

7. Policies to help the low paid

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Summary

- Low pay is more common among groups whose productivity is lower. This does not mean that low pay is entirely due to low productivity – it may reflect the ability of some employers to use market power to pay workers less than their productivity.
- Policymakers should be clear about whether they want to help low-paid individuals or low-paid families. A substantial minority (30%) of those who are low paid have partners who are not low paid. Hence, policies that help all low-paid individuals would also help some relatively high-income families.
- Further increases to the income tax personal allowance would not be particularly effective in helping the low paid. The lowest-income 17% of workers will pay no income tax in 2014–15 anyway. A large majority of the giveaway would go to families in the top half of the income distribution, or with no one in work (mostly pensioners). And many of the lower-income gainers would gain only partially as their universal credit and/or council tax support would be automatically reduced.
- Raising the employee NICs threshold would be a better way of supporting the low paid, and strengthening their work incentives, through the direct tax system. Aligning this threshold with the personal allowance would cut taxes for 1.2 million workers with earnings too low to benefit from an increase in the personal allowance, would benefit only workers, and would simplify the direct tax system.
- In-work benefits provide a more precise and cost-effective way of supporting low-earning working families than changes to direct taxes. Raising by 20%, from currently planned levels, the amounts that a family can earn before universal credit starts to be withdrawn would exclusively benefit this group. It would be a bigger giveaway in entitlements to working families in the bottom three income deciles than the gains to that group of raising the personal allowance to £12,500, despite costing £10 billion per year less. But it would make 200,000 more families eligible for universal credit (although some may not take up this entitlement), leading to weaker incentives for some people to earn more and higher administration costs.
- The Chancellor favours real increases to the National Minimum Wage (NMW) to help those on low pay. Although the NMW appears not to have had negative employment effects so far, increases should be considered carefully.
- The Labour Party plans to incentivise employers to increase the wages of all their workers to the Living Wage. Despite its voluntary nature, the policy may distort employers' behaviour in undesirable ways: for example, firms may not employ some low-paid workers who they otherwise would have, as in order to get the tax rebate all employees must be paid the Living Wage. Employers may also simply alter the timing of wage increases to benefit from the policy, leaving pay unaffected in the long term. Overall, it is unclear whether the policy would raise revenue for the exchequer, as claimed by the Labour Party.

7.1 Introduction

Average weekly earnings have fallen by 8.6% relative to CPI inflation since October 2007, just before the onset of the Great Recession. As a result, there has been an increasing focus on living standards – particularly for the modestly paid, hard-working people so frequently referred to in political debate.

A desire to help workers on low and middle incomes has been cited as a reason for the government's flagship policy of raising the income tax personal allowance throughout this parliament.¹ Looking forwards, the Prime Minister, David Cameron, stated last month that 'the priority is to target tax reductions on the poorest people in our country'² and it has been reported that both governing parties may pledge further rises in the personal allowance for the next parliament.³ Meanwhile, the Labour Party has proposed to reintroduce a 10% starting rate band of income tax and to provide financial incentives to firms to pay the 'Living Wage' (which in 2014 is £8.80 per hour in London and £7.65 per hour elsewhere in the UK) and the Chancellor George Osborne has stated he believes there is scope for an above-inflation increase in the National Minimum Wage.⁴ This chapter provides an assessment of these proposals, along with other ways that a government might attempt to help low-paid workers.

The rest of the chapter proceeds as follows. As background, Section 7.2 sets out the characteristics of the low paid and compares them with other employees. Section 7.3 analyses tax and benefit policies designed to help the low paid. Section 7.4 discusses policies aimed at increasing the pre-tax pay of the low paid – a goal labelled by Labour Party leader Ed Miliband, among others, as 'predistribution'. Section 7.5 concludes.

7.2 Who are the 'low-paid'?

Low pay might be a concern for at least two reasons. First is the link between low pay and low living standards. Official statistics show that around two-thirds of poor children and half of poor working-age adults without children live in a family where someone is working. Previous analysis of these data by IFS researchers shows that this in-work poverty is concentrated in low-paying sectors and occupations and is more strongly linked to low hourly pay than to low hours of work.⁵ Substantial amounts are spent on in-work benefits and tax credits in order to boost the incomes of low-income working families (especially those with children). A second concern is the possibility that low pay reflects exploitation of workers by firms that are able to use their power in the labour market to pay workers less than their productivity would warrant (i.e. less than the value of the output that they produce). Related to this are concerns that some parts of the population face discrimination in the labour market and are low-paid as a result.

¹ For example, see the section entitled 'Policy objective' in HMRC's assessment of the impact of increases in the personal allowance (<http://www.hmrc.gov.uk/budget2012/tiin-2044.pdf>).

² Quote from an interview with Andrew Marr on 5 January 2014, a transcript of which is available at <http://news.bbc.co.uk/1/shared/bsp/hi/pdfs/05011401.pdf>.

³ For example, 'Tories plan to raise personal allowance to £12,500', *Financial Times*, 13 October 2013, available at <http://www.ft.com/cms/s/0/95b97f76-30fa-11e3-b478-00144feab7de.html#axzz2np8YouhL>.

⁴ Reported by the BBC at <http://www.bbc.co.uk/news/uk-politics-25766558>.

⁵ J. Cribb, A. Hood, R. Joyce and D. Phillips, *Living Standards, Poverty and Inequality in the UK: 2013*, IFS Report R81, 2013, <http://www.ifs.org.uk/publications/6759>.

In this section, we examine the characteristics of low-paid jobs and low-paid workers. These suggest, as one would expect, that productivity is an important factor in explaining low pay. We also examine the position of low-paid workers' families in the income distribution to see the extent to which low pay feeds through to low family income.

Before doing this, however, we need to answer a fundamental question: what is 'low pay'? This is really (at least) two questions.

First, does low pay mean currently having a low hourly wage, or having low earnings in total (e.g. over a week, month, year or lifetime)? Here, we look at both of these types of 'low pay'. Hourly pay should, in a competitive labour market, reflect workers' productivity: low hourly pay therefore reflects low productivity and/or people being paid less than their productivity would warrant due to an imperfectly competitive labour market. Weekly or monthly earnings depend also on the number of hours worked. There are at least two reasons why this measure of pay is of independent interest. A significant minority of those with low weekly pay state that they would like to work longer hours at the same rate of hourly pay but are unable to procure the extra hours.⁶ In addition, the tax and benefit system is one obvious lever for helping people on low pay, and it is better placed to redistribute to those with low weekly pay than to those with low hourly pay.

Second, what level of (hourly or weekly) pay is considered to be 'low'? For hourly pay, we use the level of the 'Living Wage' as calculated by the Greater London Authority for London (currently £8.80 per hour) and the Centre for Research in Social Policy for the rest of the UK (£7.65 an hour). This is not because we believe this to be the most appropriate threshold for determining whether hourly pay is low. The OECD for instance, uses a definition of pay below two-thirds of the median, which has the benefit of ensuring 'low pay' is defined with reference to a measure of average wages (as measured by the median). The precise level of any chosen threshold will be somewhat arbitrary. But we choose the 'Living Wage' because this is the level of hourly pay that the Labour Party has said it plans to incentivise employers to pay (see Section 7.4) and we want our analysis to be informative of who might gain from such a policy if it were successful in boosting wages.

The data we use in this analysis come from the Labour Force Survey (LFS) and the Family Resources Survey (FRS) and cover the 2011–12 financial year (the most recent year of FRS data available). Measuring hourly wages robustly using these data is not straightforward. Box 7.1 explains how we do this using an imputation method.

Using the resulting measure of hourly wages, an estimated 29% of employees were paid below the Living Wage in their main job in 2011–12.⁷ This is considerably higher than the 20% reported for 2012 by the Resolution Foundation using data from an alternative survey, the Annual Survey of Hours and Earnings (ASHE).⁸ Our judgement is that the true figure probably lies somewhere between 20% and 29%: the ASHE-based estimate is likely to be an underestimate and the LFS-based estimate is likely to be an overestimate.

⁶ According to the Labour Force Survey, 17.5% of those in the bottom three-tenths of the weekly earnings distribution in 2011–12 would have liked to work more hours at their basic hourly pay rate.

⁷ The Living Wage in 2011 was £8.30 in London and £7.20 in the rest of the UK.

⁸ M. Whittaker and A. Hurrell, *Low Pay Britain 2013*, Resolution Foundation, London, 2013, http://www.resolutionfoundation.org/media/media/downloads/Low_Pay_Britain_2013.pdf.

Box 7.1. Estimating hourly wages in the LFS and FRS

Conventionally, analyses of hourly wages use a measure derived by dividing reported gross weekly earnings by reported weekly hours of work. However, this introduces significant measurement error and leads to a measure of derived hourly wages that has greater dispersion than actual hourly wages. This, for instance, leads to a substantial overestimate of the number of individuals paid below the level of the National Minimum Wage using this measure of hourly wages. The LFS also collects a direct measure of a worker's basic hourly rate of pay for those workers who are paid by the hour. This does not suffer from the same problems, and research has concluded that this direct measure of hourly pay is more accurate than the derived hourly wage for those towards the bottom of the hourly wage distribution.^a

The direct measure is only available for those paid by the hour in the LFS, and is not available at all in the FRS, the second survey we use in the analysis contained in this chapter. However, we use this direct measure of hourly wages to impute what are, hopefully, more accurate hourly wages for those workers who are not paid by the hour, or who are otherwise unable to provide their basic hourly pay rate in the LFS, and for all workers in the FRS. The method we employ has been used in a number of analyses of low pay and it works as follows:^b

- For those workers in the LFS for whom we have both a derived and a directly measured hourly wage, we regress the direct measure on the derived measure and a set of explanatory variables including demographic and job characteristics.
- We then predict a value for the direct wage measure for all workers in both the LFS and the FRS, whether or not they are paid by the hour, drawing randomly from the (estimated) distribution of prediction errors and the distribution of uncertainty around the estimated parameters of the regression.
- For each of the workers for whom we do not have a direct hourly wage measure, we impute a value by taking the actual value from the 'closest' observation that has a direct measure available (where 'closest' means the smallest absolute difference in the predicted values from the previous step).

We then define whether someone has a low hourly wage based on this imputed wage. We also use this imputed wage to assess how large a wage increase they would need to reach the 'Living Wage'. However, when calculating family net incomes to show the position of low-paid workers in the income distribution, we use workers' reported weekly earnings as our main measure of income (rather than the imputed wage multiplied by reported hours). This means that we implicitly assume that hours rather than weekly earnings are misreported if there is a discrepancy between imputed and derived hourly pay.

^a C. Skinner, N. Stuttard, G. Beissel-Durrant and J. Jenkins, 'The measurement of low pay in the UK Labour Force Survey', *Oxford Bulletin of Economics and Statistics*, 2002, 64 (Supplement), 653–76.

^b This method was initially proposed in C. Skinner, N. Stuttard, G. Beissel-Durrant and J. Jenkins, 'The measurement of low pay in the UK Labour Force Survey', *Oxford Bulletin of Economics and Statistics*, 2002, 64 (Supplement), 653–76. It has subsequently been used in M. Brewer, R. May and D. Phillips, *Taxes, Benefits and the National Minimum Wage*, Low Pay Commission Research Report, 2010, http://webarchive.nationalarchives.gov.uk/20130626202215/http://www.lowpay.gov.uk/lowpay/research/pdf/FromLPC_Document_Feb.pdf and in M. Brewer and P. De Agostini, *The National Minimum Wage and its Interaction with the Tax and Benefits System: A Focus on Universal Credit*, Low Pay Commission Research Report, 2013, <https://www.gov.uk/government/publications/national-minimum-wage-a-focus-on-universal-credit>.

