



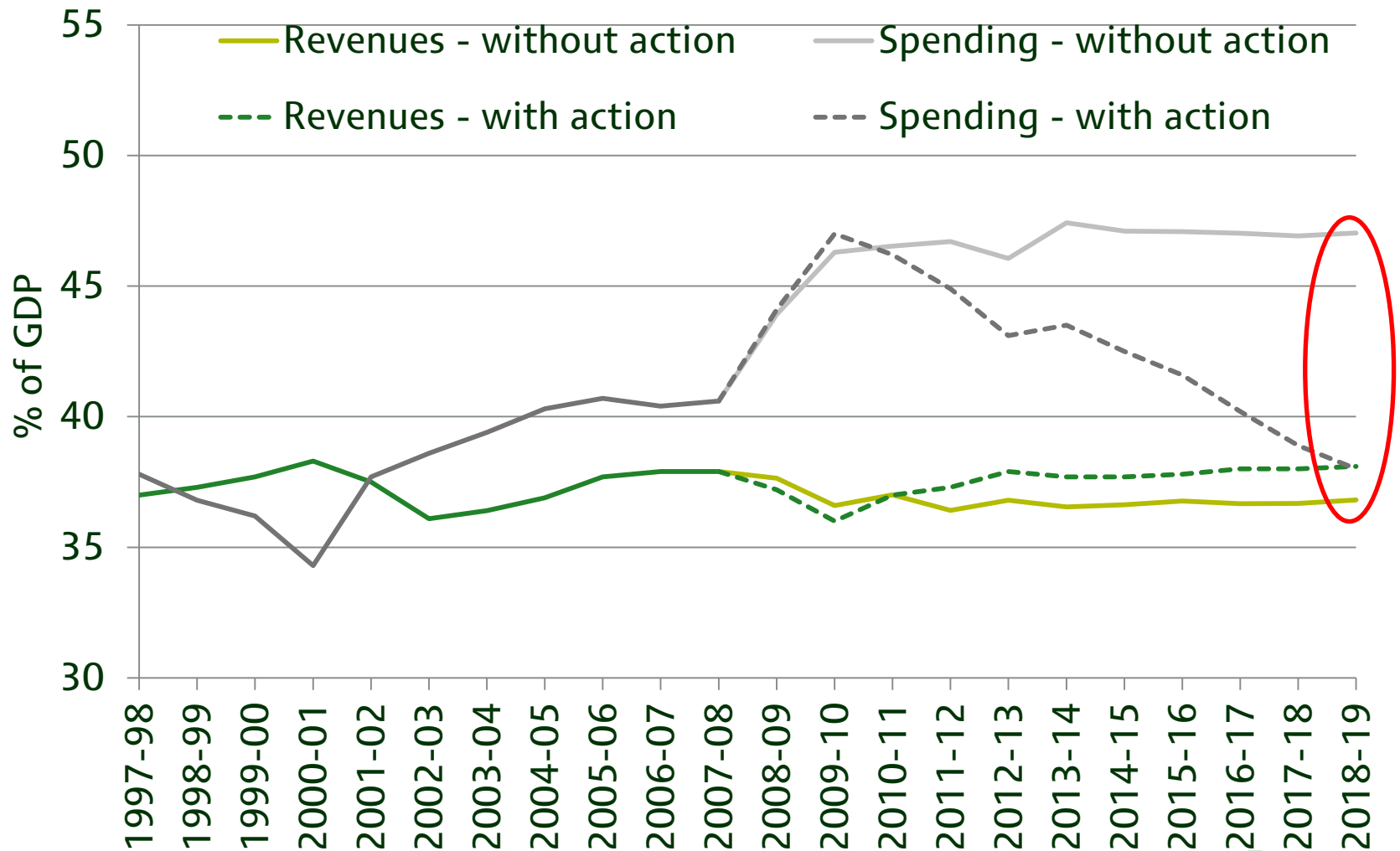
Institute for
Fiscal Studies

Welfare reform and work incentives in the UK

Stuart Adam

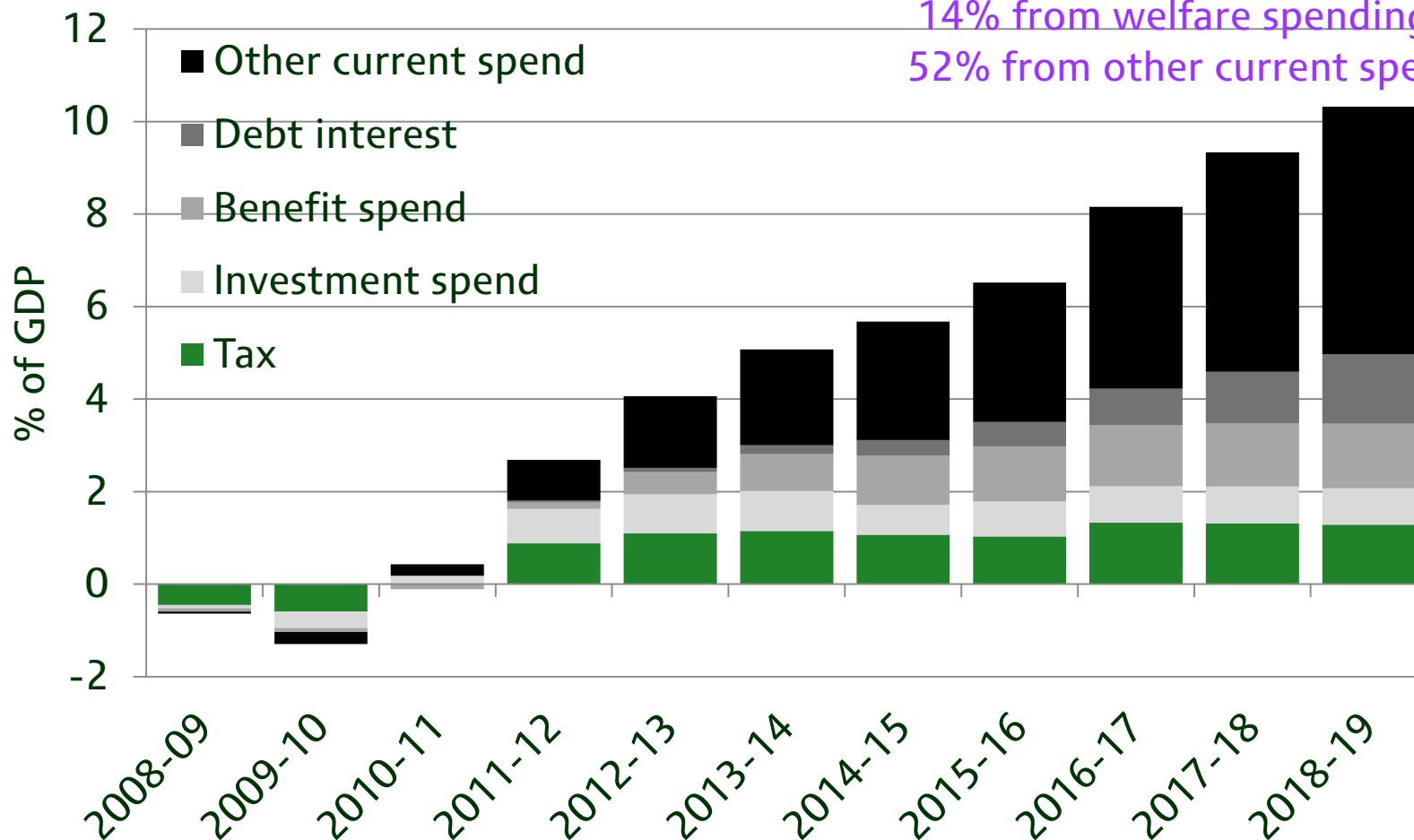
CPB, The Hague, 2 July 2014

UK government revenue and spending



Composition of the discretionary fiscal tightening

12% from tax rises
 8% from investment spending cuts
 14% from welfare spending cuts
 52% from other current spending



Source: IFS calculations based on HM Treasury and Office for Budget Responsibility figures.

