work done, the more credit should be accrued.

An alternative is to find a way of effectively tapering in Working Tax Credits. However, the structure of the current benefits regime means that it

would be virtually impossible to implement a true tapering in of Working Tax Credits or a common withdrawal rate in a practical way. This would only add to the complexity of the system – the very thing we want to avoid.

16.6 Passported Benefits

Out-of-work benefits (JSA/IS/IB/ESA) currently act as a 'passport' to various in-kind benefits, such as free school meals and prescriptions. Rather than providing extra cash benefits across all the out-of-work population to pay for them, the current system provides them directly to those who need them. These benefits are removed when people cross an hours/earnings threshold, and thereby create a significant barrier to work. For those crossing that threshold, they face losing valuable benefits for only a marginal gain in earnings (see Part I, Chapter 2.5, for further discussion). Those managing the benefits system rarely take passported benefits into account when assessing the generosity of different benefits, or the incentives to move into work or work more; though those benefit claimants who use the services find them extremely valuable.

16.6.1 WITHDRAWAL OF EQUIVALENT VALUE

In order to reduce the barrier to work, we propose that these benefits would no longer be withdrawn when the individual or household hits a certain earning or hours threshold. Instead, we propose that while a household which passes an earnings threshold can still receive the passported benefit, a financial value is imputed to that benefit, and as earnings rise, this monetary equivalent is withdrawn as part of the ULC withdrawal.

9. Passported benefits become universal benefits in-kind, tapered away with earnings, rather than withdrawn abruptly when various thresholds are hit.

i. Households of any earnings level may, as part of the application for ULC, apply for any of a set of in-kind benefits, corresponding to the current passported benefits for which they are eligible.
ii. For households not in receipt of UWC, in-kind benefits should be renewed annually. For those in receipt of UWC, it would be automatic.
iii. Households may also choose to stop receiving them at any time.
iv. Each in-kind benefit is given an imputed monetised value - towards the upper end of the market value.
v. The withdrawable amount of ULC in the tax code for a household is increased by a monetised value of those in-kind benefits received by the household (and only those received).
vi. In-kind benefits would operate in the same way for a couple household as for a single person. The monetised value of the second person's in-kind benefits would be added to the withdrawable benefit level for the household.

Non-monetisable benefits

Benefits such as legal aid, and other complex benefits, such as access to the social fund, are temporary and occasional in nature, and hence cannot be imputed a value in a meaningful way. For these we would suggest that they be time-limited, rather than tapered: they should be available in full for six months after a claimant has reached earnings beyond which they are currently withdrawn. In this way we can disconnect the immediate link between increased earnings and loss of these benefits. We recognise that there is scope for argument about the status of certain passported benefits as imputable or non-imputable, and the exact tests, determined centrally, for their ascription to a particular schedule.

16.7 Couples

We consider how the system is configured for couples, looking at benefit levels, eligibility, household disregards and benefit withdrawals.

16.7.1 BENEFIT LEVELS

We need to tackle the couple penalty. Doing so, however, requires a real readjustment that will in turn require a significant investment. We propose that this investment is made in stages. Benefit levels for couples should remain unchanged for the immediate future. This would mean that for out-of-work couples there would remain a material couple penalty, as their benefit levels would be less than 1.6 times those received by single people.[11] We recommend that, over time, the out-of-work couple penalty be steadily reduced by increasing the relevant benefit levels.

10. Over time, the relative value of the Universal Work Credit and the Universal Life Credit award for two-adult households should be increased faster than that for single adult households, in order to steadily reduce the out-of work couple penalty.

This plan has two major components:

- Adjusting the Universal Work Credit for the second adult to 60% of that for the first adult;
- Adjusting the way in which the Local Reference Rents are calculated for single households and couple households, so that the couple household level approaches 1.6 times the level for single people.

In contrast, we recommend that any initial investment in addressing the couple penalty is spent on working couples. This is a more efficient use of

11 See Chapter 14.2 for an explanation of why we consider 1.6 to be a fair equivalisation.

available funds, because it increases work incentives while simultaneously reducing the couple penalty.

16.7.2 BENEFIT ELIGIBILITY

The current configuration of Jobseeker's Allowance risks abandoning the second person in a couple: in a couple household, if one adult is workless but their partner works more than 24 hours per week (or earns more than £22 a day), no Jobseeker's Allowance is available to that person. This means that currently a single-earner couple can be entitled to Housing Benefit, without any obligations on the lost 'second worker' currently to engage in a welfare-to-work programme.

If someone is entitled to benefits, then the one they generally receive should be one that has work obligations associated with it. Hence, we propose a change in the way that UWC (the successor to JSA) is given to couple families.

11. The Universal Work Credit award for the second adult in a couple should be individualised:

i. UWC should be paid on an individual basis at the same level as today, with the second person in a couple receiving a lower amount.

ii. The second person's eligibility for UWC should be based on engagement in a welfare-to-work programme.

iii. The second adult's UWC is included in the household withdrawable benefit. Hence, it is withdrawn when the combined household earnings exceed the earnings disregard, as a result of either the first or second person's earnings.

It is still desirable to ensure that those partners in one-earner households with reasonably high household incomes would not be eligible for out-of-work benefits. In effect, the proposal changes the order in which benefits are withdrawn. In a household with 'high' earnings, but only one earner, the first benefit to be withdrawn would be the earner's Universal Work Credit (but not the second person's). Once a one-earner household reaches earnings such that all other benefits have been fully tapered away, the second person's UWC would be withdrawn at the standard withdrawal rate of 55% (based on household post-tax earnings).

This approach has an advantage that addresses another of our objectives:

Second adults in a couple are reconnected with job support and strengthened conditionality around out-of-work benefits.

By making the withdrawal of the second person's benefit the last thing that occurs, the second worker is kept connected to the labour market and welfare-to-work programmes for as long as possible. This proposal has no cost implications; rather it represents a better reconfiguration of the current UWC benefits budget. The result of this proposal would be an increased transfer of out-of-work benefits to the second person. However, this would be offset by the earlier withdrawal of other benefits than today.

16.7.3 HOUSEHOLD EARNINGS DISREGARDS

The penalties in the current system that prevent the poorest from taking life decisions such as living with a partner are pernicious, and were outlined in Chapter 4.

Under our scheme, with its withdrawal rate of 55% post-tax, the relative generosity for different groups is determined by the size of the initial award, and the earnings disregard before benefit withdrawal commences (at a standard rate). This mechanism has the virtue (among others) of allowing us to produce a simple table of disregards for different households, makes the penalty against couples that much more explicit.

Under the Minimal Losers scenario (see section 16.4.3 above), we have ensured that the net income for those at the 16/30 hour Working Tax Credit thresholds is at least the same as today. If we were to match the treatment of couples under the current system in our new one, by maintaining the same levels of out-of-work benefit awards for all households and the same net income at the WTC hours thresholds, the disregard for couple households would need to be lower than for single households. This is because couple households receive higher out-of-work benefits than single households,[12] but comparatively less generous income at the WTC thresholds, so proportionally more benefit needs to be withdrawn. Since we cannot withdraw more quickly, we would have to withdraw earlier.

Matching the current generosity of out-of-work and in-work support, the disregard for a childless couple would be £300 p.a.less than for a single person. For a couple with children, the disregard would be £3,300 p.a. less than for a lone parent.

Making these penalties more explicit and transparent through a system of variable disregards means that the policy to end the penalty – and introduce a fairer, more equal system – is made that much easier to address directly.

Our first proposal is to remove the implicit couple penalty of £300 in the household earnings disregards, so that the PTR experienced at 30 hours for childless couples would be the same as for single adults. In the Minimal Losers scenario, this disregard would be £1,500 (before rent and council tax costs). This would eliminate this particular aspect of the couple penalty for childless couples. This means that couple households (with and without children) at the 16/30 hours threshold will be ~£165 p.a. better off than before.

However, it would be at this stage prohibitively expensive to eliminate completely the couple parent penalty of £3,300. (See Appendices B and H for details.) Hence, our proposals include a (reduced) couple parent penalty, recognising explicitly the situation as it exists today: in the Minimal Losers scenario, the pre-rent and council tax disregard for couple parents would be £5,000, and £8,000 for lone parents.

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12 Though not as much as two singles would receive. See section 4.2.2.

12. Set the earnings disregard for couple parents to be £3,000 p.a. less than for a lone parent (in equivalent circumstances).

Even if the disregards were set for couples (with and without children) at the same level as for singles, another couple penalty remains, because the benefits disregard is based on a household rather than how many adults are in it. If we wanted to truly eliminate this couple parent penalty, a couple with children would need to have not only no £3,000 reduction in disregards, they would also need an additional second person earnings disregard of £900, to reflect the equivalisation ratio of 1.6 for couples to singles.

That is why we would also recommend that future budgets continue to address the source of the remaining couple penalties.

13. Over time, eliminate the couple parents earnings disregard penalty, and then introduce an additional second person's earnings disregard, and raise it to 60% of the earnings disregard available to single households.

Aligning the disregards for couples will ensure that, over time, the disregard penalty for childless couples is eliminated. However, it would still mean that there was a significantly lower reward from work for couple families compared to lone parents. The couple parent disregard penalty currently stands at £3,000 p.a. As an alternative we also propose reducing this penalty.[13]

This fulfils our objective to *reduce the penalty for working couples, especially low earning couples,* while keeping the number of 'losers' in the process to an absolute minimum. The overall disregard for lone parents remains unchanged. However, this shift will mean that lower earning couples with children will experience a greater disregard before they have benefits withdrawn. Hence, the couple penalty for low-earning couples would be reduced, which at the same time reduces the PTR and increases the rewards to work for couples.

Figure 16.6 below demonstrates how the proposed benefits schedule operates for two different couple households. (The average rent cost and council cost tax for couples, which reduces the presumptive disregard, have been calculated by analysing the Family Resources Survey.)

13 One potential source of funding is to include Child Benefit as part of the Universal Credit.

Figure 16.7 Universal Credit scheme: Proposed MTR rates for couples

As with single adults, the household without children has a lower earnings disregard. In this case the family with children and a mortgage has a higher disregard, because of the absence of any rent support. In both cases (assuming it is a single-earner couple) the UWC associated with the second adult in the couple is the last component to be withdrawn. In this way the connection with the search for work can be maintained.

16.7.4 BENEFIT WITHDRAWAL

For one-earner couples, benefits are withdrawn in the same way as for single people, i.e. not until the earner's post-tax income exceeds the household disregard. As post-tax earnings rise above that level, benefits are withdrawn until the total household withdrawable benefit has been exhausted.

These proposals mean that there will be an impact on the numbers of workers: some second earners will leave the workforce or reduce their hours/earnings. This is because the household income has increased to the point that they can afford to, while the value from working more is somewhat reduced.

14. For two-earner couples, the household disregard can all be applied to one earner or be shared between both earners.

Furthermore, each earner will be given a tax code that includes the full household withdrawable benefit. Therefore, the full household ULC amount can be withdrawn from each earner in a couple.

It is possible that the combined benefit withdrawals from a two-earner couple would exceed the household payment of benefits, because both earners are liable to have the full household amount withdrawn, depending on their earnings. Hence, there is a risk of over-withdrawal, but not of under-withdrawal.

In order to pay any over-withdrawals back to the household, there needs to be a reconciliation every 3 months. This would work in a similar way to a tax return.

15. For two-earner couples, a benefit withdrawal reconciliation can take place every three months.

However, this problem is limited to those with earnings close to the median: those with low and fluctuating earnings will not be affected, in contrast to today's problems with tax credits. Further, it is hoped that the better-off-in-work calculation would be able to inform the second person about whether to claim benefits or not.

If a couple find that they are having more Universal Credit withdrawn than exists, then they simply opt out of Universal Credit entirely. They would then cease to receive the standard payment, and also cease to have any of it withdrawn from PAYE. There could also be an end-of-year renewal of benefits that would incorporate a reconciliation, much as in the US EITC, whereby if there has been over-withdrawal of benefits, these are repaid at this point.

16.8 Supporting socially positive behaviour

Several of the objectives we identified sought to support positive behaviour. We suggest that, over time, the level of increase in out-of-work benefits should be directed towards supporting positive behaviours.

16.8.1 MORTGAGE PENALTY

Part I, Chapter 4 identified two penalties that we sought to reduce for working households: the mortgage and savings penalties.

Low-earning families who are paying a mortgage do not have access to Housing Benefit. We saw that for those in receipt of the Working Tax Credit, the mortgage penalty was substantially reduced, as Housing Benefit was replaced by WTC for many renting households – resulting in mortgagors receiving the same level of benefit. Hence, in the current system, the most significant mortgage penalty is for those working below the 16/30 hours thresholds.

One of our objectives was to *reduce the mortgage penalty for low-earning households.* Our proposed earnings disregards for benefits have been structured such that those not in receipt of support for renting have higher disregards. Hence low-earning mortgagors are particularly benefited. The mortgage penalty for low-earners is not eliminated, but it is reduced by approximately £300 p.a. Renters will still receive higher benefits, but the gap would be narrowed.

16.8.2 SAVINGS PENALTY

We also identified that the capital test was more stringent than in many other countries and created a disincentive to save, and an unfair penalty to those who have saved (see Chapter 4, section 4.2).

The presence of savings causes an income of 20% of the capital value to be imputed to the claimant. The consequence of this was that out-of-work claimants with modest capital saw their JSA being withdrawn first, but were still eligible for Housing Benefit. As a result they were receiving benefits, but were not part of the JobcentrePlus regime. For those with higher savings, Housing Benefit was also limited. However, this restriction did not apply to those working beyond the WTC hours thresholds.

Our objective here is to see that *those with reduced benefits because of capital should still stay connected to the job market*. Our proposal is that the capital tests should apply in a way that first reduces the earnings disregard, then reduces entitlement to ULC, and then finally reduces entitlement to UWC benefits. This change in order of earnings would on its own mean that there was no change to the total amount of benefit withdrawn, but that there would be more of a connection with the job market for those with savings - as other benefits would be withdrawn first.

Another objective was a desire to see these tests being relaxed, especially for those below the WTC threshold. Over time, the savings penalty should become less stringent. The introduction of more generous earnings disregards provides some further relief because the imputed income is not withdrawn until household earnings have reached a higher level. However, we propose that this penalty be steadily reduced over time.

16. Over time the imputed income from savings should be reduced from 20% to 15% and then to 10%. Furthermore the savings cap of £16,000 should also be raised.

We seek to ensure that the work incentives for those who are disabled are as strong as for other claimants. At the same time, we also wish to make sure that the extra payments for disability go to those who really need them. Hence we propose to split the work assessment from the financial needs assessment; to taper such support away as earnings increase; and also to replace "the permitted work scheme" with the generous earnings disregards.

16.8.3.1 Splitting the work and financial needs assessments

Everybody who seeks credit due to incapacity should have a personal assessment test on both ability to work and financial needs. We propose splitting the assessment of the work obligation (UWC) from the decision

about the need for extra income (as part of ULC).[14] The level of support a person requires to cope with his or her disability is not necessarily related to their capacity to work. Extra support for those who have higher living costs is provided through the ULC component, while a separate work assessment would determine whether a person be eligible for the UWC component without the work expectations.

17. Separate the fit-for-work test and the increased payments for those with disabilities.

This would mean that being on a disability regime, with lower work expectations, would not unconditionally entitle the claimant to extra ULC supplements; a person could have reduced work expectations while still not receiving extra support for living costs, if this was not judged necessary.

Those who would are currently entitled to supplementary payments on ESA, DLA and/or the disability supplement for WTC would be entitled to a higher payment level for ULC equal to the current levels of increased payment. The DLA tests should be the basis for all supplementary payments, based on a personal assessment.

We believe that this proposal would address our objective to *reduce the incentives to move to incapacity benefits and recognise the work capacity of claimants, rather than their incapacity.*

We are able to split the payment of extra living costs to those who are disabled (whether or not they work), with an adjustment of work expectations for the subset of those disabled who truly cannot work. There would be no direct financial losers or winners from this proposal. However, it would mean that those currently on ESA/DLA who are able to work despite their disability, would be entitled to appropriate extra payment, while also being expected to seek work, and be given all the necessary support to do so.

16.8.3.2 Taper away extra living costs

We also recommend that the DLA component would be tapered away,[15] so as to incorporate it into the Universal Credit scheme, and aid simplification of the system. It would operate just like other extra payments such as those for children. Legacy IB/ESA recipients would get the same withdrawal rate. Their extra living costs are calculated separately from their requirement to seek work.

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14 Such as DLA and the extra payments in IB.
15 This makes a difference to those at the higher end of the earnings scale only.

16.8.3.3 Incorporate "permitted work" disregards into the Universal Credit disregards

At the moment the permitted work regime allows people claiming ESA to earn £4,784 p.a. (working less than 16 hours per week), without losing any of the benefit. As we recognised in Section 4.5, the relatively small number of those on incapacity benefits taking up permitted work suggests that the current disregards are not encouraging a great deal of work.

18. The earnings disregards in the permitted work regime for those currently on IB/ESA is replaced by the household disregards for Universal Credit.

While this will slightly reduce the disregards for those who are currently on incapacity support, it will eliminate another source of complexity. The work incentive will remain, as a disabled claimant will, like all other claimants be better off in work.

Those receiving benefits on the basis of incapacity should still have the same financial rewards from work as all others. We propose simplifying the permitted work system by replacing it with the disregards proposed above.

16.8.4 FLEXIBLE JOBCENTRE SUPPORT

Given the lower withdrawal rate, many people with stable, but low, earnings will be eligible for continued UWC support. As a result, we will need to provide more flexibility for jobcentre advisers in managing the payments and connection with jobcentres.

19. Flexible jobcentre support

- For those claiming UWC, changes in personal and household earnings must continue be reported.
- Local providers determine the frequency of contact required to maintain UWC.
- At the discretion of the jobcentre, UWC can be paid at reduced levels, rather than withdrawn through PAYE.

One of our stated objectives was to *'personalise' the system by offering the flexibility for bespoke incentive payments to welfare-to-work providers.* Jobcentres should also operate an evening and weekend shift system. We have already outlined the arguments supporting this principle in Breakthrough Britain.[16]

16 Social Justice Policy Group, *Breakthrough Britain, Volume 2: Economic dependency and worklessness* (CSJ, July 2007), section3.

16.9 Childcare

Childcare is a crucial aspect of supporting parents returning to work, and we must make sure that it is easily accessible for all who need it.

A more detailed look at the system of childcare in relation to work has been explored in the Centre for Social Justice report *The Next Generation*.[17] It should also be the subject of future Centre for Social Justice research.

These are certainly large issues, as much to do with the supply side as with affordability.

20. Commission on childcare support

We propose establishing a Commission to review the provision of childcare and what is needed in the context of this report's broader benefits proposals.

Our Working Group has identified several policy ideas which should be further explored:

Increase appropriate access:

1. Allow supported childcare to be accessed by those working under 16 hours.
2. Ensure supported childcare is economically sensible. In a world where others are facing 70%-80% MTRs, we should not be subsidising some jobs in an economically inefficient way, while not supporting others. Providing a subsidy of £300 p.w. of childcare to someone who is earning £200 p.w. (35 hours at the minimum wage) is far from the most efficient investment to support employment.

A supply-side revolution in child-care:

3. We should establish a 'good enough' test for older children, while acknowledging that there is a strong case for more qualified care for younger children. All jobcentres should help people to qualify as child minders – so as many local people as possible can be child minders, providing a service within their own communities.
4. We should relax restrictions on eligibility to receive childcare payments, and particularly give consideration to family members who are not part of the household. Other institutions such as community centres and sports clubs should be able to receive child-minding payments when providing suitable care.
5. Child-minding should be regarded as a form of self-employment. The childminder should not be seen as part of the informal economy. Tax and benefit breaks should be provided to the payer and not the provider of child-minding services.