ASHE asks employers rather than employees to report hours and earnings, and for this reason is usually agreed to measure weekly earnings and paid hours of work more accurately than the LFS. However, because employers may not be aware of the unpaid overtime that people not paid by the hour work, ASHE may underestimate total hours of work and thus overestimate actual hourly pay for some people. In addition, the way the ASHE sample is selected – based on people with active income tax or National Insurance records at HMRC – means that those with low weekly/monthly/annual pay are under-represented. Because of the correlation between low hourly and low weekly pay, this means those with low hourly pay are also under-represented. Sample weights are provided with the data to try to account for this, but these are unlikely to overcome this problem fully.⁹

The LFS-based estimates are also problematic, however. The imputation procedure used (see Box 7.1) involves imputing hourly wages for those *not* paid by the hour using information from the wages of those who are. This has been shown to be a reliable procedure at the very bottom of the wage distribution – for example, around the level of the National Minimum Wage – but may be less reliable further up the wage distribution – such as around the level of the Living Wage – where the number of people paid by the hour starts to decline.

The main reason our analysis uses the LFS rather than ASHE is that the LFS contains many more demographic variables and, unlike ASHE, it is possible to combine it with the FRS to analyse the family incomes of the low paid. Because of the discrepancies between figures based on the LFS and those based on ASHE, we present statistics on the characteristics of the low paid, and the *relative* rather than *absolute* prevalence of low pay among different parts of the population. That is we provide information on, for instance, what fraction of the low paid are aged under 25 and how much more likely it is that someone in this age group is low-paid compared with someone older, rather than the proportion of under-25s who are low-paid.

For weekly pay, we define low pay as those in the bottom 30% of the distribution of weekly earnings (from all employee-jobs) so both our hourly and weekly measures cover approximately the same fraction of employees. The overlap between the two groups is significant but not complete: just over two-thirds of those estimated to have a job paying a low hourly rate of pay also have low weekly earnings, and vice versa.

Characteristics of low-paid jobs

In this subsection, we describe the characteristics of the main jobs of low-paid workers. Approximately 97% of all jobs with low hourly pay are the worker's main job, so the focus on main jobs is not very restrictive.

Hours of work

Unsurprisingly, lower weekly earnings are strongly associated with working fewer hours:

- 63% of people with low weekly earnings worked for fewer than 30 hours per week in their main job, compared with 6% of those who had higher weekly earnings.
- Conversely, only 4% of those with low weekly earnings worked for 45 hours a week or more in their main job, compared with 31% of higher earners.

⁹ The ASHE weights are based on matching age, sex, region and occupation totals as recorded in the LFS. No direct correction for the under-recording of those with low weekly/monthly/annual pay is attempted.

- This means that the prevalence of low weekly pay among those working under 30 hours per week was around 16 times as high as it was among those working 45 hours a week or more.

There is also a strong association between low *hourly* pay and low hours of work:

- 13% of main jobs paying a low hourly rate were of fewer than 16 hours per week, compared with 4% of higher-paying jobs; and 28% were of between 16 and 29 hours, compared with 11% of higher-paying jobs.
- This means that the prevalence of low hourly pay among those working fewer than 30 hours per week was almost 2.5 times higher than it was among those working 30 or more hours per week.

Occupation and industrial sector

Low pay is particularly concentrated among certain occupational groups and sectors of the economy. For instance, jobs that are classified as being part of the elementary occupation group¹⁰ comprise 27% of all main jobs with low hourly pay, compared with 5% of higher-paid jobs. Main jobs classified as part of the caring and personal services group or the sales and customer services group also make up a substantially larger share of jobs with low hourly pay than they do of higher-paid jobs. In contrast, jobs in the managerial, professional, technical and crafts groups make up only 17% of jobs with low hourly pay, compared with 61% of higher-paying jobs. This means, for instance, that those whose main job is an elementary occupation are just over twice as likely as average to be low-paid, and almost six times more likely to be than someone whose main job is in the managerial, professional, technical or crafts groups.

The retail and hospitality sectors together make up around one-third of main jobs with low hourly pay and of jobs with low weekly earnings. In contrast, they make up just 7% of all higher-paying main jobs. This means the prevalence of low hourly pay among jobs in these sectors is almost three times as high as among other jobs. Low hourly pay is also concentrated in the residential care sector, and among the 'other personal services' sector (which includes activities such as hairdressing). Jobs in the health, education and social care sector are substantially less likely to have low hourly rates of pay than average. However, the substantial number of people working part time in these sectors means that such jobs are about as likely as average to have low weekly pay.

Size of workplace

Low-paying jobs are also concentrated in workplaces with few employees:

- 47% of main jobs with low hourly rates of pay are at workplaces containing fewer than 25 employees, compared with 27% of higher-paying jobs.
- Conversely, only 8% of low-paying main jobs are at workplaces with 500 or more employees, compared with 23% of other main jobs.
- This means the prevalence of low hourly pay among those working in workplaces with fewer than 25 employees is over three times as high as it is among those in workplaces with 500 or more employees.
- Similar patterns are found for low weekly pay.

¹⁰ This comprises jobs considered to involve the lowest skill, such as cleaning, basic food preparation, and labouring.

Length of tenure

Employees in low-paying jobs have been in these jobs for a shorter length of time, on average, than those in higher-paying jobs:

- Almost a quarter of people in a main job with a low hourly rate of pay have been in that job less than a year, compared with a tenth of those with higher-paid jobs.
- Just 18% of those with low hourly pay in their main job have had the job for 10 or more years, compared with 37% of those with higher hourly pay.
- This means jobs held for a year or less are almost three times as likely to be low-paid as jobs held for 10 or more years.
- The pattern for weekly pay is similar.

Characteristics of low-paid workers

Age

Younger workers and, to a lesser extent, older workers are over-represented among those with low pay:

- The under-25s make up around 27% of those with a low hourly pay rate in their main job and 24% of those with low weekly pay, but just 6–7% of other employees.
- The prevalence of low hourly pay among the under-25s is just over double the average among the population as a whole and around three times as high as among people in their 30s and 40s.
- Those aged 60 or over are only slightly more likely to have low hourly pay than average. But they are 1.5 times as likely to have low weekly pay, reflecting the lower-than-average working hours of this group.

Education

Low pay is concentrated among those with low levels of education and those still in full-time education:

- Those leaving full-time education aged 16 or younger are around twice as likely to have a low hourly pay rate as those leaving full-time education aged 19.
- The rate of low hourly pay among those still in full-time education is more than twice the average among those who have completed their education.

The greater incidence of low pay among the young and those either still in education or with low levels of education is consistent with low productivity playing a role in explaining low pay (these are groups that are more likely to have low productivity). However, this does not mean that low productivity explains all instances of low pay.

Sex

According to the LFS, 49% of all employees in 2011–12 were women. However, women were a clear majority of the low paid:

- 58% of those with a low hourly rate of pay in their main job were women.
- 71% of those with low weekly pay were women, reflecting the fact that, on average, employed women work fewer hours than employed men.
- A woman is just over 1.5 times as likely as a man to have low hourly pay and around 2.5 times as likely to have low weekly pay.

Much of this may be explained by the types of jobs women have – they are more likely to work in lower-paying occupations and sectors, and to work in part-time work. But even

controlling for a range of such job and individual characteristics (such as education and age), women are more likely to be low-paid than men.¹¹

Ethnicity

Low pay is more common among ethnic minority groups than among white people. This is particularly true of those of Bangladeshi or Pakistani ethnicity, for whom low hourly pay is around 1.6 times more common than for those of white ethnicity. Again, this is explained in part by differences in individual and job characteristics.

Family type

Low pay is concentrated among single adults, both with and without children:

- Single adults without children are around 1.7 times as likely as someone living in a couple (with or without children) to have a low hourly rate of pay.
- Lone parents are 1.9 times as likely to have a low hourly rate of pay as someone living in a couple and 2.3 times as likely to have low weekly pay.

Region of residence

People living in Northern Ireland, northern regions of England, and Wales are around 1.5 times as likely to have low hourly pay as those living in the South East of England. Despite the Living Wage being around 15% higher in London than in the rest of the UK, people in London are less likely to be paid the Living Wage than people in any region other than the South East of England.

The position of the low paid in the family income distribution

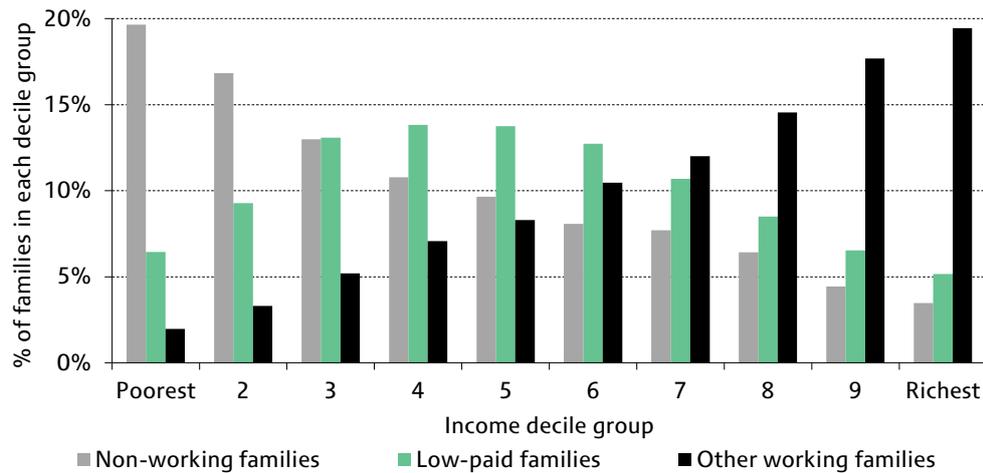
As discussed above, official statistics show that more than half of poor children and working-age adults live in families where someone works. And overall, around 11% of people living in families where someone works are in poverty. While the methodology we use here to look at low pay does not allow direct comparisons with those numbers, we can examine where in the income distribution families containing someone who is low-paid are found. This is done for low hourly pay in Figure 7.1.

The figure shows that around 16% of families with a low-paid worker are in the bottom fifth of the income distribution. This compares with around 36% of families where no one works (including pensioners) and around 5% of working families where everyone is paid more than the Living Wage. In other words, low-paid workers are substantially less likely to have low family incomes than those in workless families, but substantially more likely than higher-paid workers.

Figure 7.1 also shows that low-paid workers are relatively heavily represented around the lower-middle part of the income distribution (decile groups 3 to 6). But they can be found right the way up the family income distribution: 44% are in the top half of the distribution and 12% are in the top fifth. This largely reflects the fact that for many families, low-paid work is not the only source of earnings: in around 30% of families with at least one low-paid worker, such work contributes less than half of total earnings from employment and self-employment. This is generally due to someone paid a low hourly wage having a higher-paid partner (in some cases it is because the low-paid job is a second job).

¹¹ This finding (and the finding on ethnicity below) comes from a probit regression that examines the links between low pay status and individual and job characteristics.

Figure 7.1. The position of families by low-pay status in the net family income distribution

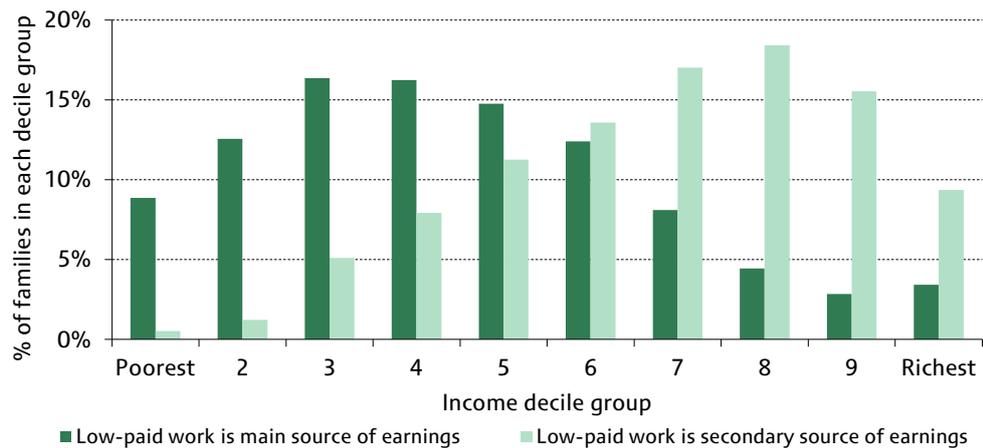


Note: Low-paid families are those with at least one low-paid worker. Low pay is defined as earning no more than the Living Wage. Income decile groups are derived by dividing all families into 10 equal-sized groups according to income adjusted for family size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.