Analysing the welfare reforms

- Effects of reforms implemented from May 2010 to May 2015
 - On those below 2010 state pension age
 - Separate out universal credit from the other reforms
 - Modelling does not yet include most recent announcements
- Use TAXBEN micro-simulation model of tax and benefit system
 - Run on Family Resources Survey, a representative cross-section of about 25,000 households
- Models entitlement, not receipt (i.e. assumes full take-up)
- Does not model behavioural responses
 - We have separate behavioural models, using TAXBEN as an input – not presenting today
- Financial incentives only
 - Calculate net incomes at different earnings levels – requires predicting earnings for non-workers

Two kinds of financial work incentives

- Incentive to be in paid work at all
 - Replacement rate (RR): out-of-work income / in-work income
 - Participation tax rate (PTR): proportion of total earnings taken in tax and withdrawn benefits
- Incentive for those in work to increase their earnings
 - Effective marginal tax rate (EMTR): proportion of an extra £1 of earnings taken in tax and withdrawn benefits
- ❖ In all cases, higher numbers = weaker incentives

Characterising the benefit reforms

Save net £22bn in 2015-16

1. Changes in the generosity of ‘safety-net’ benefits
 - Some cuts (e.g. housing benefit); some increases (e.g. child tax credit)
 - *cuts strengthen work incentives; increases weaken them*
2. Cuts to in-work support (working tax credit)
 - *weaken incentive to have someone in paid work*
 - *but strengthen incentives to earn more if working, and to have a second earner*
3. Means-testing more aggressively
 - increase in tax credit withdrawal rate; means-testing child benefit
 - *complicated and mixed effect on work incentives*
- Change to uprating of benefits is the biggest cut
 - Switch to lower inflation measure – effects get bigger each year
 - Uprating limited to 1% in 2013, 2014 and 2015
 - Affects both safety-net and in-work benefits

Effect of welfare reforms on work incentives

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children			
Lone parent			
Partner not working, no children			
Partner not working, children			
Partner working, no children			
Partner working, children			
All	-2.3	-1.2	-0.9

Note: excludes universal credit

Effect of welfare reforms on work incentives

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	-3.5		
Lone parent	-1.7		
Partner not working, no children	-4.3		
Partner not working, children	-0.1		
Partner working, no children	-1.3		
Partner working, children	-2.0		
All	-2.3	-1.2	-0.9

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Effect of welfare reforms on work incentives

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	-3.5	-2.0	
Lone parent	-1.7	+1.3	
Partner not working, no children	-4.3	-2.1	
Partner not working, children	-0.1	+4.8	
Partner working, no children	-1.3	-1.5	
Partner working, children	-2.0	-1.8	
All	-2.3	-1.2	-0.9

Note: excludes universal credit

Effect of welfare reforms on work incentives

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	-3.5	-2.0	-1.4
Lone parent	-1.7	+1.3	-1.0
Partner not working, no children	-4.3	-2.1	-0.7
Partner not working, children	-0.1	+4.8	-1.0
Partner working, no children	-1.3	-1.5	-0.5
Partner working, children	-2.0	-1.8	-1.0
All	-2.3	-1.2	-0.9

