

Reform tax credits to boost weak work incentives, says study prepared for the Mirrlees Review

Britain's tax credit and benefit system should be overhauled to strengthen work incentives for people on low incomes, to increase simplicity and certainty for families, and to reduce fraud and administration costs for the taxpayer, according to a study commissioned by the Mirrlees Review of the British tax system, which is being chaired by Nobel prize-winner Professor Sir James Mirrlees for the Institute for Fiscal Studies.¹

By delivering a net tax cut to people who currently face weak incentives to enter work or to increase their low levels of pay, the Government could do more to redistribute income and reduce poverty without harming the economy, according to the study by Mike Brewer (IFS), Emmanuel Saez (University of California at Berkeley) and Andrew Shephard (IFS).

The authors propose folding Britain's existing piece-meal benefits for low income families (income support, income-based jobseekers' allowance, working and child tax credits, housing benefit and council tax benefit) into a single programme, which they call Integrated Family Support. Compared to the current system, the maximum level of support available would be increased for those in work and reduced for those out of work. People on low earnings would be able to earn more before having their payments withdrawn and would lose less in tax and benefit reductions for every extra pound they earn, although this would have the effect of increasing the number of families subject to means-testing. For most families means-testing would take place through the existing system of National Insurance contributions. The scheme would operate on a weekly or monthly basis, not an annual one, giving claimants greater certainty and reducing the problem of over- and under-payments that plagues the current tax credit system

The Integrated Family Support would be more generous than the current tax credit and benefit system to people entering work and striving to increase low earnings. This greater generosity would be paid for by integrating child benefit and the family element of the child tax credit into the new scheme (and thus reducing them for families on higher incomes), by reducing the income at which people become liable to pay income tax and National Insurance contributions, and by increasing the basic rate of income tax by 1%.

The scheme would increase average incomes for the poorest four-tenths of the population by 4-5%. The biggest loss would be for the fourth richest tenth at 2.4% with the richest tenth losing 1.2%. The reform

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IMPORTANT: Please note that the research described in this Release is a submission to the Mirrlees Review and that the conclusions reached will not necessarily be adopted in the final report. We will be publishing a number of such submissions over the coming weeks and the Review team would welcome feedback to mirrleesreview@ifs.org.uk

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¹ http://www.ifs.org.uk/mirrleesreview/press_docs/rates.pdf

would also reduce the number of children in poverty by around 200,000. By strengthening work incentives where they are currently weakest, the reform would increase employment and deliver the extra help for low earners with minimal negative impact on the overall level of earnings in the economy.

The reform proposal draws on a detailed theoretical and empirical study of the way in which incomes in the UK have responded to changes in tax rates and means-testing in recent decades. The study identifies four key flaws in the current UK tax and benefit system:

- People have little incentive to take jobs that pay relatively modestly, because the government often takes close to 100% of their gross income in tax and withdrawn benefits when they enter work;
- Many low to moderate earners lose 70p or more of every extra pound they earn when having tax credits withdrawn. This is too high, even if you believe that people's decision whether to work a little harder or not is relatively unresponsive to their take-home pay;
- Housing benefit exacerbates the problem of high effective marginal tax rates for low earners and is not even claimed by many working families who are entitled to it;
- Tax credits, housing benefit and council tax benefit are all complicated and time-consuming to claim, expensive for the government to administer, and prone to significant fraud and error.

The Integrated Family Support proposal is designed to address all these problems, but involves a significant structural shake-up of the benefit and tax credit system. So the authors have also put forward an alternative package of measures that would significantly improve work incentives where they are weakest through the existing tax and benefit system. This would involve:

- Increasing the amount that people can earn before they have means-tested benefits withdrawn;
- Increasing the amount that second earners can earn before a family's tax credits are withdrawn;
- Reducing the rate at which tax credits are withdrawn with every extra pound earned;
- Targeting increases in working tax credit on groups other than lone parents.

This second package would cost £9 billion. This could be financed through a wider reform of the tax system, for example through a broadening of the UK's unusually narrow VAT base or through increases in environmental taxes, but these issues are beyond the scope of the Brewer, Saez and Shephard study. If it had to be financed within the income tax and benefit system, the authors suggest that the money could be raised by cutting child benefit and/or increasing the basic rate of income tax. Neither would undo the objective of improving work incentives, although both would pose big political challenges.