Source: Authors' calculations using TAXBEN, the 2011–12 Family Resources Survey and contemporaneous waves of the Labour Force Survey.

Figure 7.2 splits low-paid families into those where a low-paid job is the main source of earnings and those where it is a secondary source of earnings. The figure shows that those families where a job with low hourly wages is the main source of earnings are most concentrated in the lower and lower-middle part of the income distribution: almost half can be found in decile groups 3 to 5. In contrast, those families where it is a secondary source of earnings are predominantly found in the upper-middle part of the income distribution, with more than half in decile groups 7 to 9.

Figure 7.2. The position of low-paid families by low-pay source in the net family income distribution



Note: See note to Figure 7.1. Low-paid work is defined as the main source of earnings for a family if the sum of earnings from any jobs paying a low hourly wage is equal to at least half of the family's total earnings from employment and self-employment. Otherwise it is defined as a secondary source.

Source: See source to Figure 7.1.

Summary

The incidence of low pay is highest among those types of people and jobs where productivity tends to be lower: the young, the low-educated, and occupations and sectors that tend to require relatively low levels of skill such as cleaning, retail and hospitality. However, this does not rule out the possibility that some low pay is a result of some employers paying people less than their productivity warrants. Nor does it rule out discrimination when setting pay. For instance, low pay is more common among women and ethnic minority groups even after controlling for some broad individual and job characteristics (although this does not prove discrimination either, as productivity may be affected by more detailed considerations than we are able to control for).

Low pay does not necessarily translate into low family income. In a substantial minority of families where someone is low-paid, low-paid work is not the main source of earnings (for example, one partner is low-paid but the other has higher earnings). And other sources of income – such as benefits and tax credits – boost the incomes of many low-paid workers. However, families for which low pay is the main source of earnings are found predominantly in the lower and lower-middle of the family income distribution. And low hourly pay is associated with being in relative income poverty.¹² Boosting the incomes of the low paid would therefore help reduce in-work poverty.

The extent to which one cares about low pay and low income is likely to depend on whether they are temporary or persistent. The analysis suggests that for many people, low pay is a temporary phenomenon – for example, when they are young, still in education, or they have recently started a new job and have yet to acquire many job-specific skills. Using data that track the same people over time, the Resolution Foundation finds that a substantial number of low-paid people do move out of low pay, especially among the young.¹³ However, it also estimates that almost three-in-ten people who were low-paid in 2002 only ever had low-paid jobs in the subsequent decade, and this was especially true among older low-paid people. This suggests that a substantial number of people do persist in low-paid employment, which, if it is their family's main source of income, is likely to translate into relatively low income.

7.3 Tax and benefit policies

Having established who the low paid are, we now consider ways in which the government might try to help them. In this section, we analyse the options available via the tax and benefit system.

We begin by examining the effects of a further rise in the income tax personal allowance, to £12,500 – a policy that has been mooted as a possible central plank of both the Conservative and Liberal Democrat manifestos for the 2015 general election. We then turn our attention to alternative reforms to direct taxes: the reintroduction of a 10p starting rate of income tax advocated by the Labour Party; and increasing the threshold above which employees start paying National Insurance contributions (NICs), as well as increasing the personal allowance, in a way that aligns the two. Finally, we show how the

¹² J. Cribb, A. Hood, R. Joyce and D. Phillips, *Living Standards, Poverty and Inequality in the UK: 2013*, IFS Report R81, 2013, <http://www.ifs.org.uk/publications/6759>.

¹³ A. Hurrell, *Starting Out or Getting Stuck? An Analysis of Who Gets Trapped in Low Paid Work – and Who Escapes*, Resolution Foundation, London, 2013, http://www.resolutionfoundation.org/media/media/downloads/Starting_out_or_getting_stuck_FINAL_1.pdf.

low paid could be helped via in-work benefits – specifically, by increasing the work allowances in universal credit.

All of the analysis here is based on modelling that assumes universal credit is fully in place. Its roll-out is now planned to barely start until 2016–17, but we are considering permanent reforms to the tax and benefit system, so it is more informative to model impacts under universal credit than under the benefits it will replace. This matters, not just for the analysis of in-work benefit reform but also for direct tax changes. Gains from direct tax cuts would, for some, be significantly offset by knock-on reductions in universal credit (as with housing benefit under the current system, but unlike tax credits).

Increasing the income tax personal allowance to £12,500

In April 2014, the current government will meet its commitment to raise the income tax personal allowance for under-65s to £10,000. The personal allowance will then be £2,545 higher than under the plans the government inherited, at an estimated cost of £10.7 billion¹⁴ per year – a substantial tax cut at any time, and even more so in an era of severe fiscal restraint. This will have taken 2.0 million people out of income tax, meaning that the 4.6 million lowest-income workers¹⁵ (17% of all workers) will pay no income tax. The two major stated objectives of these increases have been ‘to help lower and middle income earners’¹⁶ and ‘to reward work’.¹⁷

It has been widely reported that a commitment to increase the personal allowance to £12,500 may be an election pledge for both the Conservatives and the Liberal Democrats in 2015.¹⁸ The Liberal Democrats have explicitly linked this commitment to an aspiration to take all minimum-wage workers out of income tax – £12,500 is roughly the annual earnings of an individual working full time at the National Minimum Wage (NMW).¹⁹

Although such an increase would probably be implemented in phases over a period of time, for illustrative purposes we model the effects of increasing the personal allowance to £12,500 in April 2014. This is, of course, sooner than is being proposed, but such a policy is likely to cost a similar amount and have similar effects to an attempt to take minimum-wage workers out of income tax by a somewhat later date (the personal

¹⁴ This is the sum of the costings given in the ‘2014–15’ columns of table 2.2 of the March 2011 Budget (http://webarchive.nationalarchives.gov.uk/20130129110402/http://cdn.hm-treasury.gov.uk/2011budget_complete.pdf); tables 2.1 and 2.2 of the March 2012 Budget (http://cdn.hm-treasury.gov.uk/budget2012_complete.pdf); table 2.1 of the 2012 Autumn Statement (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf); and table 2.1 of the 2013 Budget (<https://www.gov.uk/government/publications/budget-2013-documents>). It is calculated net of various simultaneous adjustments to the higher-rate threshold designed to limit the cost.

¹⁵ By ‘lowest-income workers’, we mean the workers with the lowest taxable incomes. This group is similar, but not identical, to the 4.6 million lowest-earning workers. The difference is because some low earners have unearned taxable income that takes them above the personal allowance. 4.0 million of the 4.6 million lowest-income workers are also among the 4.6 million lowest-earning workers.

¹⁶ See HM Government, ‘The Coalition: our programme for government’, 2010, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/78977/coalition_programme_for_government.pdf.

¹⁷ See the section entitled ‘Policy objective’ in HMRC’s assessment of the impact of increases in the personal allowance (<http://www.hmrc.gov.uk/budget2012/tiin-2044.pdf>).

¹⁸ See ‘Tories plan to raise personal allowance to £12,500’, *Financial Times*, 13 October 2013, available at <http://www.ft.com/cms/s/0/95b97f76-30fa-11e3-b478-00144feab7de.html#axzz2np8YouhL>.

¹⁹ See <http://www.publicfinance.co.uk/news/2013/09/take-minimum-wage-workers-out-of-tax-say-libdems/>. Someone working 37.5 hours a week at the current National Minimum Wage of £6.31 an hour would earn £12,300 per year. A £12,500 personal allowance would not quite take all minimum-wage workers out of income tax, as some have unearned taxable income.

allowance increases in cash terms over time as a result of uprating, but so does the NMW).

We also assume throughout this subsection that the higher-rate tax threshold is left unchanged from current plans. This means that higher-rate taxpayers have their income tax liability reduced by the same cash amount as basic-rate taxpayers from increases to the personal allowance (as has been the case for some of the increases during the current parliament).²⁰ It also means that the number of higher-rate taxpayers is unaffected by any of the changes that we model.

A £2,500 additional increase to the personal allowance in April 2014 would cost around £12 billion per year relative to current plans, taking another 2.9 million individuals out of income tax and giving a tax cut to around 28 million individuals.²¹ If £12,500 were instead a cash-terms target to be met in some future year (as the £10,000 target was during the current parliament), then the giveaway could be significantly smaller (and the cost significantly lower). For example, raising the personal allowance to £12,500 by April 2020 would cost around £5 billion per year in 2014–15 prices (given current forecasts for inflation).²² Although still a significant tax cut, this would probably not take all minimum-wage workers out of income tax, because the NMW will probably be significantly higher in cash terms by April 2020 than it is now.

Distributional impact

We focus initially just on working individuals because that is the obvious target group for policies to help the low paid. (But there are non-workers – mostly pensioners – who gain too, so we broaden the focus below.)

If an individual has an income of less than £10,000 per year, then they would pay no income tax anyway, and so they could benefit only through the effect of the reform on a higher-income partner. Under existing policy, this will be the case for the lowest-income 17% of workers (4.6 million) in 2014–15. Table 7.1 gives an indication of who these workers are. Two-thirds are women, and more than 40% are secondary earners in a couple. They are also disproportionately likely to be students: 10% are in full-time education, compared with only 2% of all workers.

This suggests that many of the workers who pay no income tax are either only temporarily on low incomes (students) or not the primary source of family earnings (secondary earners). Nevertheless, even excluding students, around a quarter of workers who pay no income tax are in relative poverty according to the government's definition based on household income (their household income is less than 60% of the median), and

²⁰ This requires a reduction to the basic-rate limit. Without any adjustment to the basic-rate limit, higher-rate taxpayers would gain twice as much in cash terms as basic-rate taxpayers from personal allowance increases. This is because the higher-rate threshold is defined as the sum of the personal allowance and the basic-rate limit. Therefore, an increase in the personal allowance in isolation increases the higher-rate threshold by the same amount. Without a corresponding adjustment to the basic-rate limit, the effect on higher-rate taxpayers is to save them 40% tax over a range of income (rather than 20% as for basic-rate taxpayers).

²¹ Source: Authors' calculations using TAXBEN and uprated data from the 2011–12 Family Resources Survey. Our central estimate of the cost is £12.2 billion per year.

²² This is the estimated cost of increasing the personal allowance to £11,067 in 2014–15. This would mean that it would subsequently reach £12,500 in 2020–21 given current inflation forecasts. The actual cost of implementing the policy in 2020–21 may differ because of fiscal drag and interactions with any future changes to the tax and benefit system. The source for the inflation forecasts is the Office for Budget Responsibility (OBR): <http://cdn.budgetresponsibility.independent.gov.uk/Economic-and-fiscal-outlook-December-2013.pdf>. We assume CPI will remain at 2% beyond the end of the forecast period.

Table 7.1. Characteristics of workers with annual taxable incomes above and below £10,000

	Workers paying no income tax (income ≤£10,000)	Workers paying income tax (income >£10,000)	All workers
Women	67%	43%	47%
Secondary earners	43%	25%	28%
Full-time students	10%	0%	2%
In relative poverty	24%	4%	7%

Note: Secondary earners are defined as those earners in a family with a higher earner. Those in relative poverty are those with household income less than 60% of the median in 2011–12.

Source: Authors' calculations using TAXBEN and uprated data from the 2011–12 Family Resources Survey.

this is far higher than the 4% rate of poverty among workers who would gain from increases to the personal allowance.²³

Figure 7.3 shows the impact of increasing the income tax personal allowance to £12,500 on the family income of working individuals. Because 17% of workers already pay no income tax, those with the lowest earnings benefit little from a further increase to the personal allowance. This is a significantly bigger consideration now than it was at the start of the parliament, because 2.0 million of the lowest-paid will already have been lifted out of income tax by increases to the personal allowance up to April 2014. Note also that many with incomes slightly above £10,000 will lose some of the gains in the form of

Figure 7.3. Impact of increasing the personal allowance to £12,500 (leaving the higher-rate threshold unchanged) among workers only, by individual earnings decile group



Note: Earnings decile groups are derived by dividing all individuals with positive earnings into 10 equal-sized groups according to their earnings. Decile group 1 contains the tenth of earners with the lowest weekly earnings, decile group 2 the second lowest, and so on up to decile group 10, which contains the highest-earning tenth.