A review of delivery mechanisms

6. Childcare is a separate discrete benefit paid to cover specific costs of working. It should be handled separately. The recently established connection between Working Tax Credit and the payment for childcare needs to be reviewed.

17 The Centre for Social Justice *Breakthrough Britain: The Next Generation, a report from the Early Years Commission* (CSJ, September 2008).

CHAPTER SEVENTEEN
Assessing the Universal Credits Scheme

These reforms lay the basis for the simpler, fairer system. The much lowered benefit withdrawal rate of 55% sends a clear signal that work will pay – at all hours and at all wages. The restructuring moreover reduces the unfairness that couples face by a significant amount.

Key Conclusions

- Our reforms would benefit 4.9 million working households in the UK by an average of £1,000 per year:
  - Those starting out in entry-level jobs would benefit the most;
  - Higher-earning families currently receiving the family element of the Child Tax Credit would lose out, as would those working just above the hours thresholds of the Working Tax Credit.
- They would result in 600,000 workless households moving into work, and an increase in £1.16 billion in national earnings.
- 210,000 children would escape poverty.
- The direct dynamic cost to the Treasury would be £2.7 billion p.a., with associated administrative cost savings and reductions in the indirect costs of worklessness meaning our proposals would break even after five years.

17.1 Winners and losers

These proposals would directly benefit 4.9 million working households – almost one-sixth of all households in the UK - by an average of £1,000 per year. As a result in the earnings and employment effects, the overall increase in income as a result of these proposals would be £4.7 billion.

The main winners would be those starting out working in entry-level jobs, especially those working below the current 16/30 hours thresholds. Some of the largest gains are received by low-earning couples without children – due to the incentive effect of reduced withdrawal rates, and also the reduction of the couple penalty. On the other hand lone parents working above 16 hours will see only a small gain. They have already comparatively low PTRs beyond that earnings level. The major change experienced by lone parents is for the group working under 16 hours. This will make shorter working hours much more financially rewarding for this group.

There are two categories of losers. The largest group are those higher-earning families currently in receipt of the Family Element of the Child Tax Credit.

This is currently tapered away when the household earnings reach £50,000 per year. Under these proposals it would be subsumed into the Universal Life Credit and thus tapered away at lower earnings. The other group are those working just above the hours thresholds of Working Tax Credits, who have benefited from the scheme's generosity, and who under the new proposals would be affected by a slightly different schedule. This is especially true for those with savings. Under the current system, WTC was not means-tested on savings, whereas Housing Benefit and JSA were. As a result those with savings working just below the hours thresholds were penalised, whereas those above were not. Under the proposals, we have eliminated this unfairness, with a more balanced approach to means-testing savings.

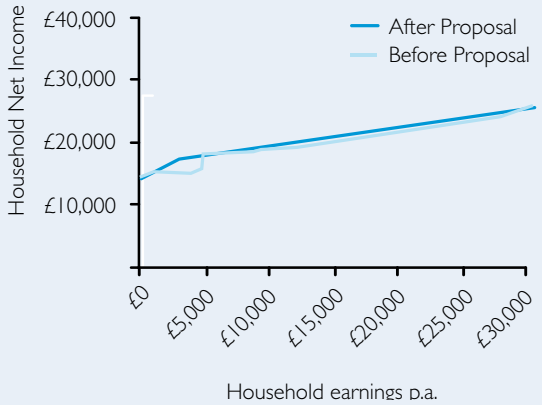
17.2 Financial impact on single adults

Winners

Under these proposals, 1.6 million working single households and 750,000 working lone parents will each gain an average of £1,000 per year. The main winners under this proposal will be those who are starting out working in entry-level jobs, especially for those working below the current 16/30 hours thresholds.

Figure 17.1 below shows the income that a lone parent with a mortgage would receive as her earnings increase (on or close to minimum wage), before and after our proposals.

Figure 17.1 Income that a lone parent would receive before and after our proposals



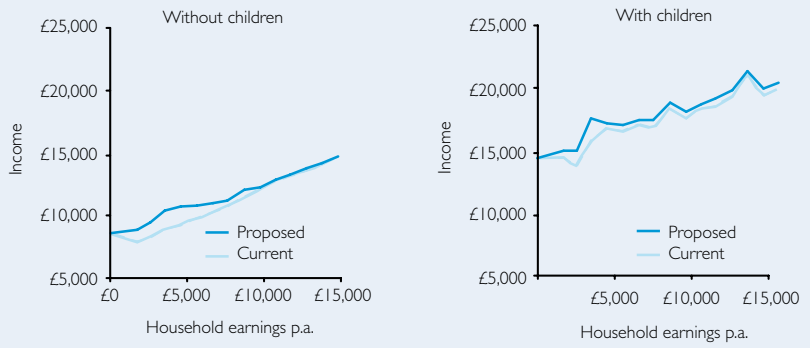
The increased disregards will help us take real, significant steps towards the broad aspiration of reducing in-work poverty. They start to make even the lowest-wage or part-time jobs pay. For example, this means those working 10 hours p.w. on low wages will be better off by about £50 p.w. A single person with gross earnings of £70 p.w. would currently receive no JSA, and hence would currently have an increased net income of £10 p.w. plus any other benefits. Under the reformed system, the same person would retain about £60

p.w. of these wages. Furthermore there would be no break in income as a result of taking a job and being paid in arrears. The benefits would continue to be received in full, and as withdrawals are through PAYE, it is only when the pay-packet is received do they take place. This contrasts with today's system where JSA is withdrawn when a job starts, not when the recipient is paid.

A further advantage is that this more generous disregard will mean that many of those working in the informal economy can be recognised, and have their income regularised.

For those without children working below the 30 hours threshold, there is a significant gain, as is illustrated in Figure 17.2. These proposals would directly lift out of poverty 200,000 low-earning single people and 12,000 lone parents. This is a static perspective. Even more households would escape poverty as a result of entering work and from earning more.

Figure 17.2 Impact of our proposals on single household income



Losers

There would be some losers among those higher earners whose benefits are currently tapered away at a rate lower than 55% net, including some of those families with household earnings over £20,000, who currently receive the family element of the Child Tax Credit (£545 p.a.). For those in private rented accommodation with higher housing costs, the losers would only be those with household earnings of more than £30,000 p.a. There are 149,000 lone parents who are worse off under this proposal, mostly because of family element of Child Tax Credit tapering away at higher earners.

There is a second set of losers among those lower-earning households who work close to the hours thresholds for WTC and are not renters, hence currently not eligible for housing benefit. This group contains 37,000 lone parents. This group is particularly helped by WTC.[1]

1 A small number of lone parents with low rent/council tax bills had a negative PTR because the value of their combined CTC/WTC award was more generous than the other out-of-work benefits.

17.3 Financial impact on couples

Winners

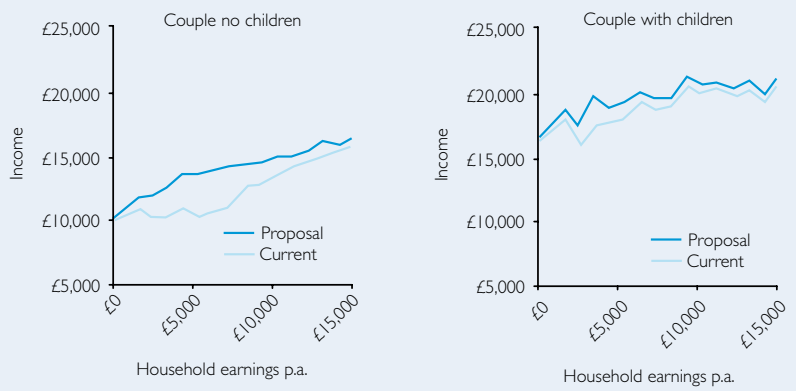
Many other low-to-moderate earning couple households will benefit from these reforms, especially those who have large rental payments supported by Housing Benefit. The capping of marginal tax rates will benefit them the most.

Under these proposals, 1.8 million working couples with children will gain an average of £1,000 p.a. In addition, there are 850,000 couples without children who are winners, predominantly earning below £20,000 p.a.

The main couple winners under this proposal will be those who are starting out working in entry-level jobs, especially for those working below the current 16/30 hour thresholds. Many other low-to-moderate earning couple households will benefit from these reforms, especially those who have large rental payments supported by Housing Benefit. The capping of marginal tax rates will benefit them the most, as, most importantly, will the progressive PTR schedule.

For those without children working below the 30 hours threshold, there is a significant gain, as is illustrated in the graphs below.

Figure 17.3 Average net income for couple households with no children and with children



These proposals would directly lift out of poverty 228,000 low-earning childless couples and 33,000 couples with children. This is a static perspective: ultimately, more households would escape poverty as a result of entering work and from earning more.

Furthermore, the working couple penalty is reduced. Comparatively low-earning working couples benefit more than the gain for single adults at comparable earnings levels. This holds for both households with children and those without.

Given that this particular proposal does not address the working couple parents penalty, there is still a further move to make to reduce the penalty. The gains to the average working parent are somewhat less than for childless

adults, because the existing 16 hour rule for WTC provides comparatively stronger incentives than for childless adults.

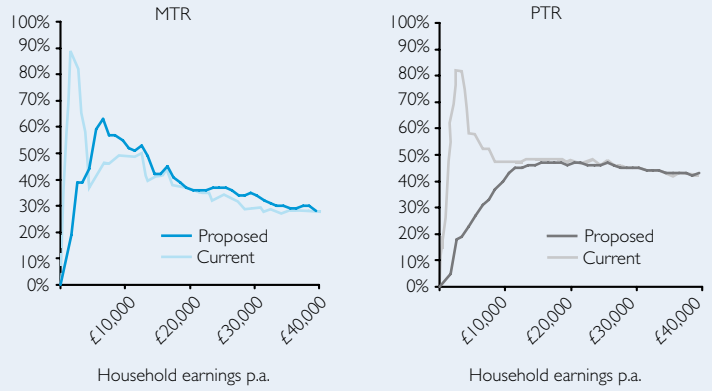
Losers

There would also be 2.34 million higher-earner couple parents who would lose some income – most of this group would experience reduced incomes because of family element of Child Tax Credit tapering away before £50,000 per year. The typical loss for these couples would be £250 per year. A small number of couples (with and without children) lose out at the 16-hour boundary.

17.4 Incentives

One of the over-riding objectives of these reforms is to make the first steps into work rewarding. As a result, there will be a significant increase in incentives for people to enter work, even on a part-time basis. We have eliminated the biggest financial barriers to work. Figure 17.4 below shows the average MTRs and PTRs for all working-age households.

Figure 17.4 Financial barriers to work under current and proposed schedule



The very high marginal tax rates for part-time work in the current system are abolished. The more generous earnings disregards mean that for many there is a very low PTR for the first £5,000 of annual earnings. Hence the rewards for those in entry-level jobs will be much greater. On average, the increased rewards for employment are focused on those earning up to £15,000 p.a., although this will vary by household type and housing tenure. Appendix F provides further detail on the changes in MTR and PTR for different household groups.

As a result of the reduced taper rates for benefits, there will be many low-middle earning households who will experience an increase in MTR (while at the same time experiencing an increase in net income). They will face a reduced incentive to earn more.

17.5 Earnings and Employment

The new personalised disregards mean that for many entering part-time work, there would be minimal impact on their benefits entitlement, thus providing enormous security. As a result there is an overall increase in employment, but for some groups a reduction in earnings.

The proposed system, with the disregards as described, would result in 600,000 workless households moving into work. It is an efficient way of doing so. Figure 17.5 below shows the number of each type of household that would enter work, and the cost for that group. The 'Efficiency' column is a measure of the number of households into work for each £1,000 spent. The efficiency of these measures is greater for each group in the population than the average efficiency of many of the alternatives reviewed in the previous chapter.

The groups for whom the reform is most efficient is for those in the private rented sector. The high PTR and MTRs they experience mean that they are most likely to make different decisions about earnings and employment as a result of reductions in withdrawal rates.

Figure 17.5: Efficiency of reform by type of household

Housing Tenure	Family Type	Dynamic Cost	Households Entering Work	Efficiency
Private Rent	Lone parent	£18,748,188	10,886	0.58
Private Rent	Single without children	£114,170,174	54,731	0.48
Private Rent	Couple with children	£52,473,360	22,614	0.43
Private Rent	Couple without children	£44,019,400	17,671	0.40
LA Rent	Single without children	£216,253,502	79,738	0.37
LA Rent	Lone parent	£98,936,019	21,496	0.22
Owner/Mortgage	Lone parent	£93,000,187	20,539	0.22
Owner/Mortgage	Single without children	£622,621,509	128,244	0.21
LA Rent	Couple without children	£100,949,396	20,634	0.20
Owner/Mortgage	Couple without children	£730,219,537	120,051	0.16
LA Rent	Couple with children	£115,965,605	17,444	0.15
Owner/Mortgage	Couple with children	£576,858,985	86,329	0.15
Overall		**£2,784,215,862**	**600,000**	**0.22**

At the other end of the efficiency scale are the results for couples not in private rented accommodation. The reduction of the couple penalty means that some of their increase in income (and hence fiscal cost) is not focused purely on reducing obstacles to work, but also in increasing fairness. Hence weaker incentives are tolerated for fairer overall support.

The overall earnings impact is also very positive, with an increase of £1.16 billion p.a. in national earnings. As can be seen from the table below, most of the gain comes from earnings from additional workers, rather than current. In fact, the current workers in most household types will over time reduce their earnings, because of the slightly higher MTRs faced by middle-income

households. In each case, this is more than compensated by the earnings gain of new workers.

Figure 17.6: Impact of reform on earnings by type of household

	Earnings change from current workers	Earnings change from Employment change	Total earnings change
Lone parent	£72m	£347m	£419m
Single without children	-£392m	£1224m	£832m
Couple without children	-£212m	£990m	£778m
Couple with children	-£223m	£766m	£542m
Dual earning Couple with children	£19m	-£920m	-£900m
Dual earning Couple without children	-£5m	-£509m	-£514m
Total	**-£741m**	**£1,898m**	**£1,158m**

The only groups where this pattern does not hold is among dual-earning couples. For many of these middle-earners today, it is the second earner whose wages make a real difference. This first worker's earnings predominantly pay back the household benefits. Under these proposals, the first earner would have a higher net income, and the second a lower net income. Hence, we would expect many families to reassess the need for the second adult to work.

17.6 Impact on poverty

Under these proposals, there is also virtually no up-front means-testing. This means that benefits are more accessible, and they do not force people to manage their benefits levels on an ongoing basis. The reduced number of benefits and automatic payment of the full amount is likely to increase the take-up, particularly among low earners, who are most likely to comprise today's working poor. The system also works more with the grain of human nature, supporting the life choices that individuals make. Hence it is less likely to be subject to fraud.

The main reduction in poverty is as a result of households entering work, rather than through income transfers. By making entry-level jobs more financially rewarding, it is now easier for many to escape poverty through work.

The table below shows the sources of poverty reduction by household type. The combined effects of reduced benefit withdrawal and increases in employment mean that 829,000 households would escape the poverty threshold of 60% of equivalised median earnings. Within these households, 210,000 children would escape poverty.

Figure 17.7: Households and children escaping poverty as a result of reform

Household Income Poverty Reduction	Income-transfer based	(Thousands of households) Employment	Combined	Total number of children (thousands)
Lone parents	12	17	29	29
Single adults	200	125	325	
Couple without children	228	145	373	
Couple with children	33	70	103	181
Total	**473**	**356**	**829**	**210**

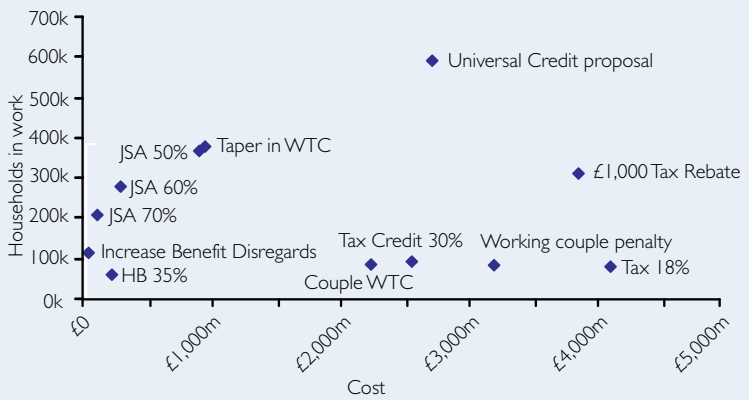
These proposals have focused on reducing worklessness, rather than directly addressing poverty. As a result, it is interesting to note that the bulk of the households that escape poverty are those without children. These are the groups that have not received attention from the Government's recent anti-poverty efforts. Furthermore, for every lone parent household escaping poverty, only one child escapes, whereas for couple households escaping poverty, 1.8 children escape. The reason for that is that the current level of benefits for children means that very few lone parents with more than one child are below the poverty line. Those that are below have on average only one child (according to our analysis of the Family Resources Survey).

17.7 Comparison with alternatives

The proposed reform described in this chapter is as efficient as those that reduce the taper rate of JSA/IS. It benefits far more households than this proposal or any of the more ostensibly efficient proposals would have done, both in terms of poverty reduction and also increasing the number of households in work.

The graph below compares the increased numbers of households in work with the annual cost of each alternative proposal discussed in the previous chapter.

Figure 17.8 Comparison of the cost of placing households in work under various proposals



As can be seen, the proposal we have described is the only cost-effective way of effecting reform to the system and producing a serious reduction in economic dependence.

17.8 Costing and funding

Accounting for the change in withdrawal rates, and the earnings and employment changes as a result of these proposals, the total benefits bill would rise by £3.6 billion. However, this cost would be partially offset by increased income and expenditure tax. The incremental receipts from Income Tax and National Insurance Contributions would be small (£82 million p.a.), because a lot of earnings gains would be in low earning jobs that are not taxed. On the other hand, there would be an additional ~£800 million VAT/Duty raised from the extra income and hence expenditure. This is already factored into the dynamic costing.

Hence, the total short-term dynamic cost of these proposals is £2.74 billion p.a., including increases in the amount of VAT/Duty and Income Tax from people earning more.[2] But this picture is incomplete. We also need to consider broader cost-reductions and savings, as well as long term elasticities.

First, the Department for Work and Pensions' annual bill for administration comes to £6 billion annually.[3] The reduction in worklessness will save money as a result of fewer demands on the benefits system. We estimate that this should save up to £900 per household. This would provide a saving of £540 million p.a.

In addition, the dramatic simplification that we propose should allow for significant cost savings in this area. The opportunity to reduce the number of Government departments involved in administering benefits and to reduce the number of tasks involved should be significant. A further reduction in the administration bill by 15% should be possible. This would save another £900 million p.a. in the medium term.

The integration of taxes and benefits under PAYE+ and the reduction in the complexity of benefits also have significant potential to reduce error and fraud (currently £2.7 billion per year).[4] A 25% reduction in this figure would save an additional £650 million p.a. over the long term, once the new PAYE+ system was in place.

The second source of saving is through the mitigation of the indirect costs of unemployment – increased health, policing and other social costs. In *Breakdown* and *Breakthrough Britain*, we estimated the cost of social breakdown to the country at £102 billion.[5] Here, we estimate that the

2 We have taken a conservative view that incremental income will be taxed at 17.5%. Lower earners will tend to spend nearly all incremental income, and are likely to have a greater share of higher duty purchases.
3 Department for Work and Pensions, *Departmental Report 2008* (DWP, May 2008), Table 1.
4 House of Commons Public Accounts Committee, *Tackling Benefit Fraud* (TSO, 2008)
5 Social Justice Policy Group, *Breakthrough Britain,* (CSJ, July 2007), p. 12.

quantifiable social benefits of getting 1,000 people from welfare to work would be worth approximately £2.1 million per year for the foreseeable future, or £1.3 billion for 600,000 jobs created. See Appendix G for more details.