Note: excludes universal credit

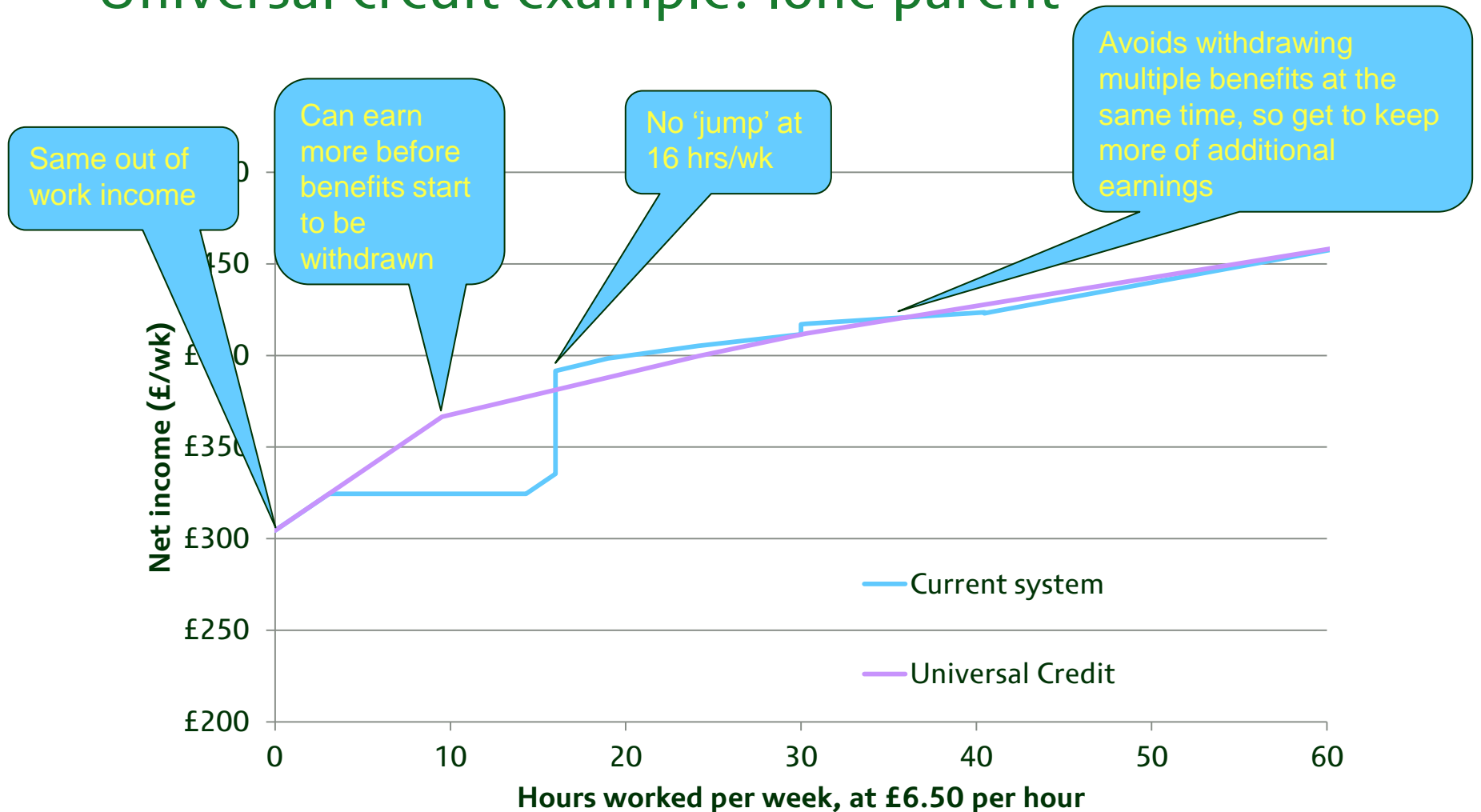
Benefit reforms affecting non-financial incentives

- Old welfare-to-work schemes replaced by new Work Programme
 - Further shift towards payment by results
 - Should give providers better incentives and flexibility to innovate
 - Initial evidence not encouraging
- More work search requirements for lone parents with youngest child aged 5-9
 - Recent study found that equivalent policy where child aged 10+ increased affected lone parents' employment by 8-10ppts after a year
- Tougher medical reassessments for disability benefits
 - Likely to promote employment but hard to quantify

Universal credit

- Benefit integration recommended several times in mid-late 2000s
 - Including by a think-tank set up by responsible minister in opposition
 - And by the Mirrlees Review
- New coalition government set out plans for a ‘universal credit’ in November 2010
 - Legislation in Welfare Reform Act 2012
- One benefit to replace 6 existing means-tested working-age benefits
 - The 7th (property tax rebate) was localised instead – strange!
 - Arguably the most radical restructuring since the 1940s
 - Roughly revenue-neutral overall
- Principle enjoys cross-party support
- Aims: simplify system and rationalise work incentives

Universal credit example: lone parent



Assumes: wage £6.50/hr, 2 children, no other income, £80/wk rent. Ignores council tax and rebates

Universal credit: non-financial aspects

- Better admin and smoother transitions into work
 - If can operate successfully with reformed income tax administration: employers must now report wage payments in real time
 - Simpler support with more transparent incentives may help
 - Though lose the salience of a working tax credit
 - And quicker response of support to earnings may be prominent
 - Conditionality may extend to many more people, esp. in couples
 - Currently applies up to 16 hours or £76 (£121 for couples)
 - UC may extend to 35 x min wage = £213 (£416 for couples)
- Little empirical evidence on likely impact of these