Source: Authors' calculations using TAXBEN and uprated data from the 2011–12 Family Resources Survey.

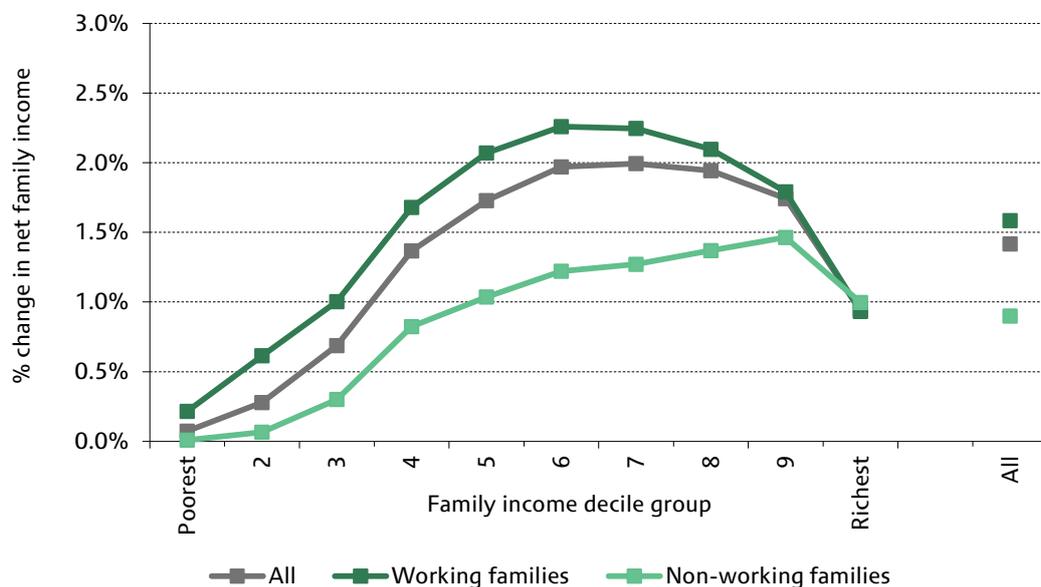
²³ Precisely, these are the actual poverty rates in the 2011–12 data among individuals who we simulate will (or will not) be income taxpayers in 2014–15, based on assumed earnings growth between 2011–12 and 2014–15.

withdrawn benefits (discussed in detail around Figure 7.5). On average, the workers who would gain most in percentage terms from this further increase are those in the lower-middle of the individual earnings distribution. All those with incomes between £12,500 and £120,000 have their income tax liability reduced by £500, and this tends to be a larger percentage of family income for earners towards the bottom of that band.²⁴

Note that individuals with taxable incomes exceeding £122,500 per year actually lose from this policy. This is because the personal allowance is gradually withdrawn as taxable income rises above £100,000, and our modelling keeps the higher-rate threshold fixed – which, given a higher personal allowance, means reducing the amount of income over which the 20% basic rate is payable (see footnote 24). Hence, these very high-income individuals would lose overall because they would be paying a 40% marginal rate (rather than a 20% one) over a larger range of income.

Figure 7.3 looked only at the population of workers. Of course, many of the lowest-income families are out of work and paying no income tax, so do not gain at all from increases to the personal allowance. The figure also ranked people by their individual earnings, rather than their family’s total income. This will miss the fact that two-earner couples, who tend to be relatively far up the family income distribution, can gain double the amount (in cash terms) that one-earner families can gain. Hence, when we look across the whole population at the distributional impact by family income, the picture is different. As Figure 7.4 shows, the families that gain the most from a £12,500 personal allowance are those in the upper-middle of the overall income distribution.

Figure 7.4. Impact of increasing the personal allowance to £12,500 (leaving the higher-rate threshold unchanged), by family income decile group and work status



Note: See note to Figure 7.1.

Source: See source to Figure 7.3.

²⁴ It is important to note that this distributional pattern is dependent on the assumption that the benefit to higher-rate taxpayers is limited to the same cash amount. If there were no adjustment to the basic-rate limit, the gains for high-income families would be larger. On the other hand, if the basic-rate limit were reduced until higher-rate taxpayers did not gain at all, the gains would be much smaller towards the top of the income distribution.

Looking at the impact on both workers and non-workers, as Figure 7.4 does, highlights another point. Families with *unearned* incomes above £10,000, the large majority of which are pensioner families, would gain from further rises to the income tax personal allowance. There is an important difference here between the rises in the personal allowance we have seen over the current parliament and any further significant increases. Most individuals aged 65 and above have a different (higher) personal allowance from under-65s. They have therefore not benefited from the increases in the under-65s' allowance up to £10,000 (though pensioners with relatively high incomes have benefited).²⁵ However, those higher age-related allowances are now little higher than the under-65s' allowance and they are being phased out.²⁶ This means that around 4.7 million individuals aged 65 and above would receive a tax cut if the personal allowance were increased to £12,500. Of course, a government might want to give a tax cut to pensioners. But this does reduce the extent to which increases in the personal allowance target low-paid workers – a key justification given for the rises so far.

Overall, the numbers underlying Figure 7.4 imply that 69% (£8.4 billion) of the £12.2 billion per year giveaway would go to working families in the top half of the income distribution, and a further 16% (£1.9 billion) would go to non-working families (mostly pensioners). Just 15% (£1.9 billion) would go to working families in the lowest-income half of the population.

The interaction between the tax and benefit systems reduces the extent to which a rise in the personal allowance will benefit the low paid. Families on universal credit (UC), for example, would typically keep no more than 35% of the reduction in income tax resulting from the higher personal allowance.²⁷ Under the means-tested benefits system that UC is replacing, the same issue applies to in-work recipients of housing benefit. But most in-work support currently given to low-income families is provided through tax credits, and tax credit entitlement is means-tested on the basis of a family's pre-tax income (so is unaffected by increases in the personal allowance). The subsuming of tax credits within UC thus represents an important change in this respect.

Entitlement to council tax support (CTS, which is being kept separate from UC) is also assessed against net earnings. Across the large majority of Great Britain, its withdrawal rate is 20%.²⁸ Hence, low-paid workers whose family receives both UC and CTS will typically keep no more than 28p from a £1 reduction in income tax.²⁹

²⁵ The lower personal allowance also applies to individuals aged 65 or over if their taxable income exceeds (as of April 2014) £28,000 per year, because additional age-related allowances are tapered away as income rises above (as of April 2014) £27,000.

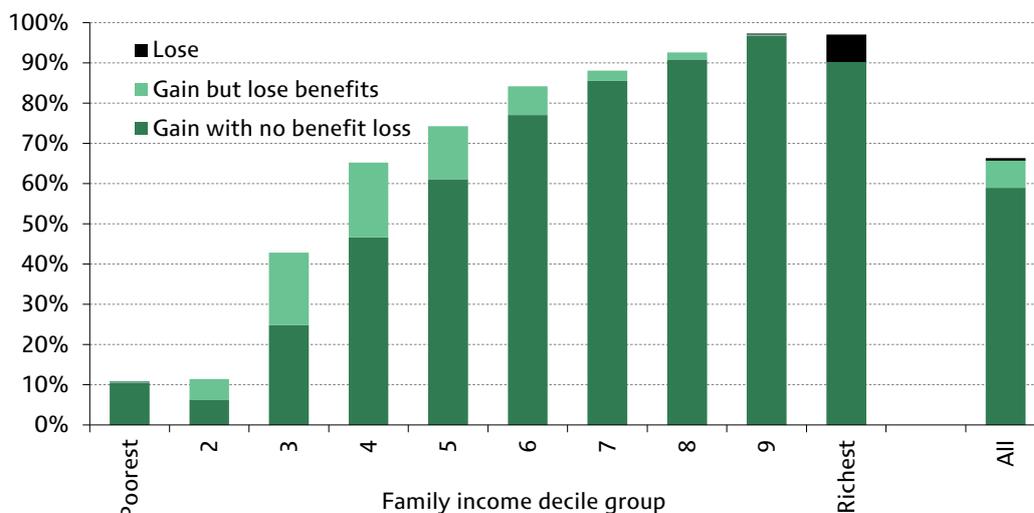
²⁶ The allowance is being frozen at £10,500 for those born between April 1938 and April 1948 and £10,660 for those born before April 1938, until it is no higher than the under-65s' allowance – after which, individuals of all ages will have the same allowances.

²⁷ Analysis by the Resolution Foundation has also considered this issue: see D. Hirsch, *Will Future Tax Cuts Reach Struggling Working Households?*, Resolution Foundation, London, 2013, <http://www.resolutionfoundation.org/publications/will-future-tax-cuts-reach-struggling-working-hous/>.

²⁸ Support for council tax was localised in April 2013. The devolved governments in Scotland and Wales both decided to retain the previous system, which included a withdrawal rate of 20%. 249 out of the 326 English local authorities (76%) have retained the 20% taper rate. 20 local authorities have explicitly increased it, and 3 have explicitly reduced it. A further 54 have 'implicitly' reduced the taper rate by implementing a flat percentage cut in entitlements for all recipients. See S. Adam, J. Browne, W. Jeffs and R. Joyce, *Council Tax Support Schemes in England: What Did Local Authorities Choose, and with What Effects?*, IFS Report R90, 2014, <http://www.ifs.org.uk/publications/7057>. A spreadsheet of scheme characteristics across English local authorities is available at <http://www.ifs.org.uk/publications/7005>.

²⁹ The 28p figure would apply if UC counts as income in the CTS means test (and the CTS taper rate is 20%). That is because a £1 cut in income tax would increase post-UC income by 35p, and a further 7p (20% of 35p) would be lost via reduced CTS. In the modelling, we do assume that UC counts as income in CTS means tests

Figure 7.5. Proportion of families affected in different ways by increasing the personal allowance to £12,500 (leaving the higher-rate threshold unchanged), by family income decile group



Note: See note to Figure 7.1.

Source: See source to Figure 7.3.

Among the 2.2 million families paying income tax and entitled to either UC or CTS, net family income increases by an average of only 0.8% as a result of a £12,500 personal allowance (on an entitlements basis), compared with an average 1.9% increase among other gainers. The gainers affected by this interaction with means-tested benefits are far more likely to be the lower-income ones. Figure 7.5 shows that more than 40% of the gainers in the second and third income deciles of the overall family income distribution could lose some of that additional income through reduced entitlement to UC or CTS.³⁰ It is important to note, however, that non-take-up of these benefits will mean some of these families do in fact gain in full, as they have no benefits to lose even though they are entitled to them (to the extent that non-take-up persists under UC and the new CTS schemes).

In summary, although the policy results in the same cash reduction in income tax liability for all individuals with taxable incomes between £12,500 and £120,000, those on lower incomes are much more likely to see reduced benefit entitlement offset much of that gain.