Hence the total cost savings that could be achieved by these reforms would be £3.4 billion.

The elasticities used to quantify these impacts are only short-term elasticities, estimating the responsiveness of people over the first 18-24 months. The longer term impact will have an incremental effect of leading more people down the road of work as 'peer effects' create change at the margins: as more people take up work, or work more, this will begin to be seen as the norm in areas where it currently is not. This will mean that it is likely to be much more than just self financing in the medium term. If the long-term elasticities were only 10% higher than short-term, then this proposal would deliver a significant financial (as well as social) benefit in the long run. In many other sectors of the economy this pattern holds, so we have good reason to believe it to be true in this context.

17.9 Conclusion

Our proposed reforms are driven by the premise that we must dramatically increase the rewards to work for low-earners and reduce the financial barriers to earning more. In doing so we both incentivise others to enter work, and ensure that work is truly the most effective route out of poverty. Nearly half a million working households would be lifted directly out of poverty, and nearly as many workless households would escape poverty through work.

The scale of these changes, and their focus on supporting low earners and part-time workers in entry-level jobs, provides a real opportunity to make a difference in some of the nation's most deprived communities. It would be financially rewarding for a lone mother to work a couple of hours a day. It would be financially rewarding for a single person to take on a part-time or occasional job. These are all the initial steps people returning to the work-force need to be able to take.

The change in emphasis has the potential to change the nature of communities. It will entrench a way of life in which work is the norm, because it pays. The decision to take a regular job will be seen as the smart move. This longer-term change in attitudes will lead to greater returns than those identified for the first 18-24 months post-reform.

CHAPTER EIGHTEEN

Implementation and Outstanding Issues

18.1 Implementation

Having laid out our Universal Credits scheme in full, and assessed how it will benefit society, we now make some suggestions as to how reform might be implemented. We believe that the Government should focus on phasing in the full system over several years. Implementing the system through PAYE will take some time, but changing the taper rate of benefits can happen very quickly.

Key Recommendations

We recommend a three-phase approach to implementing benefits reform:

- Phase 1 would ensure that no individual benefit had a withdrawal rate over 55% - this could be implemented almost immediately.
- Phase 2 would coordinate the system of overlapping benefits to ensure the overall withdrawal rate did not exceed 55% - this might take up to 2 years.
- Phase 3 would integrate the new benefits with the PAYE system – this would likely take 3-4 years.

Over the term of a parliament, the existing benefits could be made redundant. This would allow a complete transition. At this point, the UWC/ULC structure would be the only option available to claimants.

18.1.1 PHASE 1

The first phase of implementation can occur immediately, as it focuses on amending the existing system of benefits. The primary goal of Phase 1 is to make sure that no individual benefit is withdrawn at more than 55% net (even if some benefits are withdrawn in parallel).

a. Eligibility Rules: simplify the eligibility rules for benefits, so that they are more consistent. Where possible, eliminate overlaps in eligibility – so that people are entitled to only one type of out of work benefit. In addition, the mortgage interest paid to people on

IS and JSA/ESA should be paid through Housing Benefit.[6]

b. Increase Disregards:
   i. Raise the JSA/ESA earnings disregards to the minimum disregard level of £5 p.w. per adult + £12.50 p.w. per child + £32 p.w. for lone parents.
   ii. Raise the earnings disregard for Housing Benefit and Council Tax Benefit to match the point of complete withdrawal of JSA/ESA.

c. Reduce Withdrawal Rates:
   i. Reduce the JSA/ESA taper to 55%, with complete withdrawal if WTC is payable.
   ii. Reduce the withdrawal rate of Housing Benefit to 55% net.
   iii. Reduce the Tax Credit withdrawal rate to 38% gross for standard tax payers and 32.5% for higher tax payers (this will make the withdrawal equal to 55% net).

18.1.2 PHASE 2

The second phase of implementation aims to make 55% more of a standard withdrawal rate for benefits, and to start the simplification of the administration.

a. Withdrawal Rates:
   i. Set the Family Element of Child Tax Credit to taper away as soon as other Tax Credits are fully withdrawn.
   ii. Delay the withdrawal of Council Tax Benefit until HB is completely tapered, and then withdraw at 55% net.

b. Administration: With the simplification of the arrangements, it would now be possible to migrate towards one agency, based in the DWP, with Jobcentres as the local administrators. With one agency, there would be reduced fraud and error, as well as a stronger relationship between claimants and administrators. There would also be need for only one application form.

18.1.3 PHASE 3

Whilst this is occurring, the integration of ULC/UWC with PAYE should commence, such that once the current system has been phased out, PAYE integration would be possible. This last phase puts in place the distinctive components of the reform that provide for both simplification and increased rewards for work.

a. Earnings disregards: Introduce the new more generous earnings disregards.
b. Withdrawal rates: Set one standard withdrawal rate for all benefits (including CTC).

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6 For more details on the practicalities of these simplifications, see David Martin, *Benefit Simplification: How, and why, it must be done* (Centre for Policy Studies, 2009).

c. Benefit Simplification: Eliminate Working Tax Credits, as they would be subsumed by the lower withdrawal rates of other benefits.
d. Administration: Pay all benefits in full and withdraw through PAYE.

18.1.4 ALTERNATIVE MINIMUM BENEFIT

As soon as is practicable, we would propose offering the new benefit solution as an alternative for anyone wishing to claim.

Those who would be better off under the new regime – or those who simply want to get away from the complexity – would be able to claim the increased financial reward from UWC and ULC. For example, new claimants of benefits, and those who are better off on the new regime would be the prime candidates for early transition.

It would be administered within the existing system with reconciliations, such that if the new regime would be more generous, then the applicant would get a payment for the difference. These reconciliations could initially be set at six month intervals, with a view to quarterly re-assessment.

18.2 Outstanding Issues and Further Options

This initial set of proposals will make a big difference to the reward to work for low earners. There are a number of areas where we would urge a Government to continue the reform process beyond these recommendations. The following problems remain, even after the proposed reforms:

- The 55% net withdrawal rate for benefits is still very high. It means that many households continue to face MTRs of 69%.
- Single-earning couples with children face PTRs of over 50%, especially those in private rented accommodation.
- The existence of penalties for couple parents and under-25s still means that there are unfairnesses in the system.

We have considered various ways of addressing these issues: Appendix H contains our analysis of the available options, and our estimates of the associated costs and benefits. Overall, we conclude that such additional measures are less cost-effective at addressing economic dependency than our proposed reforms, so we have not included them in our plans.

We would nonetheless urge any Government to consider them as finances permit: specifically, there should probably be a balanced investment in reducing withdrawal rates, and in reducing the couple parent penalty. More research should also be conducted into the impact of the savings penalty, in order to determine how important it is to reduce it.

CHAPTER NINETEEN

Concluding Remarks

We hope our analysis and proposals have shown not just that it is time for change, but also what that change should look like. We must change not only the benefits system, but moreover the way we think about that system. Advances in economics research, and the incremental contribution made by this report, mean that we are now, for the first time, able to track the impact of benefit reform, and design a system which takes this into account.

In the absence of such an approach, successive administrations have created an inefficient and clumsy series of arrangements: a multiplicity of benefits, bewildering in their scope and in their complexity. No one has been able to control the growth of the system or its budget, nor to achieve their desired results. To call these arrangements a benefits 'system' imbues them with a sense of purpose and coherence which they plainly lack.

Trapped at the heart of this nexus is the benefit claimant, caught in a mire of bureaucracy and complexity and given little reason or encouragement to advance in work.

Our proposals will ultimately succeed in achieving social transformation if they change attitudes towards work; such an attitudinal change is required as much of the economist at the Treasury as of the welfare claimant.

19.1 Successful Society

The benefits system must be designed with reference to its effects on the broader social structures in which it is set; it cannot be a matter simply of which groups get more or less, and whether this puts them above a line on a graph. In many ways it is useful to define poverty by reference to income; to a financial standard, whether it be a proportion of the median income or any other. It gives us common ground on which to discuss problems and one focus for policy. However, such financial definitions cannot be the only touchstone. Poverty is certainly about not having enough money, but it is not only about that.

Poverty in a wider sense is about separation from opportunity, from self-belief and, ultimately, separation through social immobility from those parts of society that offer and enjoy those benefits. The loss of will and hope that attends entrenched dependency is characteristic of settled poverty. It is also a defining characteristic of a fragmented society.

Despite its merits, then, the financial definition of poverty is a potential snare. At this point, the more we struggle to end income poverty through

transfer of income alone, the more we entrench it, through unforeseen (sometimes wilfully unforeseen) consequences.

To relieve poverty, while minimising unintended consequences, requires an understanding of society and how it has responded to the benefits system. We cannot ignore the fact that many people who are able to work and able to support themselves in the main, have come to be dependent on the system. Such dependence has replicated itself across generations. It is a tragedy that, in many communities, this has proceeded from Government's most compassionate purposes.

Habituation to dependence damages both individuals and communities. To accept a system that produces it is to despair of the idea that we could ever offer those members of society the chance to progress. It is to resign ourselves, in the 21st Century, to Disraeli's 'Two Nations'; though in our updated version, the problem is one that is sustained by a well-meaning State.

We believe that earned income is more valuable than unearned income, that working is better than not working, both for benefit recipients and for society. While providing for the least well-off, we must fight dependence and the causes of dependence. We must ensure that we do not remove reasons to work, or even worse, create good reasons not to work. It is essential to get this right. Having done so, we must distinguish honestly between the relief of those who cannot work and those who can work but elect not too. We must redefine the aims of relief to the latter.

Dynamic modelling brings rigour to the analysis of benefits and welfare. It allows us to understand more clearly the effects of the benefits system on those broader social structures, and allows us to design a system that gives people good reasons to work. The benefits system can play its part in increasing social justice and pro-social policy. But it cannot, on its own, change attitudes to work and dependency.

19.2 Big Challenges

One of the Government's biggest areas of failure has been in the area of youth employment and the proliferation of a class of so-called NEETs: young people who are Not in Education, Employment, or Training. There are 959,000 in Britain[1], more than in 1997.[2] In its early years more than half of those on the New Deal for Young People landed a sustainable job (one that is held-down paid employment for 13 weeks or more). However, at the height of the boom, two-thirds of those on the New Deal failed to find such a job.[3]

In a recent article, Labour MP Frank Field delivered this indictment of the current Government's strategy:

1 *The Times*, "Unemployment among teenagers still on the rise, official figures show", 19 August 2009.
2 Frank Field and Patrick White, *Welfare Isn't Working: The New Deal for Young People* (Reform, May 2007) p.28.
3 Ibid., p.18.

> «It is terrible that we have abandoned a generation who believe they have got a pension for life. I once interviewed a group of unemployed youngsters who were anxious to work. Their contempt for the New Deal surprised me. Little wonder - it does not lead to work, it does not teach the skills that they need, and for many it is just an excuse to mess around.
>
> After six months on benefit all those under 25 are enrolled on the New Deal. First, they must negotiate what is called a gateway. Up to four months are spent getting claimants ready for the world of work. If no job is forthcoming, they must choose one of four options: employment, membership of an environmental task force, voluntary placements or full-time training.
>
> All the New Dealers I spoke to had, through lack of choice, to take training. Whether it was suitable or not, the only training was for IT work. But there were not enough workstations to go round, making a mockery of the exercise»
>
> Frank Field[4]

This is but a microcosm of the problems that emerge throughout the system. It is yet more reason to establish the encouragement of economic engagement as a fundamental social purpose to the benefit system, and the primary objective of our proposals.

The Government's failure to engage people economically in spite of the benefit system must be seen for what it is: a call to reform the system. So our job is two-fold. We wish to make the system of benefits as fair as it can be for those who must rely on it. But we must also take care that it does not trap recipients.

19.3 Finding the balance

It is a fundamental truth that any benefits system risks trapping some of its apparent beneficiaries, and so entrenching the alienation of the poor people it tries to help. In Part II, we detailed the mathematical constraints that produce this effect, most notably showing the manner in which any system which aims permanently to relieve defined income poverty must produce withdrawal rates equal to the ratio of the benefit to the poverty level.

This is consistent with intuition. The higher are long-term benefits, the greater must be the cost of working. It is an inescapable mathematical fact, no matter what adjustments one can make to minimise its impact.

The answer to this problem comes in two parts. The first part is that harmful

4 Frank Field 'Team it up: Labour's New Deal isn't Working', *The Times* (20th February 2009).

consequences must necessarily be a matter of degree. A dynamic model helps us mitigate these consequences. The second part asks what mechanisms we have in place to extend the poverty relief offered by society beyond the State. This is where civil society comes in.

The presence of the welfare state is a symbol of a compassionate and civilised society, but we should not tolerate expenditure that harms members of society, whether communities or families. William Beveridge realised the limits of state action to cure the five giants of poverty. He knew that the welfare state could not deliver his laudable objectives on its own. Based on the analysis in this report, we can confidently state that it is no longer adequate for Government to solely use expenditure to cure what we know it cannot.

Two things are required if we want to see real social transformation. We must continually seek to inspire and increase the desire for a job, by ensuring that work is clearly worthwhile; and we must also be clear that a life on benefits, no matter what their level, is not an option for those able to work. For some, this will require a change of attitude.

To succeed, direct engagement and inspiration will be more important than income transfers. We must look for very different policies across departments to reduce geographically concentrated dependency; to help promote suitable role models; to make long-term dependency unacceptable to benefit recipients themselves. Beyond this, it is vital that civil society, especially the community and voluntary sector, is empowered to play its part. The benefits system, the subject of this report, is only one aspect of the welfare state; the welfare state, only one part of the welfare society which delivers care far beyond the state. Without a healthy and active welfare society, no amount of state incentivising will solve our problems.

Nonetheless, the benefits system is fundamental to the strength of our society. The choice is between the current benefits system and the Government policy that has created it along with more entrenched poverty, reduced social mobility, compromised social values and a fettering of choice for those at the margin; between all this and a clear, dynamic alternative. If we are to reverse social breakdown and become a stronger, more cohesive society, we must embrace dynamic benefits.

APPENDIX A
Analysing the Barriers to Work: Case Studies

This Appendix presents a personal picture of the finances and incentives to work for four typical low income household types in the UK.

The case studies we choose are:

- Single person with a rent of £45 per week;
- Lone parent with two children and a rent of £65 per week;
- Couple with no children and a rent of £50 per week;
- Couple with two children and a rent of £65 per week.

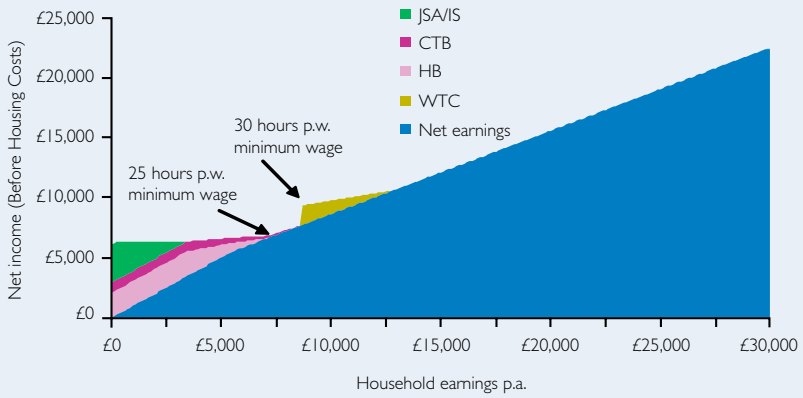
For each case study, this appendix has four levels of analysis.[1] Absolute budget constraints show how total income changes with a rise in earnings. The marginal tax rate (MTR) analysis shows the incentives to progress in work. The participation tax rate (PTR) analysis shows the incentives to move into work. Finally the PTR is put in international perspective.

A.1 Single person (over 25)

Budget Constraint

A single person with a rent of £45 per week, currently receives out of work benefits of approximately £6,000 per year. This is somewhat short of the

Figure A.1 Sources of net income showing benefits and earned income (single adult over 25)



1 Disability payments are ignored for these calculations. We also assume that all claimants have no capital and are over 25. The tax system as set out in Budget 2008 for 2009-10 is used, with benefit rates and tapers for 2009 used where possible, but from 2008 where not.

equivalised BHC poverty level of £7,567. The following budget constraint graph illustrates the different sources of net income at different levels of earnings for this single person.

We observe very flat gradients at the bottom of the earnings scale, with a person's net income not changing even though they work more hours. A single person out of work will have an income of about £6,070 (before housing costs). Working a 25 hour week, 52 weeks a year, he or she will only be about £960 better off. This means each hour will gain them an extra 74p. Work, for this group, simply does not pay.

This single person would have to earn over £8,000 in order to escape income poverty, which represents a paradigm example of being taxed back into poverty. It is only at the 30 hours per week point that there is a noticeable return from work, owing to Working Tax Credits becoming available to single earners older than 25 (see Figure A.2). For those aged under 25, the low return from work persists much further up the earnings scale.

We also observe a small gradient in the 30-45 hours per week section. Here single people experience high MTRs due to Working Tax Credit withdrawal. Once again, incremental work at this level does not pay.

Figure A.2 Net income at 30 hours per week, showing income strands (single person over 25)[2]

£ per week	Single, no children[3]
Gross Pay	£165.60
Less Income Tax	– £12.22
Less National Insurance	– £6.67
Earned Net Income	£146.72
Working Tax Credit	+ £32.28
Before Housing Costs Income	£179.00
Before Housing Costs Poverty Threshold	£145.86

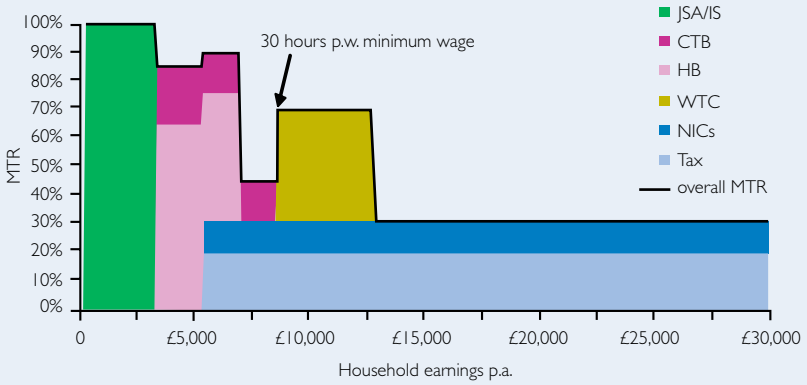
MTR

The causes of this low return from work can be seen by looking at the constituents of the MTR, illustrated in Figure A.3 below. It shows the marginal tax rate (the total percentage) built up by different withdrawal rates of different benefits and also tax. When the claimant, making her first steps into employment, is on low earnings, Jobseeker's Allowance is withdrawn at 100%. Once JSA is exhausted, Housing Benefit and Council Tax Benefit are withdrawn at 65% and 20% respectively, resulting in a MTR of 85% before the threshold of paying tax and NICs. From this point on, her combined MTR rises to 89.65%: tax + NICs + 85% of the remainder.

2 The amounts in this and the following tables are 2007-08 prices and rates.

3 Calculations based upon a single person, older than 25 working 30 hours a week at the minimum wage, assuming no extra disability payments and a rent of £40pw, council tax of £845 a year.

Figure A.3 MTR profile, showing benefit withdrawal rates and tax (single person over 25)



At the point of working 30 hours and receiving Working Tax Credit the MTR is temporarily negative. Receipt of tax credits is sufficient to cause the withdrawal of the remaining Council Tax Benefit, so the gain from tax credits is not what it first seems. As tax credits are withdrawn, the MTR is 70%. It is only when the person starts earning approximately £13,000, the point at which all tax credits and benefits have been withdrawn, that the marginal tax rate drops to the familiar 31%.