Universal credit delays

- Pilots started in April 2013
 - simplest claimant types in a few areas
- Nationwide implementation repeatedly delayed...
- Original plan:
 - start nationwide in October 2013
 - cover all new claims by April 2014
 - migrate all existing recipients by December 2017
- Now:
 - no date for nationwide roll-out
 - cover all new claims by December 2016
 - still claim will migrate most existing recipients by December 2017

Universal credit problems

- IT problems
 - Currently trying to fix existing IT *and* develop replacement system
- Management problems
 - 11 different officials in charge since 2010 doesn't help...
- Widespread reports of tensions within government
- Difficult aspects deferred instead of built into design of system
- Labour opposition now says it would 'pause' further roll-out pending a review
- Given problems, delay is a better strategy than implementing and hoping!
 - Hardship for claimants (tax credits 10 years ago) worse than delays and embarrassment

External scrutiny has been highly critical

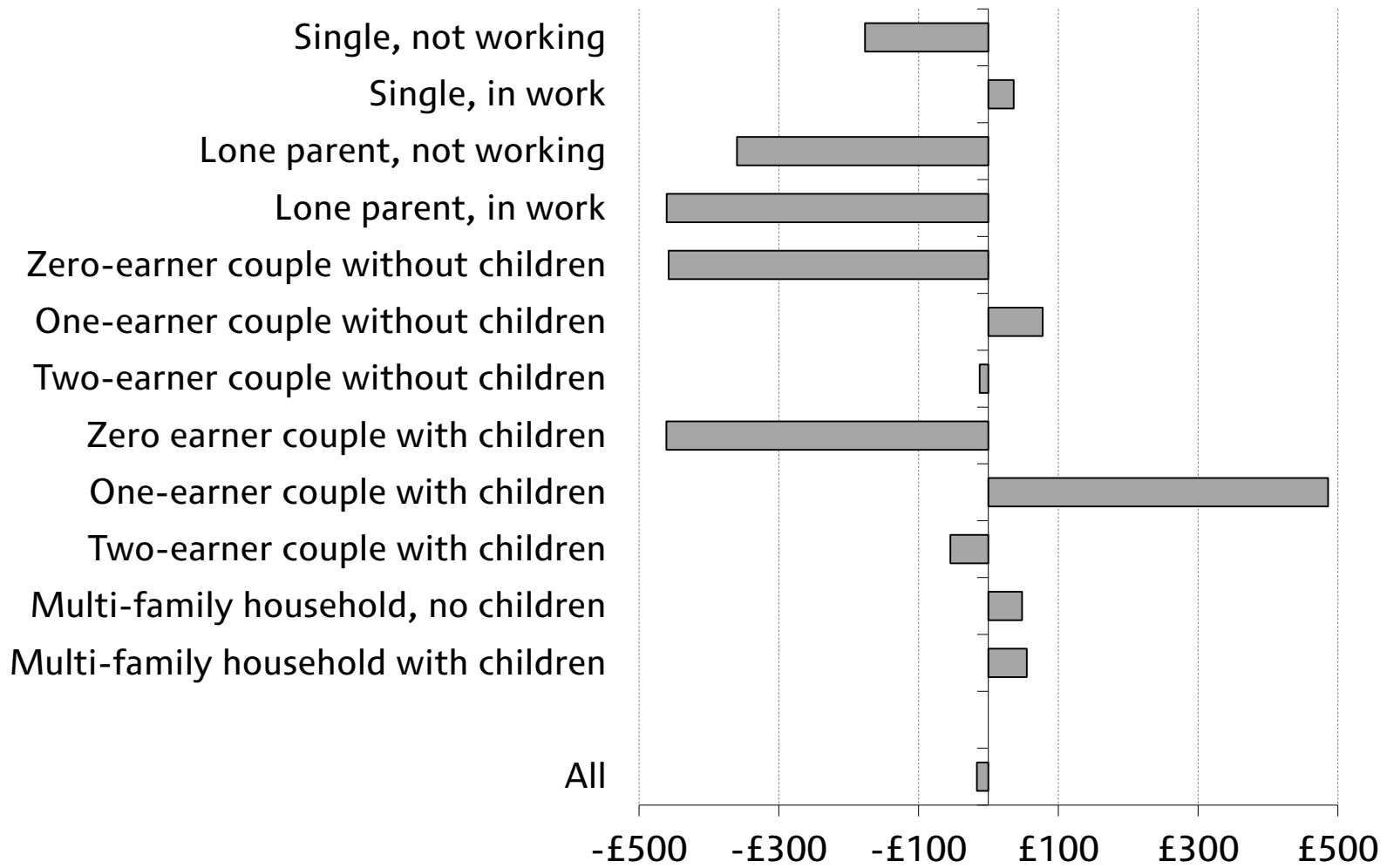
“Problems with IT systems meant that major changes to the implementation timetable were made...it is still not clear when the system will be ready or even how it will work...it is difficult to envisage how the volumes required to meet the most recent timetable are to be achieved...The Government has hampered the Committee’s scrutiny of UC implementation by not providing accurate, timely and detailed information...”