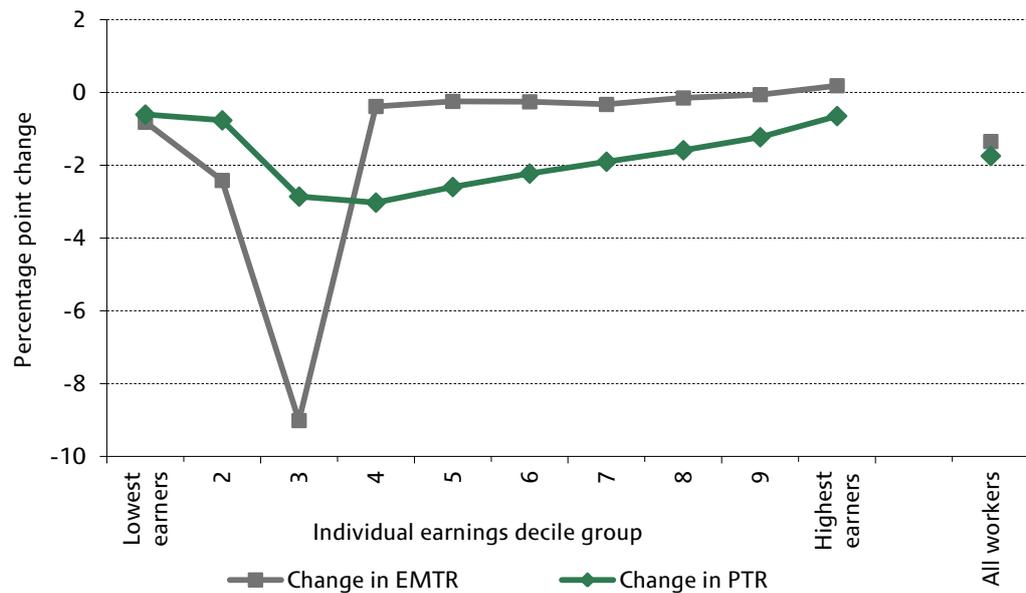
Work incentive effects

Figure 7.6 summarises the effects on work incentives across the earnings distribution. Participation tax rates (PTRs) measure the percentage of earnings lost in taxes and withdrawn benefits when an individual moves into work (i.e. they measure the incentive

(see the next footnote). If it did not, then with a 20% CTS taper rate people subject to both UC and CTS withdrawal would keep only 15p of a £1 reduction in direct tax.

³⁰ The modelling assumes that the means tests in the local systems of CTS count UC as income but add rents to work allowances. We also assume that all English local authorities have a minimum council tax payment, net of CTS, of 10.4% of the bill for working-age families. This is roughly what is required to make a 10% overall cut to spending on council tax support relative to the national system of council tax benefit that existed before April 2013. The UK government is providing English local authorities and the devolved governments with a grant for council tax support worth only 90% of what would otherwise have been spent on council tax benefit. The devolved governments have so far maintained the previous system and absorbed the funding cut elsewhere in their budgets. In 2013–14, 83% of English local authorities have changed the system and 70% have introduced minimum council tax payments.

Figure 7.6. Impact of increasing the personal allowance to £12,500 (leaving the higher-rate threshold unchanged) on work incentives, by earnings decile group



Note: See note to Figure 7.3.

Source: See source to Figure 7.3.

to work at all). Effective marginal tax rates (EMTRs) measure how much of an additional pound of earned income an individual would lose in taxes or withdrawn benefits (i.e. they measure the incentive to increase earnings slightly). In both cases, higher numbers indicate weaker work incentives.

By lowering the marginal income tax rate from 20% to 0% on incomes between £10,000 and £12,500, the policy would strengthen the incentive for individuals with income (or potential income) above £10,000 to be in work. But it has very little impact on the lowest earners, because they would pay no income tax anyway. The policy would strengthen the incentive for those with taxable income between £10,000 and £12,500 – most of whom are in the third earnings decile – to increase their earnings slightly.

Reintroducing a 10% starting rate of income tax

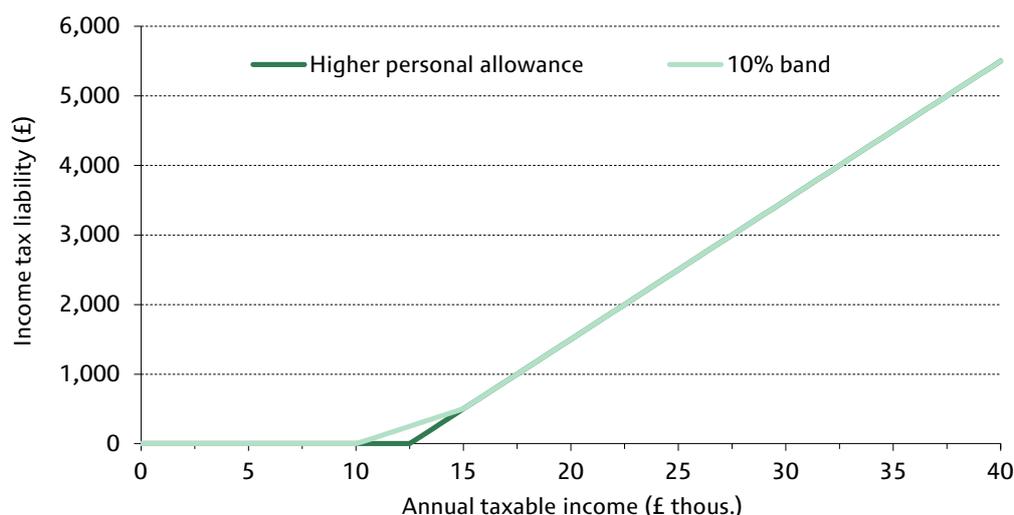
Further increases in the personal allowance are not the only change to the income tax system that has been suggested with the goal of helping the low paid. In February 2013, Ed Miliband announced that a future Labour government would seek to reintroduce the 10% starting rate of income tax abolished by Gordon Brown in the 2007 Budget.³¹

As announced, the policy would be funded by the introduction of a ‘mansion tax’ on houses worth over £2 million, and the width of the 10% marginal rate band would depend on the revenue raised from that tax.³² However, to facilitate comparison of the policy with further increases in the personal allowance, we consider the introduction of a 10% marginal rate band of £5,000 (applying on taxable income between £10,000 and

³¹ See <http://labourlist.org/2013/02/a-mansion-tax-to-fund-a-10p-tax-rate-ed-milibands-speech-in-full/>.

³² For further details, see J. Browne, P. Johnson and B. Roantree, ‘Better options exist to help low earners than 10p tax rate’, IFS Observation, 2013, <http://www.ifs.org.uk/publications/6606>.

Figure 7.7. Income tax paid with personal allowance of £12,500 and with 10% marginal rate between £10,000 and £15,000



Source: Authors' calculations.

£15,000). This would cost a very similar amount to raising the personal allowance to £12,500 (around £12 billion per year).³³ Given that a mansion tax would raise less than £2 billion a year,³⁴ this is clearly on a much bigger scale than the policy being suggested by the Labour Party. It is also a larger giveaway than simply restoring the 10% band abolished in 2007, which we estimate would cost around £7 billion in 2014–15.³⁵ Our conclusions on the relative effects of a 10p tax rate and an increased personal allowance are not very sensitive to the precise scale of the giveaway.

The key point to note is that the impact of a small 10% starting-rate band would be almost identical to the impact of a slightly smaller rise in the personal allowance. Figure 7.7 shows income tax liabilities at different levels of taxable income under the two reforms. For anyone with annual taxable income below £10,000 or above £15,000, the tax paid under the two systems is identical. Raising the personal allowance is slightly more progressive, because the lowest-earning beneficiaries from both policies – those on just above £10,000 – have their marginal income tax rate reduced to zero rather than to 10%.

In short, the reintroduction of a 10% marginal rate band would add unnecessary complexity to the income tax system. There is no plausible economic objective which could not be better and more simply achieved through further increases to the personal allowance. Of course, there may also be other policies preferable to both. We discuss a strong contender in the next subsection.

Aligning the employee National Insurance threshold with the income tax personal allowance

The effectiveness of further reforms to income tax in helping the low paid will be limited by the fact that, even under existing policy, the lowest-income 17% of workers (around

³³ The introduction of a £5,000 10% marginal rate band would in fact cost about £200 million per year less.

³⁴ See <http://labourlist.org/2013/02/a-mansion-tax-to-fund-a-10p-tax-rate-ed-milibands-speech-in-full/>.

³⁵ This is the estimated cost of applying the 10% starting-rate limit (£2,880 in 2014–15) to all taxable income, rather than only to savings income as is currently the case.

4.6 million people) will pay no income tax in 2014–15. However, of that 4.6 million, around 1.2 million will still pay tax on their earnings. This is because the point at which workers start paying National Insurance contributions will be more than £2,000 per year lower than the personal allowance, at £7,956. Raising this threshold would cut taxes for a group with lower earnings than anyone who would benefit from increases in the personal allowance. Since NICs cuts affect only the tax paid on earned income, this would also be better targeted on workers – and on strengthening work incentives – than further rises in the personal allowance.³⁶

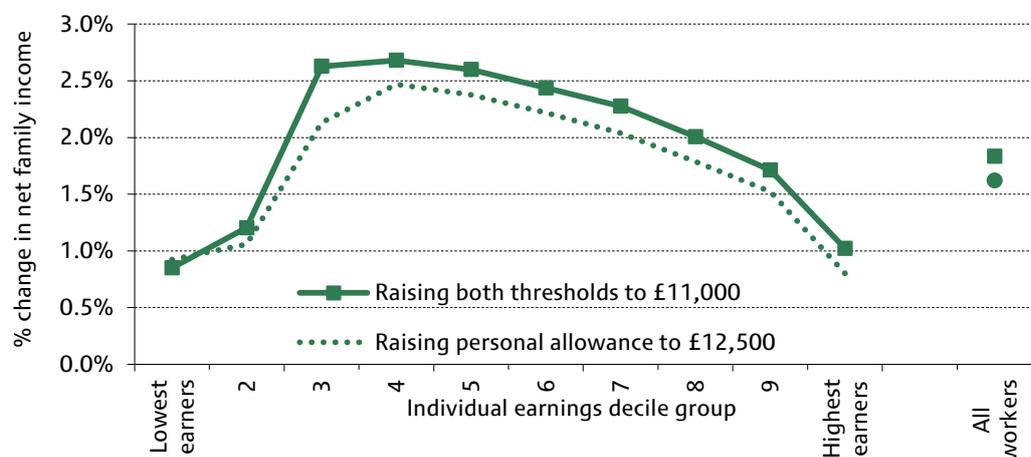
In this subsection, we consider the effects of increasing both the personal allowance and the employee NICs threshold to £11,000 in 2014–15. This would cost the same (about £12 billion per year) as increasing the personal allowance alone to £12,500. It would take 1.8 million people out of direct tax altogether.³⁷ The alignment of the two thresholds would, in itself, be advantageous because it would slightly simplify the overall structure of the direct tax system that workers face.

Note that, for ease of exposition, we do not consider changes to the *employer* NICs threshold, although ultimately we would expect these also to affect workers' incomes through knock-on effects on wages. Ideally, both employer and employee NICs thresholds would be aligned with the personal allowance. Ultimately, there is a strong case for full integration of income tax and NICs.³⁸

Distributional effects

Figure 7.8 shows the impact of the policy on the family income of working individuals. To ease comparison, it also reproduces the same analysis for the policy of increasing the

Figure 7.8. Impact of increasing the personal allowance and employee National Insurance threshold to £11,000, by individual earnings decile group



Note: See note to Figure 7.3.