PTR

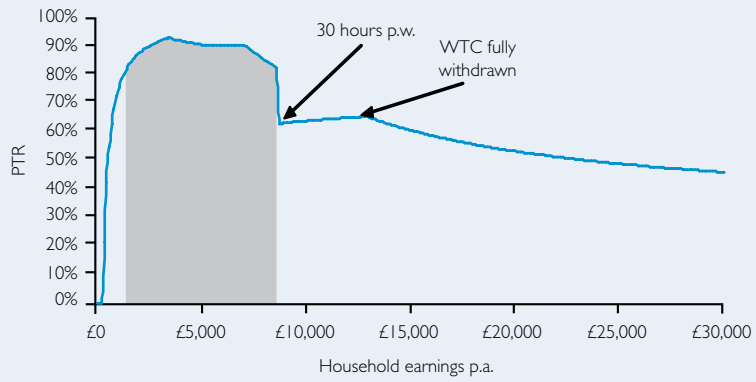
In this case, our single claimant earning low wages up to £8,500 p.a. has a PTR of 80%. This means she keeps only £1,700 extra out of a job which is nominally worth £8,500. As a result of taxes, she does not escape income poverty until she is working 30 hours a week and is entitled to Working Tax Credit. Then the incentive to work is significantly greater.

Because of this Working Tax Credit hours rule most singles will not accept jobs below 30 hours per week – unless they are satisfied with a very low financial returns of work. The rational choice is to go into work only if a good job becomes available: one that comprises 30+ hours work per week. As a result 80% of all single people in work, work for 30 hours per week or more.[4] For those aged under 25, the incentive effect of WTC does not exist, since they are not eligible for it at all.

Beyond the point of where WTC is available, the PTR steadily reduces as earnings increase (see figure A.4).

4 Authors' calculation, based on an analysis of the FRS.

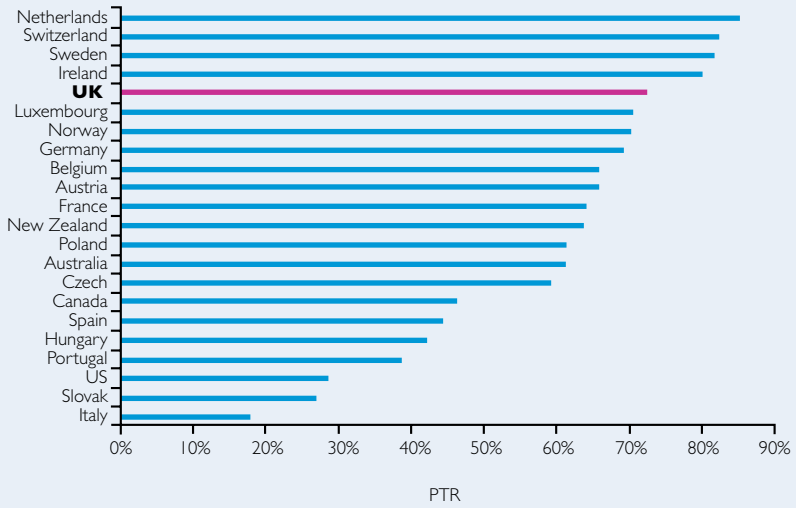
Figure A.4 PTR profile (single person over 25)



In the focus group sessions we organised in Hackney, Plymouth, Hastings, and Liverpool, we learned that workless people themselves are aware that it often does not make financial sense to take up low-paid employment.

Among OECD nations, Britain has one of the highest PTRs for single claimants (Figure A.5).

Figure A.5 Comparison of international PTRs (single person, no insurance, PTR at 60% of average wage)



A.2 Lone parent with two children

Lone parents have some of the most generous out of work benefits and incentives to enter work at 16 hours per week, but much less incentive to work beyond 16 hours per week.

Budget Constraint

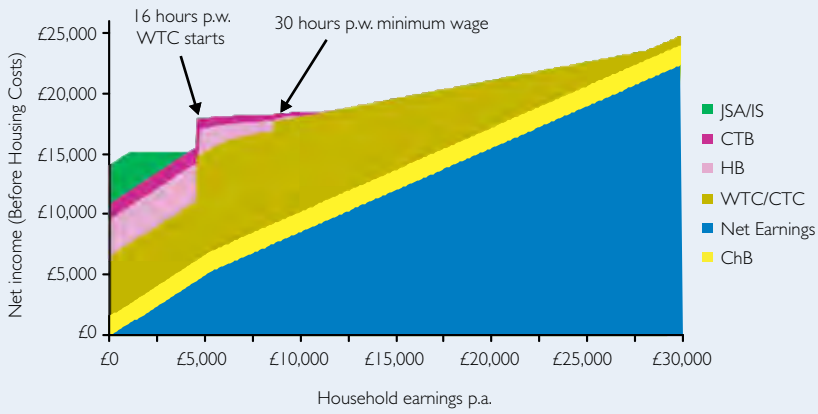
A lone parent with two children and rent of £65 per week receives out-of-work benefits of £11,300 per year, just short of the equivalised BHC poverty line of

Figure A.6 Net income at 30 hours per week (lone parent with two children)

£ per week	Lone parent, two children
Gross Pay	£165.60
Less Income Tax	– £12.22
Less National Insurance	– £6.67
Earned Net Income	£146.72
Working Tax Credit	+ £66.32
Child Tax Credit	+ £92.60
Child Benefit	+ £32.55
Housing Benefit	+ £11.21
Council Tax Benefit	+ £2.41
Before Housing Costs Income	£351.80
BHC Poverty Threshold	£232.40

£12,085 p.a. The £20 per week earnings disregard means that she gains slightly from very low numbers of hours of work per week. As a result, a lone parent

Figure A.7 Sources of net income, showing benefits and earned income (lone parent with two children)



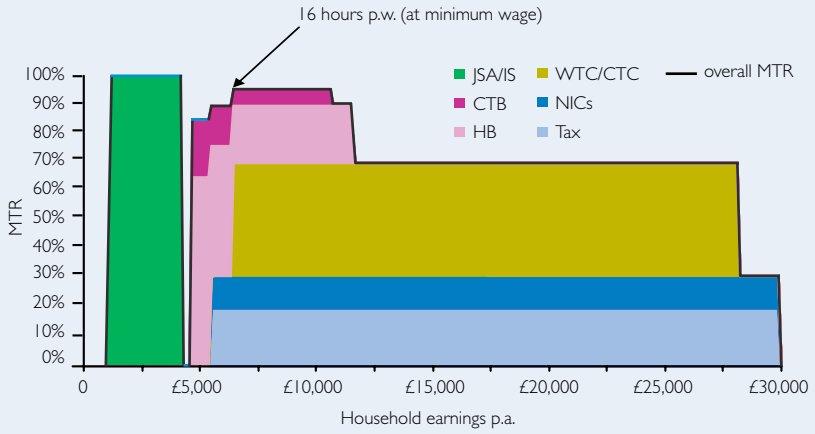
with two children will generally escape income poverty on very low earnings. The graph below illustrates how there is little financial reward for a lone parent working fewer than 16 hours per week.

The big jump in income occurs at 16 hours with Working Tax Credits, although much of the gain is lost in reduced Housing Benefit and Council Tax Benefit. Furthermore the consequence of providing tax credits at 16 hours means that Housing Benefit has not been tapered when they come into play.

MTR

In the case of a lone parent with two children, the high MTR continues much further up the earnings scale, due to a greater amount of benefits being withdrawn. In addition to the presence of Child Tax Credit, Housing Benefit is also more generous so it takes longer to taper away. Hence, a lone

Figure A.8 Average MTR profle, showing benefit withdrawal rates and tax (lone parent with two children)

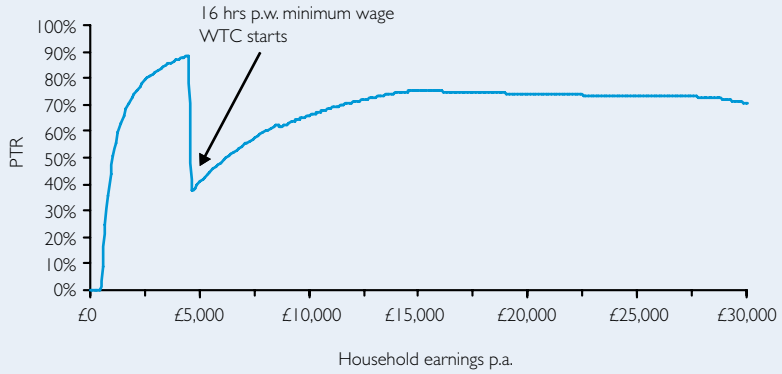


parent is susceptible to a MTR of close to 100% because of five simultaneous withdrawals. It is not until a lone parent is earning close to £30,000 p.a. that the MTR drops below 70%.

PTR

Regarding PTRs, the positive impact of Working Tax Credits at 16 hours is

Figure A.9 Average PTR profile (lone parent with two children)

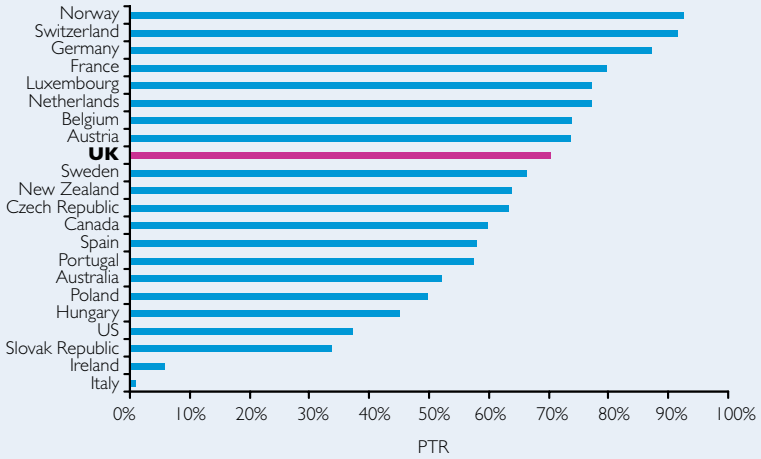


evident. For those on low wages who work 16 hours per week, their PTR can be very low – even close to 0% in some circumstances. Those earning £5,000 p.a keep £4,250 of it, compared to £750 for single people.

There is a larger earnings' disregard before IS is withdrawn at 100%. This means that there is a systematically lower PTR here than for those without children. However, there is still very little return for those seeking work at less than 16 hours per week. Given the caring responsibilities of this group, this is keeping many out of real opportunities.

Furthermore, tax credits are applicable at 16 hours working per week. This means that the effective PTR is very low for those who do work over 16 hours: 94% of all working lone parents.

Figure A.10 Comparison of international PTRs (lone parent with two children, PTR at 60% of average wage)



As a result of the eligibility of WTC at 16 hours, lone parents in the UK experience relatively high PTRs compared to other countries, though not quite as serious as for those for single people.

The real problem is the lack of return for those seeking to enter work below 16 hours per week, and those are in work but considering working more hours.

A.3 Couple with no children (aged over 25)

Budget constraint

For a couple with no children and a rent of £50 per week, out of work benefits are £8,382, which is some way below the poverty threshold of £11,296 p.a.

Figure A.11 Net income at 30 hours per week (couple with two children)

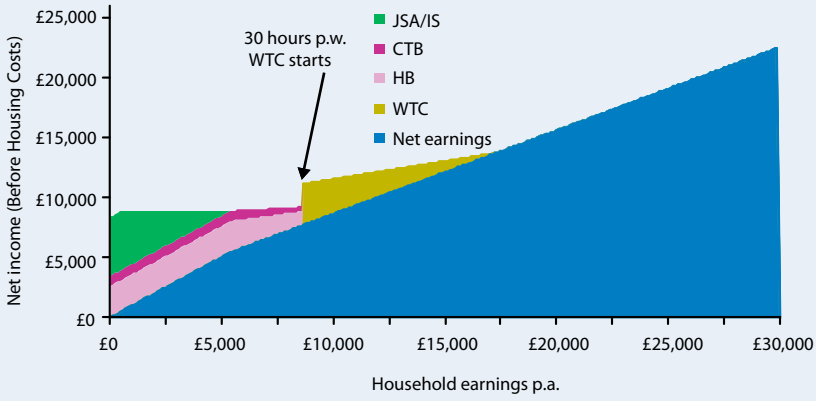
£ per week	Couple, no children[5]
Gross Pay	£165.60
Less Income Tax	– £12.22
Less National Insurance	– £6.67
Earned Net Income	£146.72
Working Tax Credit	+ £66.32
Council Tax Benefit	+ £0.00
Before Housing Costs Income	£213.04
BHC Poverty Threshold	£217

Our couple needs to earn £9,689 p.a. to escape poverty. As Figure A.11 shows below, a couple in which one person is working 30 hours per week at the minimum wage will likely not earn enough to escape poverty.

5 Based on a couple, aged over 25, one person working 30 hours a week at the minimum wage with no children, assuming no disabilities, rent of £50 per week and council tax of £845 a year.

In the graph below it can be seen that Housing Benefit and Council Tax Benefit are fully withdrawn as a consequence of the couple receiving WTC.

Figure A.12 Sources of net income, showing benefits and earned income (childless couple aged over 25)



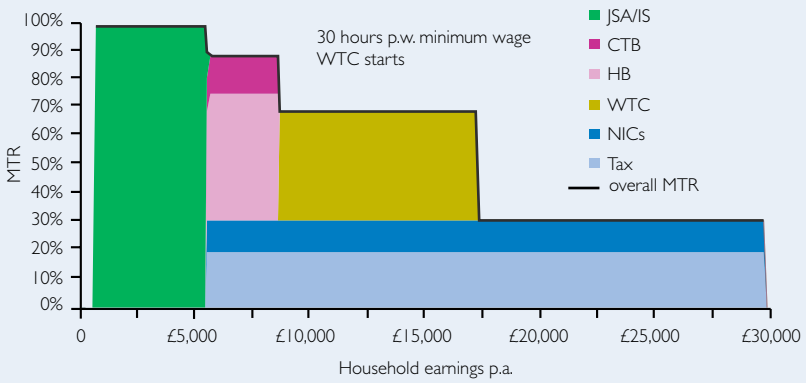
This phenomenon has led to the presumption that Housing Benefit is lost for people entering work, as discussed in Chapter 5. In fact, it is dependent on the size of the eligible HB claim at the point when tax credits kick in.

MTR

As a result of the high MTR, it is often the second earner who increases the household's income. The first earner effectively pays back the household out-of-work benefits – including the second person's JSA.

For a childless couple, the pattern of an ever-decreasing MTR also holds. Couple JSA is withdrawn first at a rate of 100%. Even the first one of them to enter work experiences very high marginal tax rates at the bottom end.

Figure A.13 Average MTR profile, showing benefit withdrawal rates and tax (childless couple aged over 25)

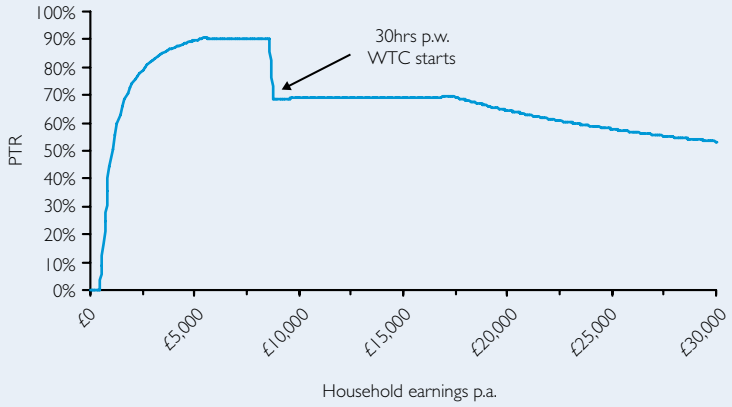


However, the absence of Child Tax Credits means that in this example, all their benefits have tapered away by the time they are earning £17,400 p.a. between them. As a result their MTR then drops to 31%.

PTR

Unlike lone parents (or even single people) the PTR remain very high for a

Figure A.14 Average PTR profile (childless couple aged over 25)



couple entering work. In contrast to the lower PTR for lone parents, a childless couple faces a PTR of up to 70% until their household earnings reach £20,000 p.a., as can be seen from the graph below.

Figure A.15 Comparison of international PTRs (earner couple with no children, PTR at 60% of average wage)

It is hardly worth taking on a job that comprises work of less than thirty hours per week. This is substantiated by the international comparisons, where the PTR for childless couples in the UK is among the highest.

The 30 vs. 16 hour rule for eligibility of Working Tax Credits places childless families at a distinct disadvantage when compared to other OECD countries.

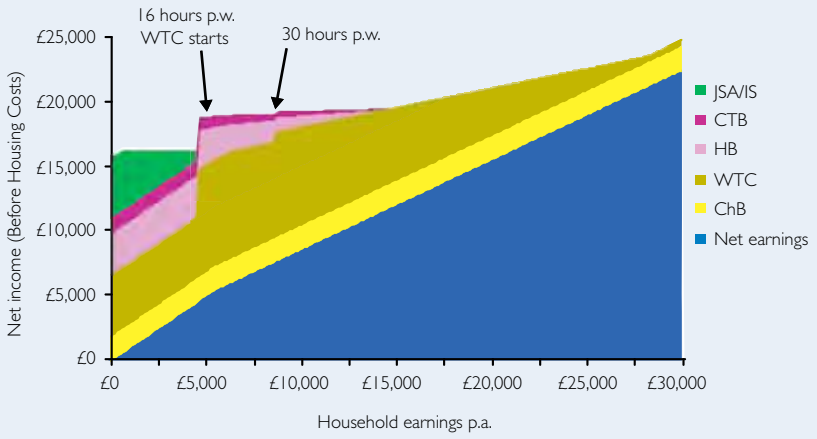
A.4 Couple with two children

Budget Constraint

For a couple with two children, and a rent of £65 per week, the out-of-work benefits amount to £15,811: just at the BHC poverty line.

Given the hours rules surrounding the WTC, it is financially sensible for at least one person in the couple to work 16 hours. This would raise the household's joint income by about £3,500 p.a.

Figure A.16 Sources of net income, showing benefits and earned income (couple with two children)

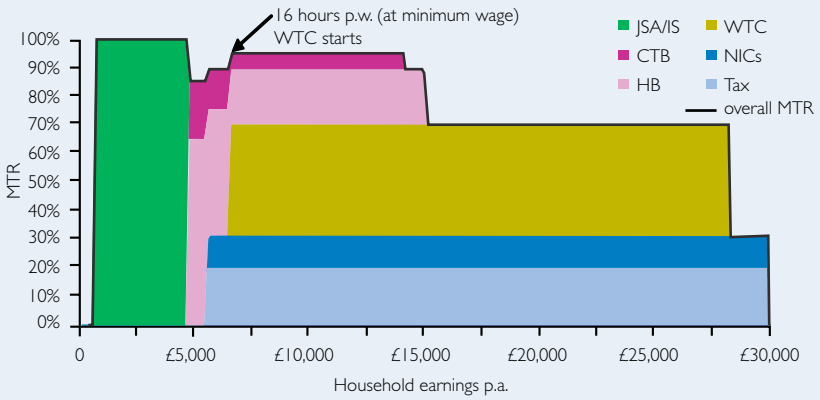


Alternatively, if the couple split up and neither of them worked, their combined net income would rise to over £20,000 p.a., giving them over £1,000 a year more than working for 16 hours per week at the minimum wage.