The study also suggests that there would be little point trying to finance more generous support for people on low earnings by increasing the rate of income tax paid by the highest earners. Empirical evidence on the

way in which incomes have responded to changes in the top marginal tax income rates in the UK over the last 40 years suggests that this would raise little if any extra revenue to transfer to the less well off.

The Mirrlees Review team also asked three leading international experts to comment on the proposals made by Brewer, Saez and Shepherd and on the wider issues they discuss:

- Hilary Hoynes (University of California at Davis) notes that the employment rate for single mothers has risen sharply in the US and is much higher than in the UK. She argues that the impact of more generous tax credits for those in work has been complemented by the time-limiting of welfare payments in the US, but offset by more generous out-of-work benefits in the UK. Professor Hoynes also notes that 70% of couples in the UK faced a “marriage penalty” through the tax system in 2004 and 25% a “marriage subsidy”. US data suggests that tax treatment has only a small impact on decisions to get or stay married.²
- Robert Moffitt (Johns Hopkins University) notes that the cost of reducing marginal tax rates at the bottom of the income range in the Integrated Family Support proposal is borne by those in the middle, but that societies will differ as to where they believe resources should be targeted. He questions the proposal in the reform to stop giving people an additional financial incentive to work at least a specific number of hours a week. Professor Moffitt also observes that recipients of the Earned Income Tax Credit in the US seem happy with an annual system in which they receive a lump-sum refund once a year and notes that while economists often favour the idea of integrating different transfer programmes, this has not fared well in the US.³
- Guy Laroque (University College London and Insee-Crest, Paris) explores a possible longer-term reform in which residents hold an account with the government tracing their cumulative debts or claims towards their fellow citizens over their lifetime, reflecting the taxes and contributions they have made and the publicly provided private services they have received (such as education, benefits and pensions). Tax and benefit rates could then depend on the “social debt” people have in such an account. Such a system could allow people to plan the timing of their work life better.⁴

Commenting on the study and commentaries, Robert Chote, Director of the IFS, said:

“This study reaches two key conclusions: first, that the Government could target further financial help on the least well off without harming the economy by targeting tax cuts on those people for whom work incentives are currently weakest; and second, that these tax cuts would have to be paid for by the bulk of the population rather than by increasing tax rates for the highest earners alone. These findings have important and perhaps uncomfortable implications for would-be tax and welfare reformers of all parties.

² http://www.ifs.org.uk/mirrleesreview/press_docs/hoynes.pdf

³ http://www.ifs.org.uk/mirrleesreview/press_docs/moffitt.pdf

⁴ http://www.ifs.org.uk/mirrleesreview/press_docs/laroque.pdf

We are very grateful to the authors of the main study, and to the commentators, for their important contributions. They are very valuable and interesting pieces of work in their own right, as well as providing food for thought for Sir James and his team when they draw up their final conclusions.”

ENDS

Notes to editors:

1. The Mirrlees Review, funded by the Nuffield Foundation and the ESRC, brings together IFS researchers and other international experts to identify what makes a good tax system for any open developed economy in the 21st century and to recommend how the UK tax system might realistically be reformed in that direction (<http://www.ifs.org.uk/mirrleesreview>). The project has been inspired by the 30th anniversary of the 1978 Meade Report, a landmark in the study of tax design and perhaps the most influential output of the IFS to date.
2. The Review is chaired by Nobel Laureate Professor Sir James Mirrlees of the University of Cambridge. The Commission’s work is being directed by Tim Besley (LSE, IFS and Bank of England), Richard Blundell (IFS and UCL), Malcolm Gammie QC (One Essex Court and IFS Tax Law Review Committee) and James Poterba (MIT). The editorial team comprises: Stuart Adam (IFS), Stephen Bond (Oxford and IFS), Robert Chote (IFS), Paul Johnson (IFS and Frontier Economics) and Gareth Myles (Exeter and IFS). The final report will be published by Oxford University Press around the end of 2008.
3. A wider group of more than 60 IFS researchers and leading experts from around the world has contributed chapters, commentaries and special studies on key themes of the research. Pre-publication versions will be released on the IFS website over the coming weeks: <http://www.ifs.org.uk/mirrleesreview/publications.php>. The final versions will be published by Oxford University Press as a companion volume to the final report.
4. Embargoes press copies of the above papers can be found at: http://www.ifs.org.uk/mirrleesreview/press_docs/embargo.php