House of Commons Work & Pensions Committee, February 2014

“Management of the Universal Credit programme has been extraordinarily poor...the litany of problems in the Universal Credit programme were often hidden...the Department only reported good news and denied the problems...there has been a shocking absence of financial and other internal controls...it is highly likely that a substantial part of the expenditure on IT development will have to be written off...the pilot programme is inadequate...”

House of Commons Public Accounts Committee, November 2013

Distributional impact of universal credit



Effect of UC on work incentives

UC gets rid of many of the very weakest work incentives:

- reduces number of people with PTRs >75% by half (1.5m)
- reduces number of people with EMTRs >85% by more than 90% (0.5m)

Effect on average work incentives:

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children			
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All	-0.7	-0.7	-0.1

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Effect on average work incentives:

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	-0.9		
Lone parent	+0.3		
Partner not working, no children	-3.2		
Partner not working, children	-5.7		
Partner working, no children	+0.1		
Partner working, children	+0.9		
All	-0.7	-0.7	-0.1

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	RR	PTR	EMTR
Single, no children	-0.9	-1.5	
Lone parent	+0.3	+3.6	
Partner not working, no children	-3.2	-3.4	
Partner not working, children	-5.7	-10.7	
Partner working, no children	+0.1	+0.1	
Partner working, children	+0.9	+2.5	
All	-0.7	-0.7	-0.1

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UC gets rid of many of the very weakest work incentives:

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Effect on average work incentives:

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	-0.9	-1.5	+0.7
Lone parent	+0.3	+3.6	-5.2
Partner not working, no children	-3.2	-3.4	-0.4
Partner not working, children	-5.7	-10.7	+1.2
Partner working, no children	+0.1	+0.1	-0.3
Partner working, children	+0.9	+2.5	+0.0
All	-0.7	-0.7	-0.1

Averages conceal huge individual-level variation

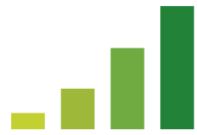
- For example, benefit reforms (including UC):
 - reduce PTRs by >5ppts for 7.5m people and by >20ppts for 1.6m
 - increase PTRs by >5ppts for 3.5m people and by >20ppts for 1.1m
 - reduce EMTRs by >20ppts for 2.0m people
 - increase EMTRs by >20ppts for 1.0m people
- Lots of reforms have big effects on small numbers of people

Work incentive trade-offs

- Work incentives *vs.* redistribution
- Incentives to be in work *vs.* for those in work to earn more
- Incentives for 1st *vs.* 2nd earners
- Very weak incentives for a few *vs.* quite weak incentives for many
- Theoretical optimality *vs.* practical considerations

Conclusions

- Reforms strengthen incentives to be in work, on average
 - More than offsetting effects of falling real earnings
 - But little net effect on incentives for those in work to earn more
- Benefit cuts primarily responsible for that strengthening
 - But not dramatic given scale of cuts, partly because of nature of tax credit reforms
- UC strengthens incentive for couples to have someone in work
 - But weakens incentive to have a second earner
- UC removes many of the weakest work incentives
- Small average effects conceal big effects at individual level
- And NB financial work incentives are not the whole story!
 - Perceptions and non-financial incentives may also be important
 - Need to be able to implement policies effectively!



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