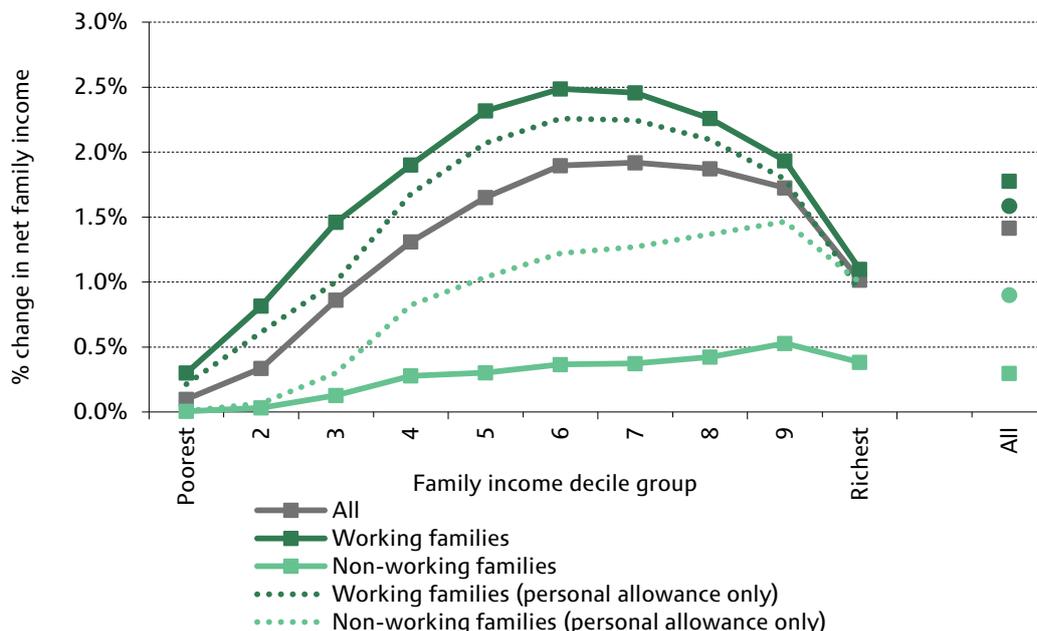
Source: See source to Figure 7.3.

³⁶ Cuts to employee NICs would not directly benefit workers aged over the state pension age, as they do not pay employee NICs.

³⁷ We again assume that the higher-rate threshold (and the upper earnings limit for NICs, which is aligned with the higher-rate threshold) is unchanged.

³⁸ See chapter 5 of J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, *The Mirrlees Review: Tax by Design*, Oxford University Press for IFS, Oxford, 2011, <http://www.ifs.org.uk/mirrleesreview/design/ch5.pdf>.

Figure 7.9. Impact of increasing the personal allowance and employee National Insurance threshold to £11,000, by family income decile group and work status



Note: See note to Figure 7.1.

Source: See source to Figure 7.3.

personal allowance to £12,500 shown in Figure 7.3 (which is estimated to cost the same amount). The first thing to note is that the gains for workers are larger across almost the whole distribution.³⁹ This is because the total giveaway is the same in both cases, but none of the gains from the cut to NICs accrue to non-workers. As with increasing the personal allowance, those with the lowest earnings see only small gains. That is because the very lowest earners already pay no NICs, while some others on low incomes would see their benefit entitlements reduced. However, because the employee NICs threshold is currently lower than the personal allowance, this policy is slightly more tightly focused on lower earners than just raising the personal allowance.

Figure 7.9 shows that the policy looks less progressive when we consider the family-level impacts across the whole income distribution, for the same reasons as with a rise in the personal allowance alone (see earlier). It also shows that working families throughout the distribution gain more from this policy than from raising the personal allowance alone at the same cost. Again, this is because the whole tax cut is on earned income.

To summarise, aligning the employee NICs threshold and the personal allowance represents a better way to help the low paid than further increases in the personal allowance alone. First, there is a group of low-paid individuals who already pay no income tax, but whose tax burden can be reduced through cuts to NICs. Second, because cuts to NICs reduce taxes only on earned income, the gains for workers are larger at a given exchequer cost than the gains from increasing the personal allowance. For the same reasons, it is a better to way strengthen the work incentives of those with low earnings

³⁹ Earners in the bottom decile benefit more from the personal allowance increase, on average. This is due to individuals with small amounts of earnings who also have unearned taxable income which makes them income tax payers (for example, older individuals doing small amounts of paid work whilst also receiving state pensions).

(or potential earnings) as well. The alignment of the employee NICs threshold and the personal allowance also has the advantage of simplifying the marginal tax rate schedule that workers face, eliminating a small (but growing) 12% marginal rate band.

Increasing work allowances in universal credit by 20%

So far, this section has considered reforms to the tax system. There are, however, at least two reasons why in-work benefits may be a better instrument to use when wanting to focus support on low-income working families. First, entitlements to means-tested benefits are, by definition, restricted to those on relatively low incomes. Hence, there exists an automatic mechanism for focusing any increase in generosity on the lowest paid (unlike with tax cuts). Second, one can get round the issue, highlighted earlier, that cuts in direct taxes are partially offset for some of the lowest paid by knock-on effects on in-work benefit entitlement.

Another important difference between using taxes and in-work benefits to help the low paid is that entitlement to means-tested benefits is assessed at the family level. Hence, changes to the benefits system target those with low *family* incomes better than changes to direct taxes, which are assessed against *individual* income. This is an important distinction. For example, as Section 7.2 showed, many of those with low individual incomes are second earners with relatively high family incomes.

There is an inevitable downside of policies that focus increases in generosity on those with the lowest incomes. While reducing the cost of providing a given level of support to those people, withdrawing the extra support as income rises weakens the incentive for some workers to earn a little more. Increasing in-work benefits might also result in higher administration costs; and take-up rates for means-tested benefits are inevitably less than 100% (though, in what follows, we model entitlement and will therefore likely be overstating the gains to families and the exchequer cost).

An obvious way of helping the low paid using in-work benefits is through the 'work allowances' in universal credit. A family's work allowance is the level of total (net) earnings above which UC entitlement starts to fall. The levels of allowance are set to differ substantially across family types. For example, it will be £111 per month for single individuals and £734 for lone parents not claiming for housing costs. Raising work allowances helps low-earning families by allowing them to keep more of their benefits. Note also that it *cannot* help families where no one is in work – it is a policy whose beneficiaries are exclusively in-work families with relatively low earnings.

Since universal credit was first announced, the government has made a number of changes to the planned levels of the work allowances.⁴⁰ On average, these have significantly reduced the planned allowances – although the changes have been different for different family types – at an exchequer saving, relative to original plans, of around £1.5 billion per year (in 2014–15 prices) once UC is fully in place. In the remainder of this subsection, we examine the distributional and work incentive effects of spending around that sum on raising all UC work allowances by 20% from their currently planned levels.⁴¹

⁴⁰ In the 2012 Autumn Statement, the work allowances were changed significantly for different family types, becoming less generous on average, and it was announced that they would be uprated by a maximum of 1% in nominal terms in April 2014 and April 2015. In the 2013 Autumn Statement, it was announced that in fact they would be frozen in nominal terms for three years from April 2014.

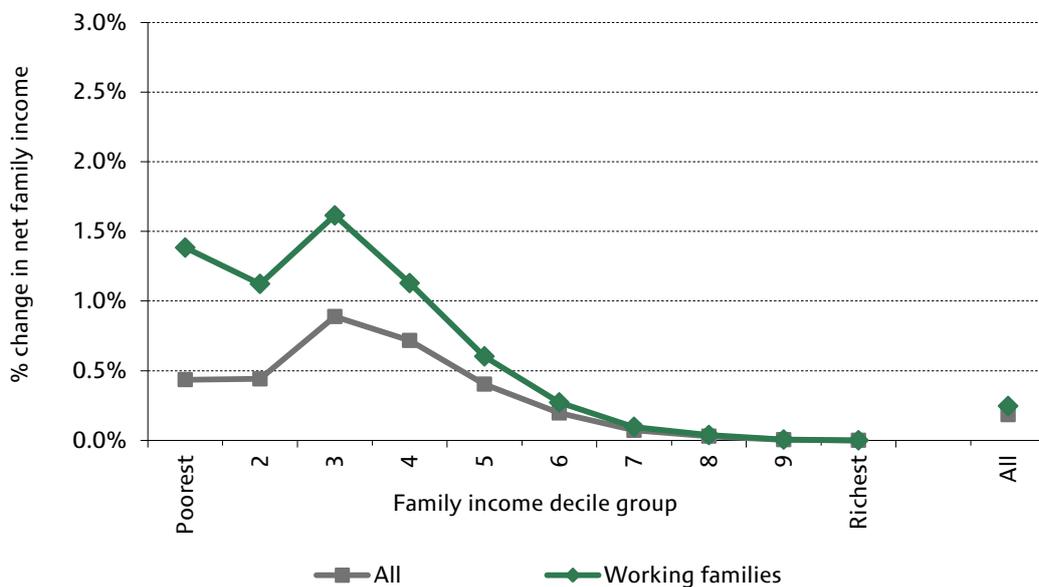
⁴¹ The cost of this policy would be around £1.7 billion per year.

Note therefore that the overall scale of this giveaway is much smaller than that for the personal allowance increases and employee NICs cuts considered earlier.

Distributional effects

Figure 7.10 shows the impact of the increase in UC work allowances on family incomes across the distribution. The change is much more tightly targeted on lower-income working families than the tax policies considered earlier. Of the 3.8 million families that gain, 3.3 million are in the bottom half of the income distribution. Despite costing £10 billion per year less than those policies, raising work allowances by 20% would increase the incomes of working families in each of the bottom three deciles by more, on average. Note also that, unlike income tax cuts, this policy exclusively benefits families where someone is in work.

Figure 7.10. Impact of increasing UC work allowances by 20%, by family income decile group and work status



Note: See note to Figure 7.1.
Source: See source to Figure 7.3.

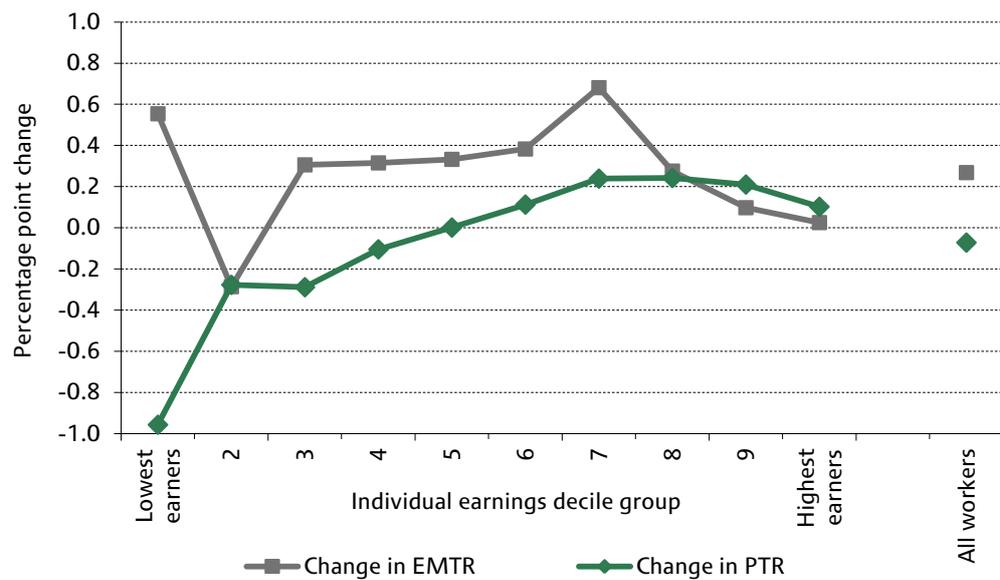
Work incentive effects

Increasing work allowances strengthens the incentive for some families to have someone in work, because they lose less in withdrawn benefits. For some of the lowest earners, it also strengthens the incentive to earn a little more because they would no longer lose some UC when doing so. Many slightly higher-earning families would find that their incentive to earn more – by existing workers increasing earnings slightly, or by a second person entering work – is weakened, because they could face the withdrawal of more UC than if the work allowance were lower (i.e. than if more of their entitlement had already been withdrawn).

Figure 7.11 summarises the average impacts on work incentives across the individual earnings distribution.⁴² The policy is particularly effective at strengthening the incentive for those with low earnings to be in work. The 1 percentage point fall in the average PTR

⁴² This figure is on a different scale from the previous figure showing work incentive effects, reflecting the much smaller scale of the policy, in terms of both impact and exchequer cost.

Figure 7.11. Impact of increasing UC work allowances on work incentives, by earnings decile



Note: See note to Figure 7.3.

Source: See source to Figure 7.3.

for the lowest tenth of earners is larger than that delivered by either of the direct tax policies discussed earlier, despite costing more than £10 billion per year less. But the policy weakens the incentive for the top half of earners to be in work, on average, because of effects on workers with a working partner (see above). It also tends to weaken the incentive to earn slightly more for the lowest-earning second earners (this explains the rise in average EMTRs in the bottom earnings decile) and earners in the lower-middle of the earnings distribution or above.