For two-parent families in rented accommodation, the 30 hour windfall from WTC has limited effect. Much of it is lost as a result of the combined 85% withdrawal rate of HB and CTB.

There is a step change in income when the first earner reaches 16 hours per week, but very little further benefit while Housing Benefit and Council Tax Benefit are withdrawn - and really only when Child Tax Credits have been withdrawn.

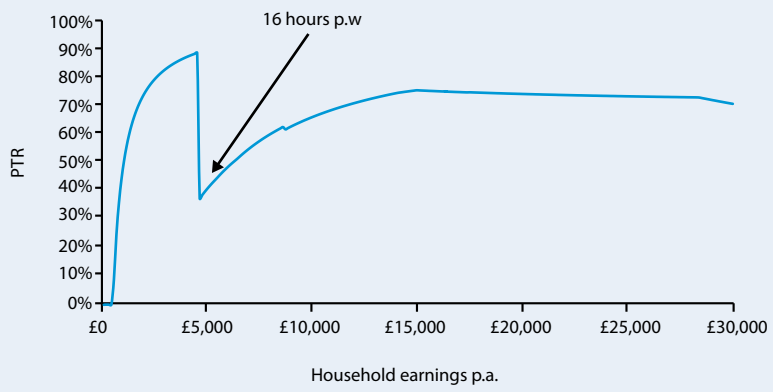
Figure A.17 Average MTR profile, showing benefit withdrawal rates and tax (couple with two children)



MTR

For our couple, high marginal tax rates continue until well above average

Figure A.18 Average PTR profile (couple with two children)



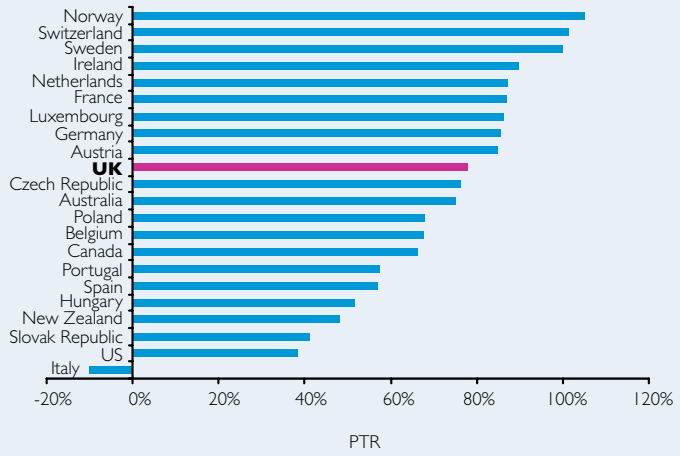
wages. The greater entitlement to Housing Benefit also means that a MTR above 90% applies to a wide range of earnings.

PTR

As a result this family faces a prolonged stretch of a high PTR, with a particularly strong barrier to work below 16 hours.

As with all the other example household types, their comparative position with respect to their OECD peers is poor.

Figure A.19 Comparison of international PTRs (earner couple with two children, PTR at 60% of average wage)



APPENDIX B
Fair for All?

Some household types are helped more by the welfare state than others. In this Appendix we explore in further depth the couple penalty, the mortgage penalty, and the savings penalty. Both out-of-work and in-work households are helped to differing degrees by the benefits system.

Figure B.1 below shows us the likelihood that different types of workless households will be lifted out of poverty by the benefits they receive:

Figure B.1 The likelihood of different types of workless households remaining in poverty after benefits are counted[1]

Tenure	Family Type		% chance of being BHC	% chance of AHC poor[2]	Number of Workless Households
Owned/Mortgage	Couple	No children	100%	100%	252,267
		one child	100%	100%	32,159
		two children	100%	96%	60,971
	Single	No children	100%	100%	1,437,482
		one child	100%	97%	74,558
		two children	97%	72%	66,469
Rented	Couple	No children	99%	100%	185,172
		one child	85%	98%	94,297
		two children	70%	89%	167,690
	Single	No children	93%	100%	1,893,298
		one child	50%	81%	366,966
		two children	32%	31%	382,997
All workless households			87%	93%	5,014,326

87% of workless households will not escape net income poverty through their benefits. In total, this amounts to some 4.7 million workless households left

1 Author's calculations based on FRS data, assuming 100% take-up. Disabilities are not considered. People with disabilities will receive additional support but will also need more income to escape poverty; these two factors are assumed to cancel each other out. Poverty lines taken from the Households Below Average Income series, equivalising with the DWP's OECD scale.

2 The reasons why two similar households could end up above or below the poverty thresholds are primarily due to the differences in levels of housing and council tax costs, and to what extent they are covered by benefits. For example, imagine a workless couple with one child living in London, with high rental costs. As a result it will receive high levels of Housing Benefit, meaning that their total income is above their (BHC) poverty threshold. However, their income after housing costs is reduced significantly by their rent, so in this case their (AHC) income is below their (AHC) poverty threshold. On the other hand, a similar family living in an area with much lower property costs would have insufficient benefit income to lift them above either the BHC or AHC poverty threshold. Paradoxically they would be likely to experience lower material deprivation – because of lower living costs across the board.

in income poverty by the current welfare arrangements.[3] Most noticeable is how the presence of children reduces the likelihood of poverty in workless households.

The benefits system helps different types of working households to differing extents too. The table below shows the total numbers and proportion of some typical working age household types in earnings and income poverty.

Figure B.2 Total numbers and proportion of typical working age household types in earnings and income poverty

Assumes 100% benefit take-up	**Lone Parent**	**Couple with children**	**Couple without children**	**Single without children**	
Local Authority	0.86m (100%) 0.78m (90%) 0.22m (26%)	0.65m (100%) 0.41m (63%) 0.19m (30%)	0.41m (100%) 0.19m (47%) 0.18m (44%)	2.01m (100%) 1.37m (68%) 1.29m (64%)	*population* *earnings poor* *resulting BHC poor*
Owned outright	0.14m (100%) 0.1m (69%) 0.06m (41%)	0.58m (100%) 0.19m (32%) 0.1m (18%)	1.43m (100%) 0.41m (28%) 0.38m (27%)	2.33m (100%) 1.05m (45%) 1.08m (46%)	*population* *earnings poor* *resulting BHC poor*
Private Rented	0.33m (100%) 0.27m (81%) 0.1m (29%)	0.43m (100%) 0.15m (35%) 0.05m (12%)	0.69m (100%) 0.11m (16%) 0.1m (15%)	2.14m (100%) 1.06m (49%) 0.99m (46%)	*population* *earnings poor* *resulting BHC poor*
Owned with mortgage	0.59m (100%) 0.3m (51%) 0.13m (21%)	3.68m (100%) 0.6m (16%) 0.23m (6%)	3.16m (100%) 0.32m (10%) 0.28m (9%)	4.08m (100%) 1.34m (33%) 1.36m (33%)	*population* *earnings poor* *resulting BHC poor*

Government has a responsibility to raise children out of poverty; however, one of the key pillars of recent failure in this area is an inability to apply a fair metric of need.[4] The current welfare arrangements do not do so.

The couple penalty, mortgage penalty, and savings penalty hinder the fight against poverty.

3 Of the 5 million, 87% chance of remaining in poverty.

4 Gordon Brown, Labour Party Conference 2007, "And I say to the children of two parent families, one parent families, foster parent families; to the widow bringing up children: I stand for a Britain that supports as first class citizens not just some children and some families but supports all children and all families. We all remember that biblical saying: "suffer the little children to come unto me." No Bible I have ever read says: "bring just some of the children."", 2007.

APPENDIX C
Income Effects on Work Decisions

Regardless of earnings, MTR and PTR, the higher a benefit claimant's absolute net income, the lower the incentive to work more.[1] Hence, increasing out-of-work benefits without changing MTR or PTR will reduce the incentive to work more.

To understand this phenomenon, let us consider a simple example in which there are two sovereign countries, Exland and Whyland. In Exland, earning £100 a week provides an individual with an additional net income of £60. (This means that the PTR is 40%.) Weekly out-of-work benefits are set at £30. Earning the additional £60 seems quite worthwhile – the total income would be £90, and a person would be three times richer.

In Whyland, earning £100 a week also provides an additional net income of £60. However, the out-of-work benefit for an individual is far higher, at £110. Earning the additional £60 would put the person's net income at £170. Making the extra effort doesn't seem quite as important as in Exland.

In both countries, the participation and marginal tax rates are the same, but the incentives are vastly different.

This income effect also applies to those already in work. For example, suppose an individual has a net income of £200 per week. If their benefits were increased by £20, they could achieve the same net income of £200 from fewer hours work. Even though their MTR has not changed, some will choose to work fewer hours.

Meghir and Phillips highlight that studies have consistently found that increasing out-of-work benefits lead to claimants experiencing longer periods out of work.[2]

This was confirmed recently in a Treasury working paper by Mulheirn and Pisani. It compared the effect of work incentives for two different groups: singles without children aged under-25 and singles without children aged over-25.[3] The significance of these groups is that out of work benefits become more generous for those over 25. The object of the study was to test the theory that "these policy changes reduce the probability of being in employment."[4]

1 And vice versa.
2 Meghir and Phillips, *Labour Supply and Taxes,* (IFS, 2008).
3 Mulheirn and Pisani, *Working tax credit and labour supply,* HM Treasury, (2008).
4 Mulheirn and Pisani, *Working tax credit and labour supply*, HM Treasury, (2008), p. 31.

The statistical analysis that emerged led Mulheirn and Pisani to state.

> *[the analysis shows] a clear discontinuity in the regression, with employment as a function of age falling by around 3.9 percentage points at the age of 25.*[5]

Despite its real-world effects, our model does not account for it for two reasons. First, we do not change levels of out of work benefits, where the impact is greatest. Second, while in theory the income effect exists for low earners, Meghir and Phillips note that "empirically this has not proved to be an important issue."[6] Hence we do not apply it in our modelling.

5 Mulheirn and Pisani, *Working tax credit and labour supply*, HM Treasury, (2008), p. 33.
6 Meghir and Phillips *Labour Supply and Taxes*, (IFS, 2008)

APPENDIX D
The Dynamic Benefits Model: Details and Calculations

D.1 The Dynamic Benefits Model

The dynamic benefits model has been used to analyse a wide range of potential reforms to both the benefits system and also to income taxes. These include many of those suggested by others in recent policy proposals. In doing so, we have been able to compare the impact of different types of changes to the system.

The impact of a change in MTR or PTR on different groups of the population is dependent on the starting tax rates and the size of the change. For example, a reduction in the marginal rate from 70% to 65% has a greater impact on behaviour than a reduction in the marginal rate from 10% to 5%. The first example means that the net income kept per extra pound earned will increase from 30p to 35p – a rise of 17%. In the latter example, net income rises from 90p to 95p – a rise of 6%. The proportionally greater increase in 'net income' will be worth more to an individual - and so encourage greater effort.[1]

D.2.1 Changes in MTR leading to changes in earnings

Changes in earnings are given by the following formula:

New earnings / Old earnings = [(1- new MTR)/(1- old MTR)] ^ elasticity

Let us take a couple of examples, and use them to illustrate how this equation works, and what the implications are for high earners compared to low earners.

A high earner has an earnings elasticity of 0.182 and typically has a marginal tax rate in the region of 41%.[2] If the MTR were reduced by 10 points to 31%, then on average this would cause a 2.9% increase in their earnings.

[(1-31%)/(1-41%)]^0.182 = 102.9%

On the other hand, low earners have much lower elasticities (0.091), but will typically have a much higher MTR (say 85%). If their MTR were reduced by

1 The distortion caused by a tax rises more than proportionately with the marginal tax rate. Rosen (1995, p. 314) has suggested roughly with the square of the rate. This essentially means that those who have it hardest respond the most – because additional income is worth much more to them.

2 The elasticities used in the calculations for this report have been taken from Stuart Adam, *Measuring the marginal efficiency cost of redistribution in the UK* (London: Institute for Fiscal Studies, 2005).

the same 10 points, to 75%, then on average this will induce a 4.8% increase in earnings.

[(1-75%)/(1-85%)]^0.091 = 104.8%

So here we conclude that a 10 point reduction in MTR has a much greater impact for those starting at higher MTRs, and that for low earners this MTR effect typically offsets the fact that they have lower elasticities. A priority for reform will be to reduce the highest MTRs, as this will be likely to have the most positive impact on both earnings and employment.

D.2.2 EARNINGS ELASTICITIES

The following table contains the specific earnings elasticities segmented by demographic type, as used in the model. They are based on those provided in Adam.[3]

Figure D.1 Earnings elasticities by demographic type

	Household Earnings decile										
Earning elasticity	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Average**
Single	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.18	0.10
Lone parent	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.18	0.10
Man, no children, working partner	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.18	0.10
Man, no children, non-working partner	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.18	0.10
Man, children, working partner	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.18	0.10
Man, children, non-working partner	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.18	0.10
Woman, no children, working partner	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.18	0.10
Woman, no children, non-working partner	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.18	0.10
Woman, children, working partner	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.18	0.10
Woman, children, non-working partner	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.09	0.18	0.10
Average	**0.09**	**0.09**	**0.09**	**0.09**	**0.09**	**0.09**	**0.09**	**0.09**	**0.09**	**0.18**	**0.10**

D.3.1 EQUATIONS FOR CHANGES IN PTR LEADING TO CHANGES IN WORK PARTICIPATION

We use the same approach for determining the changes in work participation for a particular group of workers. If the PTR for a particular group of workers increases, some of them will end up leaving the workforce. If the PTR is reduced then new workers will join this group.[4] We model this impact in a manner similar to the changes in earnings, albeit with a different set of elasticities:

new number in-work / old number in-work = [(1- new PTR)/(1- old PTR)] ^ elasticity

3 Stuart Adam, *Measuring the marginal efficiency cost of redistribution in the UK* (London: Institute for Fiscal Studies, 2005).

4 It is worth noting some difficulties around choosing the hours that those who start work are assumed to have. We therefore draw the hours distribution from the population who are already in work, assuming that increases in this group reflect the decreases in the out-of-work group which occur with increased participation.

Taking low earning lone parents as the example here, the best evidence to date indicates that lone parents have high work participation elasticities (0.448) for the lowest earners. PTRs for lone parents working fewer than 16 hours per week are ~75%. If this were reduced to 55%, then we would expect to see up to 30% more lone parents engaged in this pattern of work.

$$[(1-55\%)/(1-75\%)]^{0.448} = 130\%$$

This demonstrates the dramatic potential of reducing the withdrawal rates for those on low earnings.

Hence to increase jobs, we want to reduce high PTR levels for those who have the highest work participation elasticity.

D.3.2 EMPLOYMENT ELASTICITIES

The following table contains the specific employment elasticities segmented by demographic type, as used in the model.

Figure D.2 Employment elasticities by demographic type

	Household Earnings decile										
Earning elasticity	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Average**
Single	0.30	0.30	0.24	0.24	0.18	0.18	0.12	0.12	0.06	0.06	0.18
Lone parent	0.45	0.45	0.36	0.36	0.27	0.27	0.18	0.18	0.09	0.09	0.27
Man, no children, working partner	0.30	0.30	0.24	0.24	0.18	0.18	0.12	0.12	0.06	0.06	0.18
Man, no children, non-working partner	0.30	0.30	0.24	0.24	0.18	0.18	0.12	0.12	0.06	0.06	0.18
Man, children, working partner	0.30	0.30	0.24	0.24	0.18	0.18	0.12	0.12	0.06	0.06	0.18
Man, children, non-working partner	0.30	0.30	0.24	0.24	0.18	0.18	0.12	0.12	0.06	0.06	0.18
Woman, no children, working partner	0.60	0.60	0.48	0.48	0.36	0.36	0.24	0.24	0.12	0.12	0.36
Woman, no children, non-working partner	0.30	0.30	0.24	0.24	0.18	0.18	0.12	0.12	0.06	0.06	0.18
Woman, children, working partner	0.60	0.60	0.48	0.48	0.36	0.36	0.24	0.24	0.12	0.12	0.36
Woman, children, non-working partner	0.45	0.45	0.36	0.36	0.27	0.27	0.18	0.18	0.09	0.09	0.27
Average	**0.42**	**0.42**	**0.33**	**0.33**	**0.25**	**0.25**	**0.17**	**0.17**	**0.08**	**0.08**	**0.25**

APPENDIX E
Simple optimisation model

E.1 The shape of our simplified UK model

In Chapter 9, we illustrated the tax and benefit patterns that arise from different objectives. In this section, we explain more of the workings of this simplified model, which is distinct from the main model used to evaluate proposals.

The tax optimisation model used in Chapter 9 includes a simplification. It assumes that payment of tax is the same as the withdrawal of benefits. More specifically, it assumes that every household (regardless of earnings) receives a non means-tested demogrant, and all earnings are then taxed at the marginal rate.

This simplification does not alter the income or earnings for any household: we have simply made a simplifying assumption around the mechanism by which that end is reached.

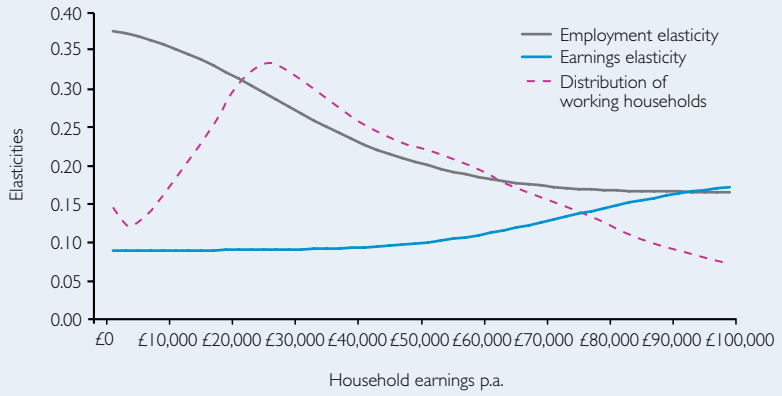
We have also assumed that the government needs to raise an average of £5,000 p.a. per household from Income Tax and National Insurance Contributions, to be spent on other purposes (healthcare, education, defence, and so on). The remaining Income Tax base is then used to fund benefits/income redistribution.

It is worth highlighting that, despite these simplifications, the sophistication of this model is greater than those previously used to generate policy recommendations. Its limitations should be viewed in this context. In Part III of this report, where we lay out our recommendations, we use a more granular model at a household level using data from the Family Resources Survey. In doing so, we will also treat different earners in a household separately. For the purposes of the current discussion, we treat the household as a single entity.

To calculate the impact of different tax/benefit schedules we will use a population base that corresponds to the current UK population, as it would be if there were no taxes or benefits.[1] From this starting point, we can then add on the effects of different tax and benefit withdrawal schedules. In the graph below, we also illustrate the employment and earnings elasticities we are assuming. They are derived from the research discussed earlier.

1 With some adjustments to unwind the impact of today's tax and benefits – leading to ~4m workless households, rather than over 6m today

Figure E.1 Employment and earnings elasticities at different levels of earnings



The following sections illustrate some of the thinking underpinning the design of an optimal tax and benefits schedule – starting with a simplified assumption of earnings-only elasticity, then looking at employment-only elasticity, and finally combining the two. (See section 10.4 for further discussion.)

E.2 Earnings-only elasticity modelling

We will first analyse the social and economic effect of changing MTRs. We do so first, assuming a flat tax rate, and then allowing it to vary as earnings increase. (This model was first discussed in section 10.2 and we refer to it below as the Mirrlees model.)

E.2.1 EARNINGS-ONLY ELASTICITY: WHAT HAPPENS WHEN THE MTR IS CHANGED?