Overall, 3.5 million workers (2.7 million of them being the only worker in the family) would see their incentive to be in work strengthened; 4.2 million workers with a working partner would see their incentive to be in work weakened; and 200,000 more families would be made eligible for UC – meaning that they could lose entitlement if they increase their earnings.

Summary

There are better ways to help the low paid via the tax and benefit system than through further increases in the income tax personal allowance. The 4.6 million lowest-income workers will pay no income tax in 2014–15 even under existing policy, and further significant increases to the personal allowance would benefit many pensioners, or others with unearned income, as well as working families. Overall, just 15% of the gains from increasing the allowance to £12,500 would accrue to workers in the bottom half of the income distribution.

Introducing a 10p starting rate of tax over a small band of income would have almost the same impact and, if anything, would be even less well targeted on the low paid. It would therefore introduce unnecessary additional complexity. It is hard to think of any economic rationale for such a policy.

A better way to help the low paid – and strengthen their work incentives – through the direct tax system would be to align the employee NICs threshold with the personal

allowance (and then – if desired – raise both together). Aligning the thresholds would cut taxes for 1.2 million low-paid individuals whose earnings are too low for them to benefit from further increases to the personal allowance. It would also simplify the direct tax system.

If the key objective is to help the low paid, though, there are significant advantages to using in-work benefits rather than direct taxes. Any increases in generosity are focused on that group, rather than benefiting almost everyone who pays direct tax. Indeed, many of the lowest paid may gain relatively little from tax cuts if they lead to loss of means-tested benefits. Policymakers may also see it as an advantage that in-work benefits support only low-income working *families*, rather than individuals with low earnings or low incomes. On the other hand, increasing their generosity would extend means-testing further up the income distribution. This would weaken the incentives of a number of slightly higher earners, and second earners in a family, to earn more; and it would increase the costs of administration. Non-take-up also means that not all eligible families would actually benefit – although the government does expect take-up to increase under universal credit.⁴³

7.4 Policies to increase pre-tax wages

As Chapter 6 shows, recent years have seen a substantial fall in real wages, which is the main factor driving a substantial fall in average household incomes. Notwithstanding the large increases in the income tax personal allowance (at an annual cost of just over £10 billion) that the current government has delivered, the large structural deficit has perhaps made it harder to find further large sums to spend on giveaways through the tax and benefit system. These factors have led to a renewed debate on the scope for policies to increase the *pre-tax-and-benefit* incomes of low-income families, which has sometimes been termed ‘predistribution’.

In the long run policies, aimed at things such as improving education, and thus productivity, might be most effective in achieving higher earnings. More immediately, incentivising and supporting moves into employment and increases in hours of work, by tightening work-search conditions, or increasing the affordability of childcare may also help (see Chapter 8). Here, though, we focus on proposals aimed at increasing hourly rates of pay among low-paid workers directly.

The effectiveness of such policies will depend on the reasons why people have low hourly pay in the first place.

In the classic model of a perfectly competitive labour market, workers are paid what their output is worth to their employer (their ‘marginal product’). In this case, low pay is the result of low productivity, and efforts to tackle low pay should focus on raising the productivity of low-paid workers. Compelling employers to pay a higher wage via a legally binding minimum wage (such as the National Minimum Wage) would in this case hurt, rather than help, those with the lowest wages: they would lose their jobs, because their output would be worth less than the wage they would have to be paid. Efforts to

⁴³ HM Treasury, *Impact on Households: Distributional Analysis to accompany Autumn Statement 2013*, 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263548/impact_on_households_autumn_statement_2013.pdf.

improve productivity through, for example, the education and training system should be at the centre of any long-term strategy to improve the wages of the low paid.

But no labour market will be perfectly competitive and other more direct interventions may have merit too. If employers have some power in the labour market, some low-paid workers may be paid less than their productivity warrants (and indeed the same could be true of some higher-paid workers). This market power may result from costs to employees of searching for and moving jobs (including, for instance, the loss of income associated with knowledge or skills that are useful to the current employer but not to other employers). It may be particularly important where workers are tied to a very limited geographic location, perhaps because of childcare responsibilities. In this case, a minimum wage – at least if not set too high – may not have negative employment effects and instead would redistribute from the owners of capital, higher-paid employees or consumers, to low-paid employees.

The UK has had a National Minimum Wage (NMW) since 1999. This is currently set nationally at £6.31 per hour for those aged 21 or over. Approximately 5.3% of all employee jobs were paid the NMW in 2012, the most recent year for which data are available.⁴⁴ The Low Pay Commission (LPC), which is tasked with recommending the level of the NMW and monitoring its impact on the labour market and wider economy, has commissioned a substantial amount of research to ascertain the effects of the NMW on wages, employment, hours of work, productivity, training, prices and profits.

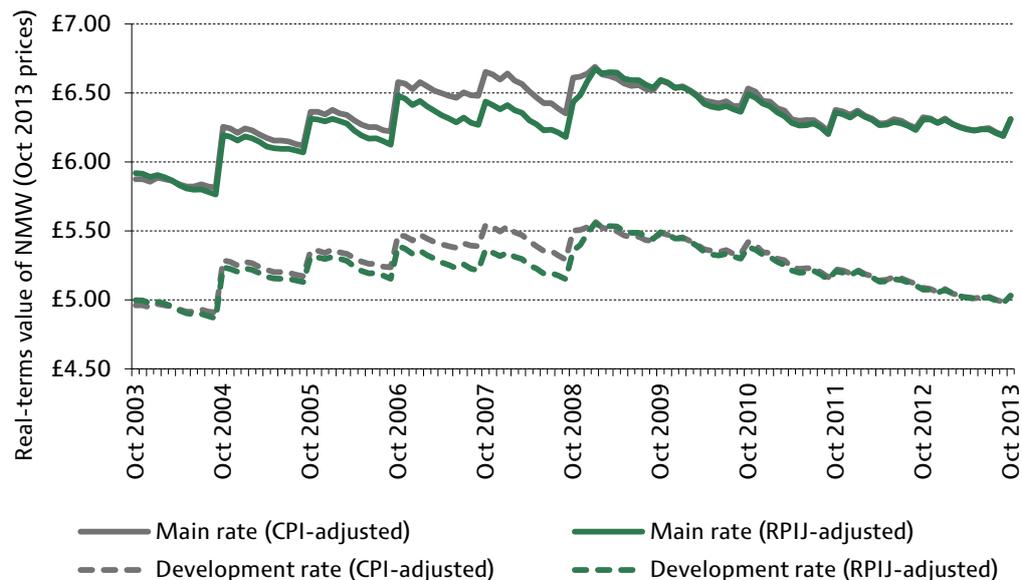
The conclusions of the LPC's analyses are not unanimous. However, the broad consensus is that there is little evidence of negative employment effects of the NMW in the UK, although hours of work may have declined a little (but not to the extent that this offsets the higher hourly wages). Higher wages may have been paid for, at least in part, by higher prices for goods and services whose producers employ a large fraction of low-paid labour and where output is produced largely for the domestic market (for example, hairdressing). There may also have been some small increases in productivity among low-paying firms, although the evidence on whether this is due to additional investment in training is unclear. But increases in prices and productivity do not look to have been big enough to pay for the higher wages: studies have generally found increases in the NMW have led to reductions in the profits of employers in low-pay sectors. This suggests that, at least in part, the NMW has redistributed from the owners and shareholders of low-paying employers to low-paid workers, and that employers do have some market power in some parts of the labour market (and the product market).

After increasing substantially in real terms in the years up to 2007, the NMW has failed to keep pace with inflation since the onset of the 'Great Recession'. Figure 7.12 shows the real-terms value of the main (solid lines) and development⁴⁵ (dashed lines) rates of the NMW between October 2003 and October 2013. In the six years between October 2007 (the last increase before the recession) and October 2013 (the most recent increase), the main adult rate of the NMW fell substantially in real terms: by 5.1% relative to CPI

⁴⁴ Low Pay Commission Report 2013 (<http://www.official-documents.gov.uk/document/cm85/8565/8565.pdf>), which defines a minimum-wage job as one that paid below, at or up to 5p above the NMW. The analyses in that report, and references therein, are also the sources for the 'consensus' findings discussed in the following paragraph.

⁴⁵ The NMW rate that applies to those aged 18 to 20.

Figure 7.12. Real-terms value of the NMW (October 2013 prices)



Note: The jumps in the real-terms value of the NMW each October reflect the October upratings of the NMW, which are then progressively eroded by inflation during the following year.

Source: Authors' calculations using NMW rates and CPI and RPIJ inflation.

inflation and by 2.0% relative to the new RPIJ measure of inflation.⁴⁶ If it had kept up with CPI inflation since October 2007, it would have been £6.65 in October 2013, rather than £6.31; if it had kept pace with RPIJ inflation, it would have been £6.44.⁴⁷ The development rate, paid to those aged 18 to 20, has seen smaller nominal increases than the main adult rate in recent years, meaning it has fallen even further in real terms during the same period: by 9.3% relative to the CPI and by 6.2% relative to the RPIJ.

However, these real-term falls in the NMW have taken place at the same time as real-terms falls in earnings right across the income distribution. For instance, it can be seen from Figure 7.13 that median hourly pay fell by 5.7% relative to the CPI and 3.4% relative to the RPIJ between April 2007 and April 2013 according to ASHE: this exceeds the 4.0% (CPI) or 1.6% (RPIJ) real-terms fall in the main adult rate of the NMW during the same period.⁴⁸ In other words, although the main adult NMW has fallen in real terms, it has actually risen a little relative to median hourly pay, pushing it a little further up the pay distribution. Despite this, in recent months, there have been increasing calls from MPs in each of the three main UK parties for a substantial increase in the NMW to undo, at least in part, the real-terms falls, and to move the NMW somewhat closer towards the so-called 'Living Wage' (which is currently £7.65 per hour outside of London and £8.80 in London).⁴⁹ The Chancellor, George Osborne, added his support to such an increase on 16 January 2014, saying that 'I want to make sure we are all in it together, as part of the

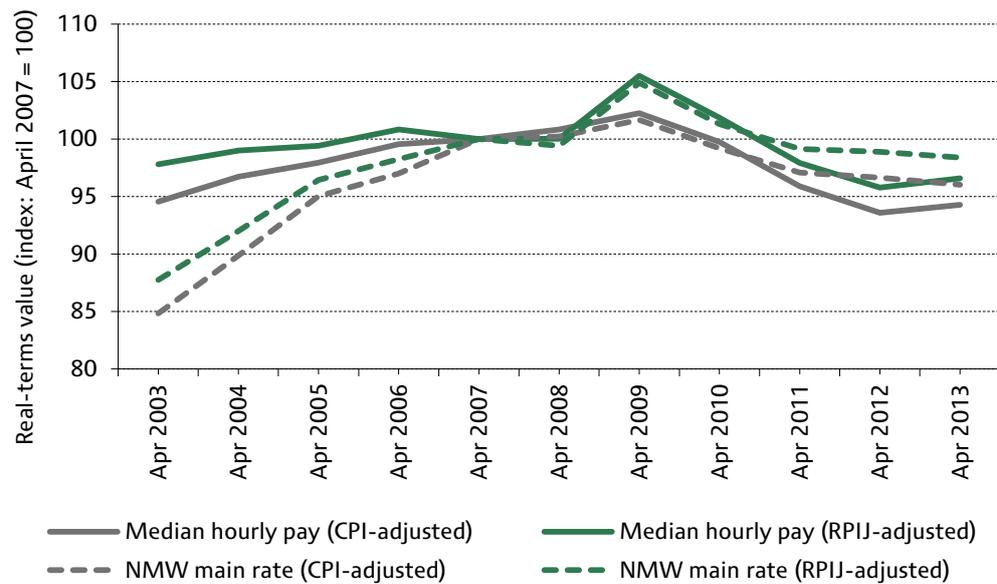
⁴⁶ The real-terms value of the main adult NMW rate actually peaked in January 2009 following the temporary cut in VAT to 15% (which reduced prices). Between January 2009 and October 2013, the NMW fell by 5.7% relative to CPI inflation and by 5.4% relative to RPIJ inflation.

⁴⁷ In order to match its real-terms peak in January 2009, the NMW would have needed to be set at £6.69 (CPI) or £6.67 (RPIJ) in October 2013.

⁴⁸ ASHE figures are only available for April of each year.

⁴⁹ See, for instance, articles in the *New Statesman* (<http://www.newstatesman.com/politics/2014/01/how-will-labour-respond-tories-minimum-wage-plans>) and the *Guardian* (<http://www.theguardian.com/society/2014/jan/07/tories-nicking-lib-dem-low-pay-policies>).

Figure 7.13. Comparison of real-terms value of NMW and median hourly pay (index: April 2007 = 100)



Source: Authors' calculations using NMW rates, ASHE 2003 to 2013, and CPI and RPIJ inflation.

recovery, which is why I want to see above-inflation increases in the minimum wage, precisely because the British economy can now afford that',⁵⁰

We cannot know who would ultimately gain or lose from an increase in the NMW to the Living Wage or to any level between the NMW and the Living Wage. That will depend on the effects on employment, prices, profits and the wages of higher-paid workers. What we can do is show where in the family income distribution those who potentially stand to directly gain from a higher NMW sit, and discuss how big their gains could be relative to their existing income.

Recall Figure 7.1 (in Section 7.2): this shows the position in the family income distribution of families in which someone is paid no more than the Living Wage. It shows that such families are found right across the income spectrum, but are more likely to be in the lower-middle of the income distribution (just over half are in decile groups 3 to 6). In contrast, just 6% are in the bottom decile group and 5% are in the top decile group (although a full 44% are in the top half of the income distribution, reflecting the fact that many low earners live with high-earning partners or have other sources of income). This means that more of the potential direct gainers from increases in the NMW towards the Living Wage would be in the middle of the income distribution rather than towards the bottom, and many would be relatively well-off.

Among those families that could potentially gain, however, those towards the bottom of the income distribution would gain more, on average. This reflects at least two factors. First, earnings from jobs paying less than the Living Wage are more likely to be the main source of earnings – rather than a secondary source – than for families further up the income distribution. Second, those families towards the very bottom of the income

⁵⁰ Reported by the BBC at <http://www.bbc.co.uk/news/uk-politics-25766558>. The Chancellor also stated that an increase to £7.00 by 2015 would restore the NMW to its pre-recession real-terms value. An NMW of £7.00 in October 2015 would equal its October 2007 real-terms value if CPI inflation averaged 2.6% between October 2013 and October 2015. It would equal its January 2009 peak if CPI inflation averaged 2.3% over the same period.

distribution would lose less of the increase in gross earnings in the form of tax and reductions in benefit entitlements than families towards the lower-middle and middle of the income distribution. Overall, we estimate the potential gains in net income among those families containing a worker who could potentially benefit from a rise in the NMW to be around 12% among the poorest tenth of families, 9% among the second-poorest tenth, and between about 4% and 6% across the rest of the income distribution. This suggests that the potential income gains from a higher NMW would be concentrated towards the lower and middle parts of the income distribution.

Of course, unless productivity were to increase in line with the higher wages, higher income for those benefiting from a higher wage would need to be paid for by lower income for other people via lower wages, lower profits or higher prices – and the last may also undo at least some of the increase in income for those families directly gaining from the higher NMW. And although the broad consensus is that the NMW has not had significant negative employment effects *so far*, this does not imply that it could be substantially increased from its current level without such effects.

The Labour Party's proposed 'Make Work Pay' contracts

Rather than compelling employers to increase the wages of low-paid workers by raising the National Minimum Wage, another approach is to encourage them to do so *voluntarily*. This is the approach taken in the Labour Party's proposed 'Make Work Pay' contracts announced on 3 November 2013.⁵¹

Under these contracts, employers that increase the wages of all their workers to the Living Wage or higher and become accredited Living Wage employers in the first year of a Labour government (if elected in 2015) would receive a tax rebate for one year, equal to 32p for every £1 increase in wages up to the level of the Living Wage.⁵² This 32p is equal to the basic rate of income tax plus employee NICs. The Labour Party argues that this policy would raise revenue in its first year in operation, as more would be raised from employer NICs and less would be spent on means-tested benefits and tax credits. After the first year, the government would also benefit from the higher income tax and employee NICs revenues if these higher wages persisted. On average, the combined rate of income tax, National Insurance, and benefit and tax credit withdrawal for someone below the Living Wage is around 50%.⁵³ All else equal, this would mean a gain to the exchequer of around 50p, on average, for every £1 increase in wages for those paid less than the Living Wage. When that additional income was spent, the exchequer would also gain in the form of higher VAT and excise duty revenues. The gain to the low-paid workers would be about 60p for every £1 increase, on average.⁵⁴

Is this a sensible proposal?

⁵¹ The policy was communicated to the press in time for articles published on 3 November. Ed Miliband first spoke about the policy during his Living Wage Week speech on 5 November (<http://labourlist.org/2013/11/ed-milibands-cost-of-living-crisis-speech-full-text/>).

⁵² Employers that already pay all their workers the Living Wage or more prior to the policy commencing would not benefit from the tax rebate.

⁵³ The Labour Party cites a figure of 49%, while IFS's tax and benefit microsimulation model, TAXBEN, suggests a figure of 51%.

⁵⁴ The total gains to the exchequer and to the employee exceed £1, on average, because the employer rather than the employee would pay the higher employer NICs (the change in employer NICs is around 10–11p per £1, on average).

The first thing to note is that some qualifying employers would likely increase the pay of at least some low-paid workers in the absence of the policy. Because the temporary tax rebate applies to the entire cost of the wage increase needed to reach the Living Wage, part of it acts to subsidise wage increases that would have taken place anyway.

More importantly, the tax rebate is not particularly well targeted at addressing the underlying factors that may drive low pay. If low pay is a result of low productivity, then a temporary subsidy that covers only part of the wage increase required to reach the Living Wage would not be enough to incentivise employers to raise pay. It also seems unlikely to encourage pay increases by those employers that are able to pay low wages by exploiting their labour market power, although it may change the relative bargaining power of low- and high-paid employees (albeit perhaps only temporarily).

The Living Wage campaign argues that employers that pay the Living Wage benefit from higher productivity, as a result of lower absenteeism, lower staff turnover and increased effort.⁵⁵ It also reports that Living Wage employers see improvements in customer service and in their reputation with their customers.⁵⁶ Thus, the argument goes, an employer that raises the pay of its lowest-paid workers to the Living Wage may actually see lower costs and higher profits as a result. But if this were the case, additional financial incentives for paying the Living Wage should not be required – the lower costs / higher profits would provide sufficient incentives on their own – although they may incentivise a few employers on the margin, especially if some face credit constraints.

Of course, one may not expect employers to increase wages voluntarily as a result of the tax rebate unless they believed doing so would make them better off in some way. But employers' decisions could be distorted in undesirable ways; and a decision that makes an individual employer better off may have negative feedback effects on the rest of the economy.

The most obvious potential distortions are to the timing of pay increases.⁵⁷ Employers may collude with their employees to distort the timing of pay increases: reducing or freezing pay in the run-up to the policy; increasing pay to the level of the Living Wage when the policy is in place; and then, if there is no mechanism to ensure employers remain Living Wage employers thereafter, reducing or freezing pay subsequently. This would allow an employer to benefit from the temporary tax rebate and potentially share it with workers – to incentivise them to agree to such a scheme – but may leave the longer-term level of wages paid by the employer unchanged. Thus, the Treasury may lose out by subsidising employers to change merely the timing of workers' remuneration.

⁵⁵ The higher productivity reported by Living Wage employers may not be a good indicator of its effect on economy-wide productivity. Consider the case where their higher productivity is due to their pay being relatively higher than that of other employers (rather than absolutely higher). In such circumstances, those employers paying less than the Living Wage may find that the productivity of their workforces falls. This is because jobs paying less than the Living Wage would then be relatively less well paid, making them less attractive to employees – potentially leading to difficulties recruiting and retaining able staff and reductions in staff effort. In addition, the initial productivity gains among early adopters of the Living Wage may start to decline as more employers sign up to it (the pay of the early adopters now looks relatively less attractive). Therefore, any increase in productivity seen when an employer increases its wages to the Living Wage may be reflected, at least in part, by falls in productivity among other employers. Such falls in productivity could result in lower profits, lower wages, lower employment or higher prices charged to customers – all of which would cost the exchequer money, offsetting some (or even all) of the gains from the higher wages for those now benefiting from the Living Wage.

⁵⁶ Living Wage Foundation, *Living Wage: A Guide for Employers*, London, 2013, <http://www.livingwage.org.uk/guide-employers>.

⁵⁷ Other production decisions may also be distorted. For instance, an employer may change the type of workers it employs in advance of the policy or change the extent or way in which it outsources work.

Furthermore, the voluntary nature of the policy does not mean that there would be no adverse effects on some low-paid workers. This is because an employer must pay all of its workers the Living Wage (and ensure plans are in place to ensure subcontractors do the same) to become accredited and benefit from the tax rebate. Hence, the most cost-effective way for them to satisfy this condition may be to increase the wages of some of their low-paid workers but not to employ others (perhaps, instead, using higher-paid workers or investing in additional capital).

In summary, the Labour Party's proposals would provide some financial incentive for employers to increase pay and would raise the profile of the Living Wage campaign. Both of these may lead to employers that would otherwise have paid lower wages increasing wages to the Living Wage, although the impact looks likely to be modest. But the policy also has two key problems. First, it does not seem particularly well targeted at addressing the ultimate causes of low pay – low productivity and/or exploitation by employers with substantial labour market power. Second, it may distort the behaviour of employers in ways that reduce employment and economic output, and reduce rather than increase exchequer revenue.

7.5 Conclusion

Falls in real earnings since the recession have increased concerns about low pay and the effects of low pay on living standards. Our own work using official incomes statistics has shown that more than half of children and working-age adults below the poverty line live in a family in which someone is in work.

In considering possible policy responses to this issue, it is first important to be clear that low earnings and low family income are not the same. Those with the lowest incomes are generally not in work at all. And many of those with low earnings have higher-paid partners. Those families where low-paid work *is* the main source of earnings are found predominantly towards the lower-middle part of the overall income distribution.

To the extent that low family income is the reason for concern about low pay, the most cost-efficient response via the tax and benefit system would be to increase in-work benefits. But there are downsides to such a policy too, including weakened work incentives for some (especially those with a working partner), increased complexity and less than full take-up.

Cuts to direct taxes also benefit those on higher incomes. As a result, they are much less well targeted on the low paid, and hence a much more expensive way of providing a given amount of additional support to them. On the other hand, they result in stronger work incentives for higher earners as well as some lower earners, and the administration is simpler. Of possible changes to the direct tax system aimed at helping those on low pay, increasing the point at which National Insurance contributions start to be paid clearly dominates further increases in the personal allowance. Of other policies recently mooted, (re)introducing a 10p starting rate of income tax is least well targeted – it is hard to think of a good economic rationale for such a policy.

Ideally, of course, one would tackle the underlying problem and then wages themselves would rise. In the long run, that is likely to require improved education and skills and higher levels of productivity. In the shorter term, increasing the National Minimum Wage could help those on low pay, but significant increases risk raising unemployment. It is

very difficult to say what level of the NMW could spark a significant increase in unemployment, but a large and immediate rise in the NMW would be risky.

Proposals to incentivise employers to pay higher wages look attractive on the face of it. But it is difficult to design such policies in ways that avoid gaming by employers and other distortions. They could still lead to employers employing fewer people.

As ever, there are no free lunches here. There may well be employers that exploit their power in the labour market to pay less than workers' marginal product, but a large part of low pay is explained by low productivity. That will only be tackled in the long run by improving levels of skill, education and investment.