According to the Mirrlees model, an increase in MTR over a very small band of earnings has three effects on Government tax receipts and welfare:

1. Increased taxes are paid (or lower benefits received) by every household with earnings *above* the small band (the mechanical effect).
2. This results in a reduction in income for every household with earnings above the small band.
3. The increased MTR will also cause some households in this band to reduce earnings, thus generating a loss in tax revenue.

The impact on social welfare from an increase in MTR could be either positive or negative. It can be measured by considering the change in income for those above the affected earnings band, and the net change to tax-take, which, if positive, can pay for other general purposes or be used to raise levels of benefits.

Therefore, the task is to find the MTR schedule that maximises social welfare, however defined. Before doing so, we will illustrate some simple examples.

E.2.2 EARNINGS-ONLY ELASTICITY: ILLUSTRATIONS ASSUMING FLAT TAXES

To illustrate the interaction between tax rates and behaviour under the Mirrlees assumptions, we will demonstrate how the tax take can be maximised using a flat tax rate.

The following graph shows the different tax takes (on the Y-axis) that would result from different levels of flat taxes (X-axis), given different earnings elasticity assumptions (also assuming for the moment that the decision to become employed in the first place is unaffected by the tax rate). A flat tax is a simple model as it gives a constant marginal tax rate. For each elasticity assumption, there is a flat marginal tax rate that would maximise the overall tax take.[2]

Figure E.2 Tax Take for different flat tax rates – 'Earnings-Only' Laffer Curves

Given the range of earnings elasticities that have been observed in the UK labour market, we find that:

- Up to a point, the higher the tax rate, the lower the post-tax earnings, but the greater the tax take. (The maximal tax-take is represented by the high point of each line.)
- The greater the elasticities, the lower the marginal tax rate at which tax take is maximised, and the lower the overall available tax take.

However we must consider a world of varying MTRs across earnings.

E.2.3 EARNINGS-ONLY ELASTICITY: VARIABLE TAX SCHEDULES

When tax rates can vary across earnings, there are a number of further effects:

2 Based on a population of 1,000 households with earnings of £1,000 when there is no tax.

- Raising the tax rate on low earnings (but not high earnings) reduces earnings and tax take from lower earners (because they reduce their work effort). But this is more than offset by the fact that it raises tax take from higher earners (they do not reduce earnings, because this increased tax rate is not marginal for them).
- Lowering taxes on higher earnings, but not on lower earnings, can raise the total tax take from higher earners, as they increase their earnings more than sufficiently to offset the reduced tax rate on their last £x of earnings.

Therefore, perhaps counter-intuitively, under the Mirrlees assumptions, a tax schedule that declines for higher earnings will often generate greater tax take than a flat tax.[3]

A worked example of this phenomenon is provided in the box below.

Reducing Marginal Tax Rates for higher earners

Imagine that the working population has two groups of earners, half earning £10,000 and the other half £20,000, both with an earnings elasticity of 0.2. The flat tax that raises the greatest tax is a rate of 83%.

Let us compare what happens if the tax rate is different for the first £10,000 than the next £10,000 of earnings.

If the tax on earnings above £10,000 is lowered to 66%, the high-earning group each earn an extra £2,181. Even with a lower marginal tax rate, an additional £724 is raised in tax from each higher earner.

Tax rate for first £10k earnings	Tax rate for next £10k earnings	Low earners		High earners		Total population
		Earnings as % of potential	Tax take per person	Earnings as % of potential	Tax take per person	Average tax take per person
83%	83%	70%	£5,823	70%	£11,647	£8,735
83%	66%	70%	£5,823	81%	£12,371	£9,097
93%	66%	59%	£5,451	81%	£13,371	£9,411

Furthermore, if the tax on earnings below £10,000 is raised to 93%, higher earners do not change their behaviour, because this tax change does not affect their marginal earnings. Hence, a further £1,000 is raised in tax from each higher earner. On the other hand, lower earners will reduce their earnings further, and hence their tax take is reduced by £372.

As a result, the overall effect of moving from a flat tax of 83% to a decreasing marginal schedule of 93% and 66% generates a 5% increase in national income and an 8% increase in overall tax take.

This increased tax take can be used to fund more generous benefits. However, the net effect of this change would also be for low earners to have lost out with reduced earnings, while those on high earnings would have benefited from higher earnings and net incomes.

However, it is not clear that the resulting distribution of income is necessarily socially beneficial. From a social policy perspective, the question is how to balance the economic efficiencies with questions of fairness and opportunity.

3 Note that this will not always be the case when employment effects are added into consideration.

The extent to which having different tax rates for different earnings bands can increase tax take is determined by the earnings distribution across the population.

If the goal is to maximise tax take, the greater the population *above* a particular earnings band, the higher the tax rate should be *within and below* that band. At the very highest earnings, the tax rate should be very low. However, if the population distribution of high earners diminishes fast enough, the optimal tax rate diminishes very quickly, and only at the very highest earnings. A good approximation, therefore, is to ignore this effect, and assume a flat top rate of tax is optimal.

For the UK, Brewer, Saez and Shephard (2008)[4] have estimated this optimal top rate of tax to be around 40% (net of VAT), slightly lower than today's 41% rate, corresponding to 40% Income Tax and 1% National Insurance Contributions. They also note that there is no compelling case for increasing the income tax on very high earners as the Government has proposed – even on redistributive grounds. They estimate that cuts in the tax rate for the top 1% could actually raise tax revenues. This is in stark contrast to the Government's stated goals for the planned rise in tax for top earners to 51% (including NI) from 2010 onwards.

The earnings cost of reducing benefit withdrawal rates

We have explained that we believe reducing withdrawal rates for the lowest earners makes work pay more. However, there is a twist to this - because it would come with a cost to the earnings incentives for those slightly higher up the earnings scale.

Today in the United Kingdom, there are high withdrawal rates for low earners. There is a group of modest earners who have reached the point where they are currently no longer eligible for benefits and have a low MTR (because benefits are no longer being withdrawn).

If we were to reduce withdrawal rates for benefits, this group would then become eligible to receive benefits, and would therefore face a much higher MTR, as a result of the additional withdrawal rate of these newly received benefits.

As a result of the higher benefits (and hence higher net income) and the higher MTR they will on average (as a group) reduce their earnings. Therefore, the cost of reducing withdrawal rates can increase because of this negative earnings effect. If this group is more numerous than the group on lower incomes who gain from reduced benefit withdrawal, the economics of any reform become very difficult.

It can become very costly to reduce benefit withdrawal rates and create opportunities for the very poorest in society. So government stops trying and entrenches dependency.

Later, when we introduce into the model movement into and out of work, we find that the gains from encouraging more of those who can to enter into work can overcome this cost.

4 Brewer, Saez, Shephard, *Means-testing and tax rates on earnings*, (IFS, 2008)

E.3 Employment-only elasticity modelling

Another partial view of the world is to assume that the only behaviour change is with respect to employment decisions, i.e. tax rates do not impact earnings. This approach illustrates (in isolation) the other key decisions households make in the labour market.

E.3.1 EMPLOYMENT- ONLY ELASTICITY: WHAT HAPPENS WHEN THE PTR IS CHANGED

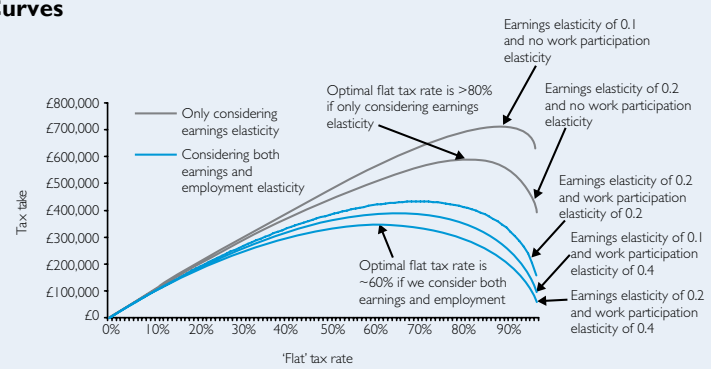
Following a small increase in the net gain of work, people tend to enter employment at, say, ten, twenty or forty hours a week, rather than one or two hours. Hence, for a given earnings level, if the PTR is reduced, then more people will enter work at that earnings level.

In the previous section we looked at 'earnings elasticities' without considering the effect of withdrawal rates on employment incentives; here we look at 'employment elasticities' on a standalone basis: i.e. we assume that there are no earnings effects and that households enter and leave employment as a function of the participation tax rates (PTRs) that they experience.

E.3.2 EMPLOYMENT- ONLY ELASTICITY: FLAT SCHEDULES

The following graph shows the different tax take for different earnings and employment elasticity assumptions separately. Generally, employment elasticities are higher than earnings elasticities – especially for lower earners. One reason for this is because many earners have less choice about the hours they work – and hence how much they earn in employment.

Figure E.3 Tax Take for different rates - 'Work Participation' Laffer Curves



As a result, when employment elasticity is considered, then the tax take is greater at a lower tax rate of ~60% - significantly lower than the 83% optimal tax rate we found when considering only effects on earnings.

E.3.3 Employment- only elasticity: Variable Schedules

In an employment- only elasticity model, the principal reason to vary the participation tax rate is because of different employment elasticities.

If we wanted to maximise tax take, the optimal PTR is a function of the employment elasticity for each earnings level. Brewer, Saez and Shephard have demonstrated the following formula for optimal participation tax rates (t) at earnings level z for a given employment elasticity η:

$$\frac{t(z)}{1 - t(z)} = \frac{1}{\eta_{(z)}}$$

As the elasticity η varies for a particular earning (z), then the tax maximising PTR varies. Hence the optimal PTR schedule is a function of the elasticity η. The MTR schedule that generates the required PTR schedule can be determined.

Since employment responses are particularly important at the bottom of the earnings distribution, accounting for them radically modifies the structure of optimal taxes for low earning households. Indeed, given the same objective, this argues for lower marginal tax rates for the lowest earners in order to generate lower PTRs.

If on the other hand we wanted to give different weights to the income of households at different points in the earnings scale, we would need to modify the value of marginal taxation. The formula to calculate optimal taxes is adjusted to account for the cost of depriving taxpayers of income, where the value of marginal income g(z) declines (from 1 to 0) with increasing earnings (z)

$$\frac{t(z)}{1 - t(z)} = \frac{1}{\eta} \cdot (1 - g(z))$$

The consequences of these formulae are considered in more detail by Brewer, Saez and Shephard (2008).[5]

E.4 Combined elasticity modelling

When we combine earnings elasticity and also employment elasticity into one model, it becomes much more difficult to explain the optimisation function analytically. Hence we will present a range of different scenarios to illustrate the consequences of optimising to different objectives. The resulting MTR/PTR schedules should be taken as directional guides, rather than specific proposals.

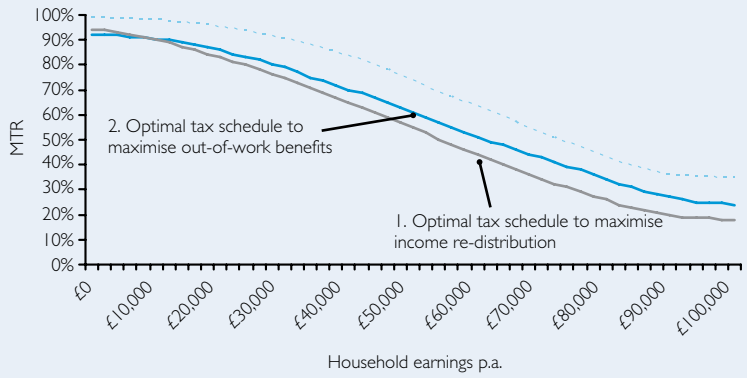
5 Brewer, Saez, Shephard, *Means-testing and tax rates on earnings*, (IFS, 2008).

E.4.1 Regressive Schedules

The graph shows two different regressive tax schedules – each optimised to meet slightly different objectives (for reference we also include the tax schedule derived from an earnings-only elasticity model):

1. Maximise broad income re-distribution. This objective values incomes at all levels, but places greater weight on seeking to raise the income of lower earners.
2. Maximise the cash benefit given to those out of work. This is in effect an extreme version of income re-distribution where the only income that is valued is that of those with no earnings.

Figure E.4 Regressive Tax Schedules



The first schedule, emphasising broader income distribution[6] results in a slightly lower cash benefit to those out-of-work (£13,750 vs. £13,950), but greater overall income across the population. This is because the lower tax rates higher up the scale encourage higher earners to earn more (and hence pay more tax). The objective is a broader distribution of income rather than focusing only on those at the lowest end of the earnings scale.

Both of these schedules provide similar levels of out of work benefits with a median income of ~£15,000 p.a. In both cases, out of work benefits would be well above 60% of median income, and hence everyone (in or out of work) would be well above the poverty threshold.

For the broader income distribution schedule, the Gini coefficient would be 0.2. For the maximum out-of-work benefit schedule, the Gini coefficient would be 0.17.

However, both of the regressive schedules would significantly hamper GDP because the total level of national income would be lower than under other tax regimes.

From a practical perspective, administering an MTR that tapers across

6 In this case the income of those earning more is valued less, for each group income is valued at only 95% that of those earning £2,000 or less p.a.

the whole earnings spectrum would be complicated to understand and cumbersome to administer. A more realistic approach would be to set a constant MTR for all earnings above a certain threshold.

E.4.2 FLAT VS. VARIABLE TAX SCHEDULES

The consequence of a flat tax (at any level) is that higher earners are not incentivised to earn as much as they might be, and this reduces the total tax take.

If the objective is simply to maximise national earnings/income, while maintaining out of work benefits at the level set for the flat tax (50% of median income in our scenario), then there is a benefit from reducing tax rates for higher earners. This would generate a comparable tax base, but allow for greater economic activity, and reduced worklessness. The increased national income (and GDP) could be 8% higher than the 54% flat tax, and 21% greater than the regressive schedule above.

However, it comes at the expense of greater income inequality. The result of this greater income for higher earners would be to increase the Gini coefficient to 0.3.

E.4.3 OUT-OF-WORK BENEFITS AND REQUIRED MTR SCHEDULES

Instead of seeking to maximise out of work benefits, we could set them as a percentage of median income. In Chapter 10, we considered the consequences of setting the out-of-work benefit to be 50% of median income.

If, instead of at 50%, we sought to set out of work benefits to 60% of median income, this would eliminate poverty according to the Government's current definition. The flat tax regime would need to be set higher, at 63% (as against 54% for the 50% level).

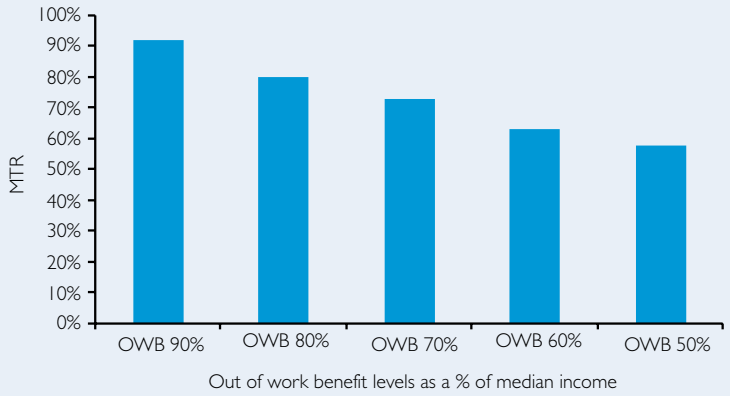
This would provide out-of-work benefits at ~£12,000 p.a. - 60% of a median income at £20,000 p.a. - and a Gini coefficient of 0.21.

However, the cost of doing so would be to have 900,000 more workless families, and a 10% lower national income than at the 54% flat tax rate.

Meeting the current income poverty target comes with a very high social and economic cost.

The graph below shows how the optimum schedule for maximising national income would change if different levels of out of work benefit were required. It can be seen that as less tax needs to be raised, the most effective way to maximise national income is to reduce the marginal tax on low earnings, because this is where the combined employment/earnings elasticity is highest (and marginal taxes are also highest). In effect, as the level of out-of- work benefits is reduced, the taxes saved are transferred disproportionately to low earners, rather than to high earners. The required MTRs for high earners are virtually unchanged. Hence low to middle earners pay disproportionately to fund high out of work benefits.

Figure E.5 MTRs on low earners to maximise national income, at different levels of out-of-work benefits



APPENDIX F
Detailed impact analysis

This appendix reviews the impact of the proposed reform on different household types: single adults, lone parents, couples with and without children. We also review the impact across another dimension: housing tenure.

F.1 Lone Parents

The net impact of these proposals is to reduce the marginal tax rates for lone parents on average up to the point where only the family element of Child Tax Credits remains.

Figure F.1 Impact of proposed Universal Credits scheme on lone parent income

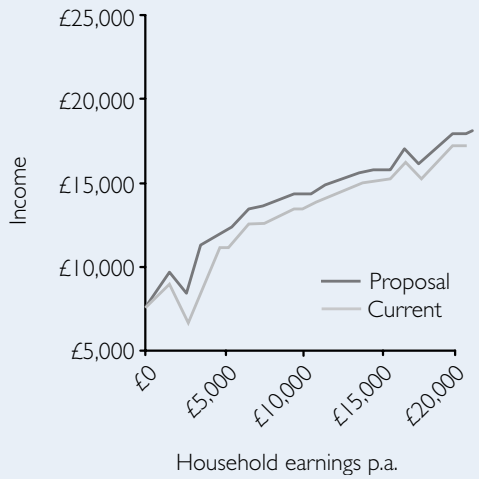
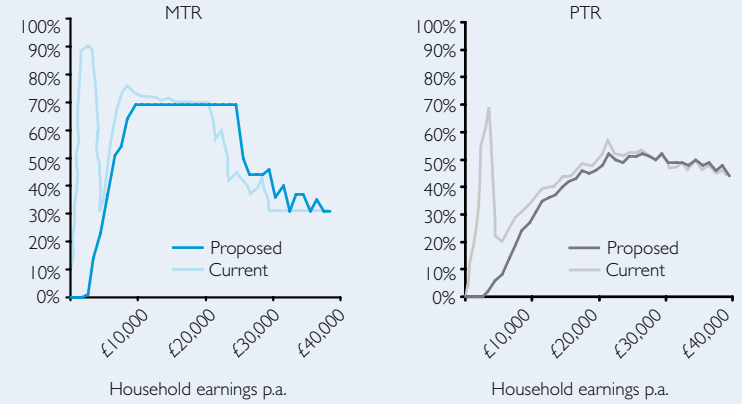


Figure F.1 shows the increase in income for a lone parent under the proposed Universal Credits scheme, as compared to their current income at any given earnings level. For a given level of earnings, the increase in income for a lone parent is modest, because he or she will already face some of the greatest work incentives of the whole population. The point at which these modest gains stop occurs on average at earnings of £25,000 p.a., which is approximately the level of median income equivalised for lone parents.

Figure F.2 below shows that the PTRs for lone parents are dramatically lower for those working below the 16 hours per week threshold. Above that they remain lower until the equivalent of family element of Child Tax Credits starts to be withdrawn under the new proposals. The cross-over point occurs on average at earnings of £25,000 p.a., which again is approximately the level of median income equivalised for lone parents.

Figure F.2 MTRs and PTRs for lone parents under current and proposed schemes



As a result of these lower MTRs, lone parents at all earnings levels below £25,000 will on average increase their earnings by £100 p.a. Those earning above £25,000 would reduce their earnings on average by £566 p.a. The net effect would still be an average earnings increase for those lone parents in work of £38 p.a.

In addition to the earnings increase, there would also be an employment increase of 53,000 lone parents. This is relatively small because participation tax rates are currently low for lone parents working more than 16 hours per week. We would expect to see the gains split evenly between those entering work below 16 hours, and above 16 hours but less than £25,000.

F.2 Single Adults

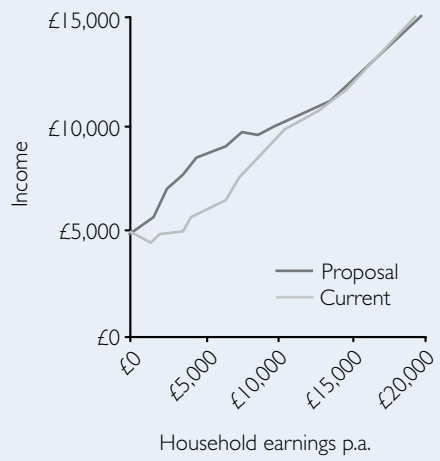
The situations for over-25s and under-25s are different.

Over-25s

There is a significant financial gain for single adult aged over 25 earning below £10,000 p.a. Many part-time workers would be up to £2,500 p.a. better off – a gain of ~£50 p.w. (See Figure F.3)

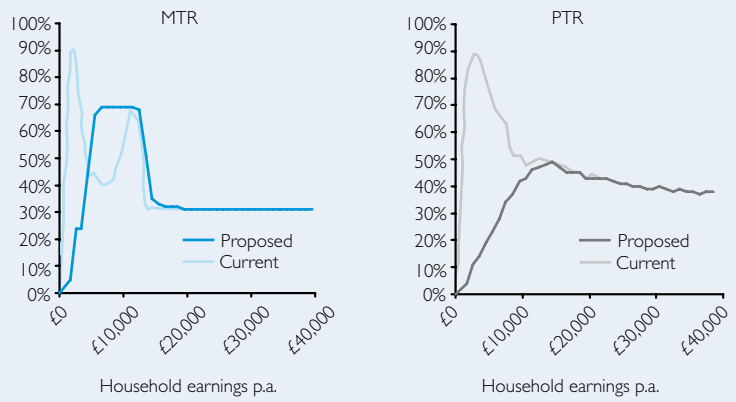
The net impact of these proposals is to reduce the marginal tax rates for single adults earning on average up to approximately £4,000 p.a., at which point today, many benefits have been withdrawn (see Figure F.4). Thereafter they would face a noticeably higher average MTR (at 69%) up to earnings of £12,500 p.a., as a result of the delayed withdrawal of benefits. However, the PTRs for single adults are dramatically lower for those working below the 30 hours per week threshold (i.e. earning less than £9,500 p.a.). Above that they are only slightly lower.

Figure F.3 Impact of proposed Universal Credits scheme on the income of a single adult (over-25)



As a result, single adults over 25 currently working below the 30 hours WTC threshold will tend to marginally reduce their earnings by an average of £38 p.a., whereas those currently in receipt of tax credits will increase their earnings by £20 p.a. because of the lower withdrawal rates. However, the overall impact would be that current working single adults would marginally reduce their earnings by an average of £38 p.a.

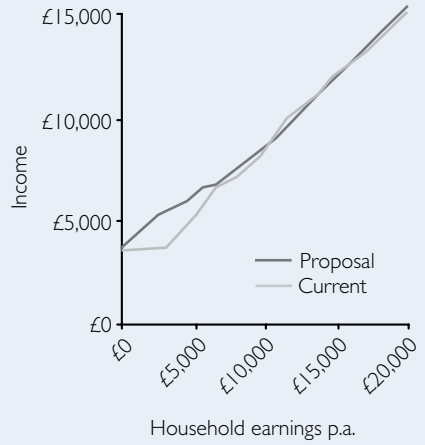
Figure F.4 MTRs and PTRs for single adults under current and proposed schemes



Compensating for the earnings decrease, there would be an employment increase of 139,000 single adults over 25. They would be predominantly in jobs that would not currently allow WTC to be claimed. By dramatically increasing the rewards for work under 30 hours, much more flexibility and opportunity are afforded to those making the first steps into work.

Under-25s

Figure F.5 Impact of proposed Universal Credits scheme on the income of under-25 singles

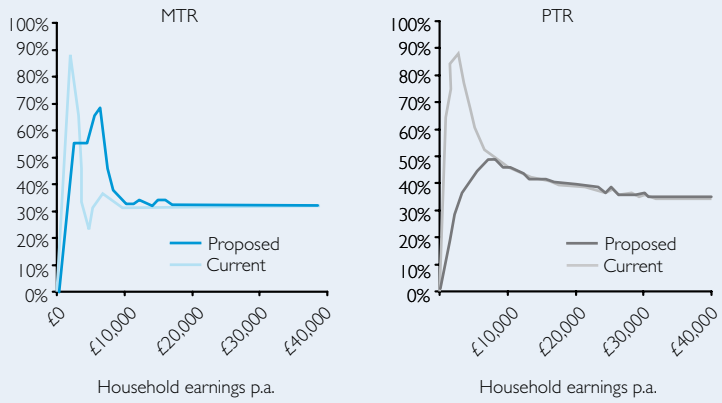


Under-25s are currently awarded a lower out of work benefit, and have no entitlement to Working Tax Credits. As a result their income, for a given level of earnings is lower than for their over-25 counterparts.

The proposed earnings disregard will double the take home pay for many of the lowest earners, though, because it is lower than for older workers, they will gain up to £1,500 p.a. less than older single workers.

As a result of the lower earnings disregard, they face higher MTRs at lower earnings level, though because more of their benefits are withdrawn before tax is paid (unlike their older counterparts), they do not experience much withdrawal at 69% MTR.

Figure F.6 MTRs and PTRs for under 25 singles under current and proposed schemes



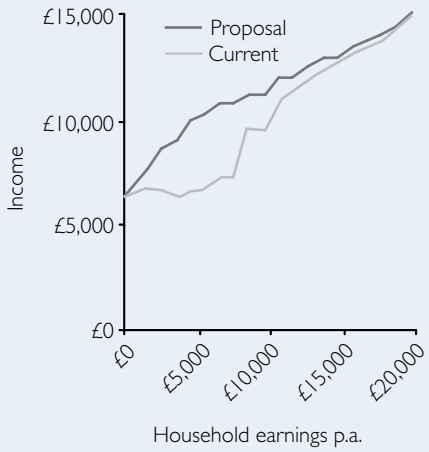
As a result of these higher MTRs, single adults under 25 currently will tend to marginally reduce their earnings by an average of £29 p.a. However, this group currently faces some of the highest PTRs of all household groups. The

Universal Credits proposal dramatically reduces these PTRs up to earnings of approximately £8,000. So while we would see a small decrease in average earned income, there would be an employment increase of 140,000 single adults under 25.

F.3 Couples without children

In order to effectively review the impact on couples, we must consider single-earning and dual-earning couples separately.

Figure F.7 Impact of proposed Universal Credits scheme on the income of single-earning couples without children

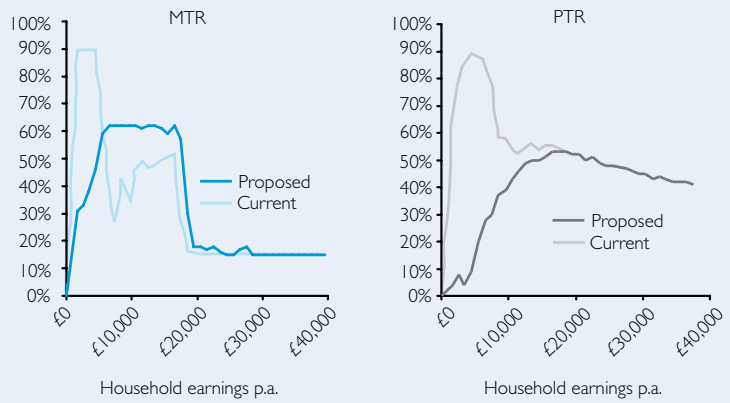


The net impact of these proposals is to increase the incomes of low earning single-earner couples without children.

Figure F.7 shows that on average those with earnings below £10,000 p.a. will experience significant increases in household income – up to £3,500 p.a.

The marginal tax rates for single-earner couples without children with wages up to approximately £4,000 are reduced on average, at which point today, many benefits have been withdrawn (Figure F.8). Under the Universal Credits proposal, these couples face a noticeably higher average MTR up to earnings of £18,000 p.a., as a result of the delayed withdrawal of benefits. As a result of these higher MTRs, single-earning couples will tend to reduce their earnings by an average of £100 p.a. The very few very low earners will tend to increase their earnings.

Figure F.8 MTRs and PTRs for single-earning couples without children under current and proposed schemes

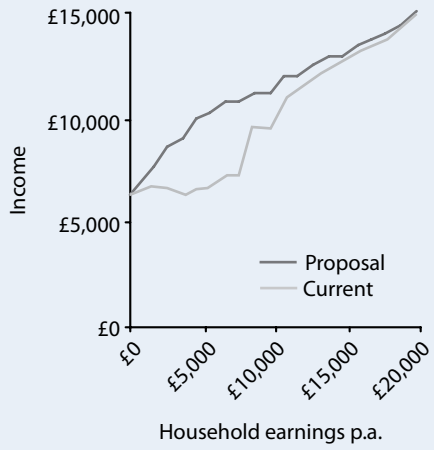


The PTRs for single-earning couples are dramatically lower for those earning less than £18,000 p.a. Compensating for the earnings decrease, there would be an employment increase of 153,000 couple households with single-earners. They would be predominantly in jobs that would not currently allow WTC to be claimed. As with the case for single adults, much more flexibility and opportunity are afforded to those making the first steps into work.

Dual Earning Couples

For dual-earning couples without children, the net impact of these proposals is to increase the household income of those earning up to £12,000 p.a. For many this increase in income can be as much as £3,500 p.a.

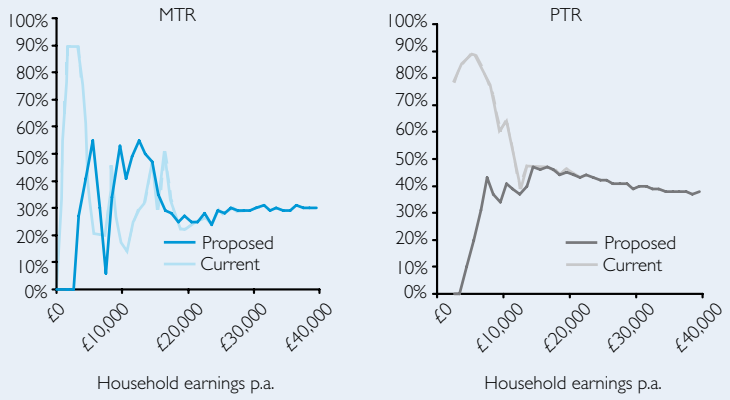
Figure F.9 Impact of proposed Universal Credits scheme on the income of dual-earning couples without children



This proposal reduces the marginal tax rates for dual-earning couples without children on average up to approximately £4,000. Beyond which the MTRs are often higher. The PTRs for dual-earning couples are lower for those earning

less than £8,000 p.a. The biggest impact on dual-earning couples is the PTR of the second worker. As benefit withdrawal is delayed, then the PTR for the first worker is much lower than currently, but the PTR for the second worker is higher than before, leading to a comparable overall household PTR.

Figure F.10 MTRs and PTRs for dual-earning couples without children under current and proposed schemes



As a result of reducing the PTR for the first earner in a family, there has been a slight increase in the PTR for second earners. Hence, there will be a decreased incentive for some families to maintain two-earners. While there is virtually no change in the number of households in work, there is a significant reduction in the number of jobs, as 75,000 second earners leave work. The more balanced MTR schedule has meant that these second earners who used to make a significant difference to the household income, no longer do so. As a result it is less worthwhile them doing so than before. This results in a loss of £513m p.a. of earnings from this group, which is more than compensated by other households.

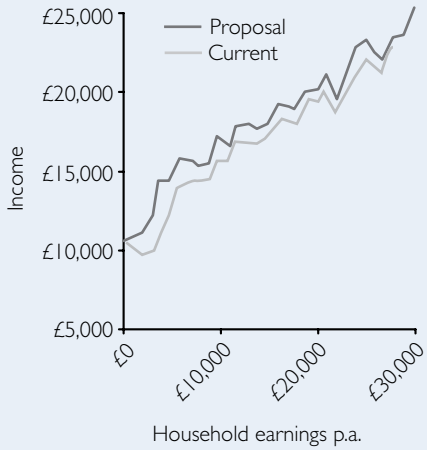
F.4 Couples with Children

Just as for couples without children, it is most effective to review the impact on single earning parents separately from dual-earning parents.

Single-earner households

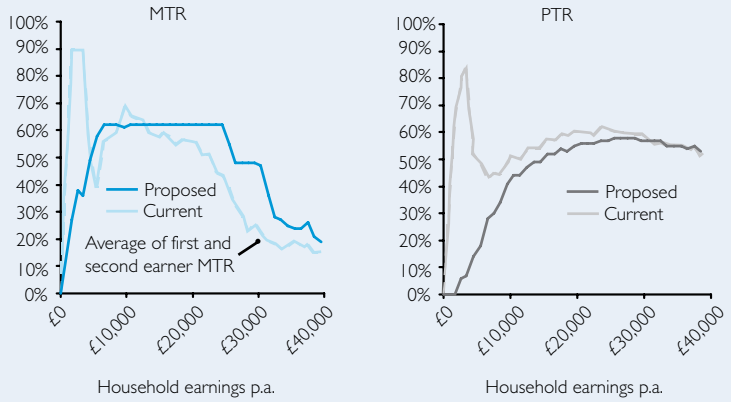
The net impact of these proposals is to increase the household income for the average couple with earnings below £30,000 p.a. The lowest earners would see increases in income of between £1,500 to £2,500 p.a. Given that these couples are eligible for WTC from 16 hours, the uplift from the new earnings disregards is significant only for those working below this level of hours.

Figure F.11 Impact of proposed Universal Credits scheme on the income of single-earning couples with children



This proposal reduces the marginal tax rates for single earning couples with children on average up to approximately £4,000, at which point today, many benefits have been withdrawn. Under these proposals, these couples face a higher average MTR up to earnings beyond £40,000 p.a., as a result of the delayed withdrawal of benefits. The PTRs for single earning couples are dramatically lower for those earning less than £10,000 p.a., and stay lower for households earning up to £30,000 p.a.

Figure F.12 MTRs and PTRs for single-earning couples with children under current and proposed schemes



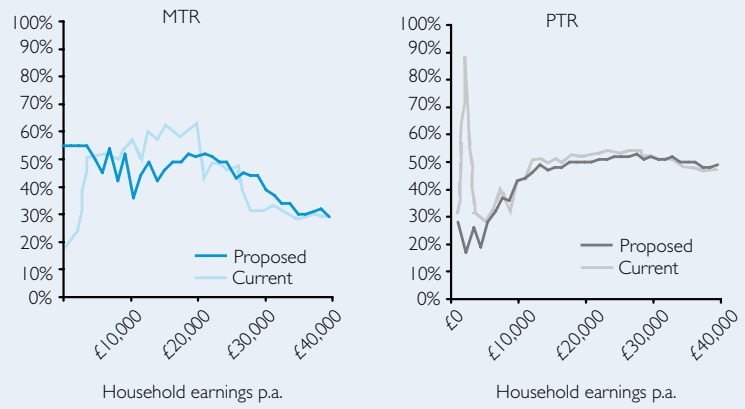
As a result of these higher MTRs, single-earning couples will tend to reduce their earnings by an average of £88 p.a. The very few very low earners will tend to increase their earnings.

Compensating for the earnings increase, there would be an employment increase of 110,000 single-earning couples with children. They would be predominantly in jobs that would not currently allow WTC to be claimed.

Dual Earning couples

The PTRs for dual-earning couples are significantly lower for those earning less than £10,000 p.a. The biggest impact on dual-earning couples is the PTR of the second worker. As benefit withdrawal is delayed, then the PTR for the first worker is much lower than currently, but the PTR for the second worker is higher than before, leading to a comparable overall household PTR.

Figure F.13 MTRs and PTRs for dual-earning couples with children under current and proposed schemes



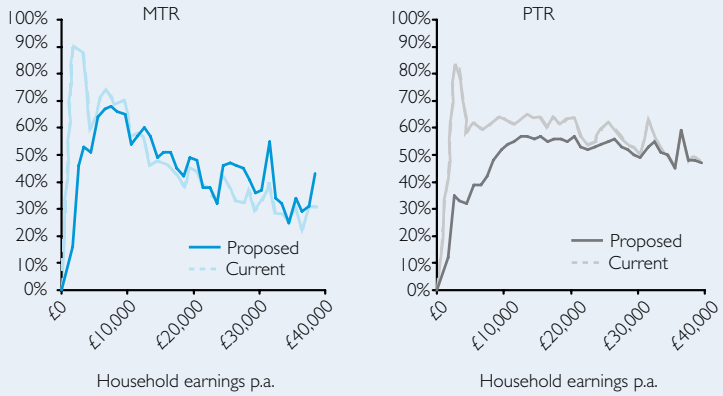
As a result of reducing the PTR for the first earner in a family, there has been a slight increase in the PTR for second earners. Hence, there will be a decreased incentive for some families to maintain two-earners. While there is virtually no change in the number of households in work, there is a significant reduction in the number of jobs, as 112,000 second earners leave work. The more balanced MTR schedule has meant that these second earners who used to make a significant difference to the household income, no longer do so. As a result it is less worthwhile them doing so than before. This results in a loss of £900m p.a. of earnings from this group, which is more than compensated by other households.

F.5 Private rented

Households in private rented accommodation currently face the highest MTRs and PTRs, mostly because of the large HB payments that must be withdrawn. Hence, as a group they experience some of the greatest reductions in withdrawal rates as a result of the proposals.

The average gain across all those in the private rented sector is £353 p.a. The dynamic cost of this gain focused on low earners is £230m. As a result 106,000 households enter work.

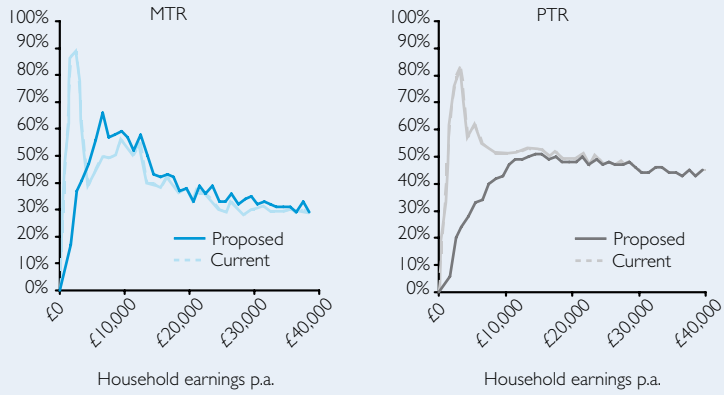
Figure F.14 MTRs and PTRs for households in private rented accommodation under current and proposed schemes



F.6 Social rented

The average gain among households in the social rented sector is £191 p.a., somewhat less than for private rented. The impact of the proposals on PTRs is less, because these tenants have less HB to withdraw, because rents are lower. As a result the marginal tax rates experienced by those earning less than £25k p.a. start at a lower level. Hence it is only the lowest earners who experience a significant change.

Figure F.15 MTRs and PTRs for households in the social rented sector under current and proposed schemes



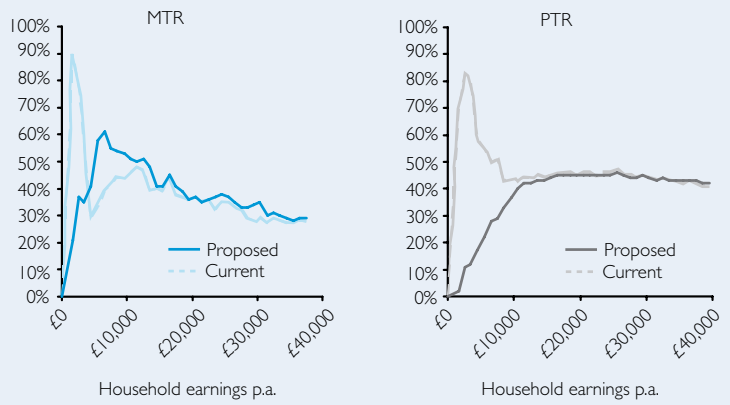
As a result the dynamic cost of the proposals for this group is £532m, and it results in an additional 139,000 households in work. The efficiency of this investment is somewhat lower than for the private rented sector.

F.7 Owned / Mortgage

For those workers who own or have a mortgage on their property, the reforms have a significant impact on income for those earning below £10,000 p.a., but less for those above. The average gain across this group is £119 p.a. This is the

group that has the lowest barriers to work today, because they are not entitled to Housing Benefit, and hence do not experience its withdrawal.

Figure F.16 MTRs and PTRs for workers who own or have a mortgage on their property under current and proposed schemes



As a result the impact of the proposals is less pronounced, being slightly less efficient than for social renters. However, the households in this group mostly face low PTRs already, and are disproportionately constituted by couples who gain from the couple penalty removal. There is further impact among low earning parents in this group. They benefit significantly from a much higher disregard than others, which also addressed some of the unfairnesses (including the mortgage penalty) what we had identified in Part I.

Appendix G
Indirect Financial Impact of our Reforms

Reform of the benefits system will generate both direct and indirect costs and benefits. This Appendix presents the indirect benefits that may be derived from reform that encourages people to work rather than claim out-of-work benefits. The estimates provided in this Appendix are not at the same level of detail or precision as the calculations of the direct costs and benefits of reform proposals elsewhere in the report: they are intended to demonstrate the wider, indirect advantages and savings that result from of encouraging people into work as opposed to claiming out-of-work benefits, and to provide indicative financial estimates of the magnitude of the indirect social and fiscal benefits of successful reform. While further work is required in order to provide detailed and precise estimates of the indirect benefits from our reform proposals, we are nonetheless confident that these are too significant to be ignored.

G. 1 Government administration and reductions in fraud and error

A study by Oxford Economic Forecasting for Tomorrow's People in 2004 concluded that for every job created in the economy, the government saves £786 (in 2004 prices) per year.[1] This estimate is based on the total annual administration costs of the Employment Service in 2004 divided by the claimant count. This is equivalent to £900 in 2009 prices. This could therefore yield savings of £540m per year, as a result of the 600,000 households that enter work.

Besides this, the dramatic simplification that we propose should allow for significant cost savings in this area. The opportunity to reduce the number of Government departments involved in administering benefits and to reduce the number of tasks involved should be significant. A further reduction in the administration bill by 15% should be possible. This would save another £900m p.a. in the medium term.

In addition, the integration of taxes and benefits under PAYE+ and the reduction in the complexity of benefits have significant potential to reduce error and fraud (currently £2.7bn per year).[2] A 25% reduction in this figure would save an additional £650m p.a. over the long term, once the new PAYE+ system was in place.

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1 Oxford Economic Forecasting, *Twenty Year Evaluation of Tomorrow's People Trust Limited*, (OEF, 2004).

2 House of Commons Public Accounts Committee, *Progress in Tackling Benefit Fraud: Thirty-first Report of the Session 2007-08,* (July 2008).

G.2 Crime

In a report for the Prince's Trust[3], McNally and Telhaj found that each additional property crime by a person aged 10-20 costs society on average over £2,400[4]. In addition, Levitt has estimated that a 1% increase in the unemployment rate is associated with a 1% increase in property crime,[5] though empirical studies generally do not provide firm evidence of any link between unemployment and crime.

Research by the Government's Social Exclusion Unit does suggest that employment is estimated to reduce the risk of re-offending by ex-offenders by between a third and a half. On this basis, a study by Oxford Economic Forecasting for Tomorrow's People in 2004 estimated that for each ex-offender who enters employment, total savings to society amount to £30,000 (in 2004 prices).[6] It is estimated that ex-prisoners make-up between 2-3% of monthly inflows to unemployment. Since ex-prisoners are disproportionately likely to have very low incomes, they would be strongly affected by our reforms: we have used the upper-end value of 3% to give a figure of £900 of re-offending costs saved for each person who enters employment, and we believe even this is likely to be a somewhat conservative estimate.

G.3 Health

A study by Oxford Economic Forecasting for Tomorrow's People in 2004 estimated that per capita health expenditure for an unemployed person is twice as high as for someone in work.[7] In 2004 prices, the saving from getting unemployed people into work was assumed to be £750 per head p.a. based on average NHS per capita expenditure of £750 per head. This is equivalent to £860 in 2009 prices.

G.4 Depression

A study by New Philanthropy Capital in November 2008, using data from the 1970 British Cohort Study (BCS70), concluded that whether or not a person was unemployed between the ages of 16 and 18 is an independent predictor of depression at 21.[8] Controlling for other factors, the differential incidence of depression between a man who leaves school aged 16 and gets a job, and a man who leaves school aged 16 and does not get a job is 15%. For women, the differential incidence of depression is 10%, but the chance of depression is higher for both groups. The King's Fund has recently calculated the average cost to the NHS of treating someone with depression to be £2,026 (at 2006 prices).

For every year an additional man is employed, it can be assumed that the

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3 The Cost of Exclusion: Counting the cost of youth disadvantage in the UK Prince's Trust, 2007.
4 Their actual estimate was £2441.46
5 Steven Levitt, 'Understanding Why Crime Fell in the 1990s. Four Factors that Explain the Decline and Six that Do Not,' *Journal of Economic Perspectives,* 18, 1 (2004), p163 - 190.
6 Oxford Economic Forecasting, Twenty Year Evaluation of Tomorrow's People Trust Limited, (OEF, 2004).
7 Oxford Economic Forecasting, Twenty Year Evaluation of Tomorrow's People Trust Limited, (OEF, 2004).
8 Sarah Keen, Valuing potential: An SROI analysis on Columba 1400, (New Philanthropy Capital, 2008).

NHS saves £304 as a result of the reduced incidence of depression. For each additional woman employed for a year, the figure is £203.

G.5 Conclusion

We estimate savings of £2,090 million in reduced government administration costs combined with reduced levels of error and fraud.

In addition, the quantifiable social benefits of getting 1,000 people from welfare to work would be worth approximately £2.2 million p.a. for the foreseeable future - an additional gain of just over £1.3 billion for 600,000 jobs created.

Overall, then, the indirect benefits of our reforms are expected to be £3.4 billion – significantly more than the short-term dynamic cost of £2.7 billion

Figure G.1 Annual savings and indirect benefits of our reform proposal

Source	Savings (£ million)
Government Administration + Reduced Fraud & Error	2,090
Crime	622
Health	518
Mental Heath	152
Total Returns	**3,382**

APPENDIX H
Alternative Reform Options

Our initial set of proposals will make a big difference to the reward to work for low earners. However, they represent one particular set of trade-offs, whereby we have sought to minimise the number of losers, with the indirect benefits of reduced worklessness and simplification covering the increased cost of the transfer payments.

In this Appendix we review three alternative reform options. The main variation between the scenarios is in the levels of annual earnings disregards provided for different household types. They provide different trade-offs between economic efficiency, fairness and preserving legacy positions.

The three alternative options are:

1. Break-even on direct dynamic costs, while maximising the number of households moving into work, and allowing for more losers.
2. Compromise between break-even and the main proposal.
3. Reducing the couple parent penalty. This would especially help single-earning couples with children, especially those in private rented accommodation, who face PTRs of over 50%.

We have compared each of these with our main proposal, which aims to minimise the number who lose out.

Figure H.1 Alternative scenarios

Annual Household Earning Allowances	Minimal Losers (the proposal)	1. Break Even	2. Reduced Losers	3. Reduced Couple Parent Penalty
Households	£1,500	£3,000	£1,500	£1,500
Couple Penalty	£0	-£300	-£300	£0
Over 25/ Parent bonus	£3,500	£0	£2,000	£3,500
Lone Parent bonus	£3,000	£3,500	£3,000	£3,000
Couple Parent	£0	£0	£0	£1,500
Each of 2nd and 3rd children	£350	£350	£350	£350
Rent	-1.8 x rent supplement			
Council Tax[1]	-1.3 x Council Tax supplement			

With a 'disregard floor' of £260 per adult + £650 per child + £1,660 for lone parents, should the formula above suggest a lower disregard.

1 This deduction in the allowances is not applicable to those under 25 who have the youth penalty.

The following sections illustrate the consequences of making different trade-offs. In particular, we review the marginal cost of an extra household entering work that result from each of these proposals.

In addition we also look at two other variations to the proposal.

1. Changes in the withdrawal rate (even under our proposals, taxes combine with the 55% benefit withdrawal rate to produce MTRs of 69% for many households)
2. Adjusting Tax Schedules to reduce churn.

Recap: The proposal (Minimal Losers scenario)

Our proposed scenario sets the earnings allowances at a higher level than the other scenarios: these levels are defined to be the lowest level that can be achieved for each household type so as to minimise the number of losers in each group. It also eliminates the couple penalty. As a result the levels of investment for a marginal job for a single person rises to £18,000, and for a lone parent £15,000.

These are significant marginal investment levels – well above the identifiable social costs of household employment – including health and crime as well as administration savings. This suggests that the investments made in back-to-work schemes and targeted training and work support may be well worth making, when compared with the cost of further investment in reducing PTRs.

H.1 Break-even Scenario

The objective in the break-even scenario is to maximise the number of households moved into work, at effectively no additional static cost to the Exchequer. The approach to reaching this most efficient level is to find the level of earnings allowance for which the cost of moving a marginal household into work is as low as possible. This will mean it is the same for each household type, i.e. the point at which investing a further £1 million in increasing the earnings allowance for each household type would result in the same number of additional jobs.

Low earners (without children) aged under 25 face particularly high PTRs, both today, and to a lesser extent under the proposed reform. They are the group with the highest PTR at earnings below £10,000 p.a., because their earnings disregard is £3,500 lower than for older workers. Because of the high PTRs currently experienced by under-25s, the marginal cost of moving these households into work is low. Hence the break-even scenario makes a significant investment in that group at the expense of other household types. As a result, the break-even scenario results in many winners and no losers among under-25s, but creates many losers in other household groups.

At the levels given for scenario 1 in the table above, the marginal investment required to move a household into work is £10,500 p.a.. This scenario would

cause 470,000 households to enter employment at a dynamic cost of £193 million p.a. After including administrative and broader social savings, this proposal pays for itself many times over.

H.2 Reduced Losers

In scenario 2, we reduced the investment in the under-25s, so that their earnings allowance was £1,500. This brought it down only so far as to create a very small number of losers among that group. The cost savings we then reinvested in higher earnings allowances for non-lone parent households, as this is where the allowances were furthest below what it would take to minimise the number of losers. In scenario 2 we set all allowances (except Under-25s) to be £1,500 lower than would be needed to minimise losers. In effect they are all penalised equivalently. We include in this scenario the couple penalty that reflects the existing penalty in today's system. With these allowance levels the marginal investment in an extra job for an under-25 falls to £6,000, whereas for an over-25 single adult it rises to £13,000.

H.3 Reduced Couple Parent Penalty

Couples with children are the group with the highest resulting PTRs, and hence should be the candidates for the next investment (see Appendix F for details of their PTRs).

We have already identified the £3,000 earnings disregard penalty as a manifest unfairness. The main cause of this has been the historic effort to encourage lone parents back into work.

The cost of halving this penalty would be £1.4 billion p.a., and it would result in 42,000 more households in work, although a loss in jobs overall as second earners would face higher MTRs. Hence, the overall national earnings would reduce. The limited returns on this reform would be compensated for by increased fairness and support for the family.

It is time to support couples with children at the lowest end of the earnings' scale – and not penalise them for their vulnerability. This is important, as in many cases, living with a partner can mean taking an active role in the bringing up of a child, which will generally positively influence children.

H.4 Adjusted Withdrawal rates

A further reduction in the benefit withdrawal rate to 50% would help to reduce the highest MTRs by 3 points, and also the higher PTRs. It would cost an additional £1.7 billion p.a., and raise national earnings slightly by £62 million p.a., as well as resulting in a further 80,000 households entering work. Most of its impact would be on the earnings of those already in work.

This reform would be relatively expensive compared to our proposals. Hence, we have suggested 55% as the first target withdrawal rate. However, should the public finances permit, we recommend reducing this level over time.

H.5 Changes to tax schedules

An alternative way to do so would be to raise personal allowances for Income Tax – or provide a rebate. This would reduce marginal tax rate for lower earners, hence also reducing PTRs. Furthermore, benefits would taper away faster at lower earnings, because the withdrawal rate would be based on net (post-tax) earnings. Hence, tax and benefit churn would be reduced.

Tax-based reductions in MTRs will always be less effective than those driven by changes in the benefits system. For any given level of earnings, those in receipt of benefits will always have higher MTRs than those without. Hence, reducing MTRs for those in receipt of benefits will target the investment on those who will be most responsive,[2] rather than the whole tax base.

H.6 Conclusion: Cost-benefit analysis

The following table shows how the different scenarios perform against the metrics we have used to evaluate other options. The break-even scenario is by far the most efficient in terms of the cost of additional jobs. However, the large number of losers is an argument against it.

Figure H.2 Cost-benefit analysis

	The proposal - Minimal Losers	1. Break Even	2. Reduced Losers	3. Reduced Couple Parents Penalty
Static Cost	£3.7bn	£720m	£779m	£5.1bn
Dynamic Cost	£2.7bn	£193m	£203m	£4.2bn
Number of households in work	600k	470k	448k	641k
Average Cost/additonal job	£4,637	£410	£455	£6,516
Change in Earnings	£1.15bn	£1.37bn	£1.23bn	£0.68bn
Household Poverty Reduction	829k	723k	500k	864k
Number of winners	4.9m	2.7m	2.6m	5.3m
Number of losers (under £30k)	300k	2.7m	2.6m	300k
Average loss (of losers under 30K)	-£355	-£595	-£500	-£359

What is also noticeable is that the difference between the static and dynamic costs shrinks as the investments made are less driven by the behavioural dimension, and more by ensuring certain households are kept whole. The break-even scenario has the same numbers of winners as losers, but the winners are more focused on lower earners (especially under-25s). Hence, this scenario achieves a greater reduction in household poverty than scenario 2, and 85% of the reduction of scenario 3. Furthermore, fewer moderate earners face higher marginal tax rates, hence they do not reduce their earnings. As a result, the overall earnings gain is higher than that in the reduced or minimal losers option.

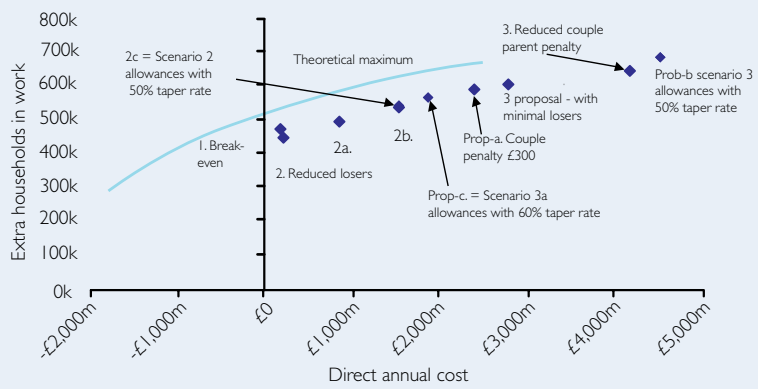
2 In Part II we discussed the shape of the elasticity function – whereby an equivalent drop in withdrawal rate for those experiencing a high MTR is more impacting than the same drop for those experiencing a lower MTR.

The graph below illustrates some of the different options available to policy-makers, together with a theoretical maximum number of households that could enter work as a result of different investment levels.

We present a range of variants of scenario 2 and our main proposal:

- Scenarios 2a and 2b represent increasing the earnings allowances by £500 and £1,000 p.a. respectively over the base case for scenario 2.
- Scenario 2c represents reducing the benefit withdrawal rate to 50%, while maintaining the allowances of scenario 2. This results in a very similar overall result to scenario 2b. However, there are more losers among low earners working close to the WTC hours thresholds. On the other hand, the lower resulting MTR means that national earnings are higher than in 2b.
- Scenario Prop-a maintains the couple penalty that is present in scenarios 1 and 2, but raises all other allowances. The impact of moving from this scenario to the main proposal is primarily that of removing this penalty, rather than reducing the number of losers.
- Scenario Prop-b shows the impact of reducing the benefit withdrawal rate to 50%. It increases the number of households in work, and has a further increase in earnings to £1.2bn. However, the cost of doing so is very high.
- Scenario Prop-c uses the minimal loser set of allowances together with a 60% benefit withdrawal rate. While it has a relatively efficient increase in employment for the cost, it has a low increase in earnings £0.9bn, because many earners face increased MTRs.
- Scenario 3 is the reduced couple penalty at 55% post-tax withdrawal rate.

Figure H.3 Efficiency of options available to policy-makers



It can be seen that there is a significant cost to pay to reduce the number of losers in the system. These last set of households have been relatively expensive to move into work. The arguments for doing so need to be considered more on fairness grounds than on the basis of economic return.

Given the reduced numbers of losers from scenario 2, there is a strong argument that this would be a favourable alternative to the break-even scenario 1. These scenarios all fall a little short of the theoretical maximum – which introduces greater couple penalties.

The trade-offs in Scenarios 2c and Prop-c explain why we have chosen 55% as the preferred taper rate. It achieves a balance between the number of losers and increasing national earnings. It contains the number of households who face an increase in MTRs, while also providing affordable earnings allowances to reduce the number of losers around the WTC hours thresholds.

If reducing PTRs further was our priority, then the most effective approach would be to increase the disregards of those who have the highest PTRs, so that they can be kept mostly below 50%, especially for low earners. There are three groups who would still face high PTRs. They are couples with children, under-25s, and renters.

When the perceived objective for in-work benefits was simply to relieve poverty, then there was a social argument to prefer older workers. However, now that it is clear that these in-work benefits play a major role in determining the rewards and incentives associated with work, rather than just poverty relief, it makes no sense to restrict their availability. Given the importance of ensuring that those facing the labour market for the first time receive all possible encouragement to take up a job, it seems ineffective to confront them with greater financial barriers to work. Hence, there is undoubtedly a major long-term return from investing in increasing the earning disregards for under-25s.

The proposals for further reform are all less effective at addressing economic dependency than our proposed reforms. Hence, we have not included them as part of our plans. Nonetheless, we would urge any Government to consider them as finances permit. There probably needs to be a balanced investment in reducing withdrawal rates, and also reducing the couple parent penalty. More research should be conducted into the impact of the savings penalty, in order to gauge the need to reduce it.

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GLOSSARY

AHC	After Housing Costs
BHC	Before Housing Costs
CSJ	Centre for Social Justice
CTB	Council Tax Benefit
CTC	Child Tax Credit
ESA	Employment and Support Allowance
FIS	Family Income Supplement
FRS	Family Resources Survey
HB	Housing Benefit
HBAI	Households Below Average Income survey
IB	Incapacity Benefit
IFS	Institute for Fiscal Studies
IS	Income Support
IVB	Invalidity Benefit
JSA	Jobseeker's Allowance
LHA	Local Housing Allowance
LRR	Local Reference Rent
MTR	Marginal Tax Rate
NIC	National Insurance Contributions
OPB	One Parent Benefit
PTR	Participation Tax Rate
ULC	Universal Life Credit
UWC	Universal Work Credit
WFTC	Working Families' Tax Credit
WTC	Working Tax Credit

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