

IFS and the Future*

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I. Role of IFS

The Institute for Fiscal Studies (IFS) was founded in 1969 by four men working in the private sector who wanted to see expert analysis and critique of tax policy from outside the government itself – something of a radical proposition in those days. They had, two years earlier, published a ‘Charter for the Taxpayer’ in *The Times* lamenting ‘half-baked’ proposals for tax reform put forward by then Chancellor James Callaghan. They determined that a new organisation was needed to provide an independent source of expertise in tax and fiscal policy. As they put it back in 1967, there was ‘nothing between a bright idea privately discussed by academic economists with no practical experience and the publication of an actual Finance Bill’.

From those slender beginnings, IFS has grown to the – still rather slender – organisation it is today. After its early days under the directorship of Dick Taverne, the key appointment was of John Kay as Director in 1979. He was followed by Bill Robinson, Andrew Dilnot, Robert Chote and now myself. Having arrived in 1986, Richard Blundell acted as Research Director for almost 30 years, and for much of that time he has directed the ESRC Centre for Microeconomic Analysis of Public Policy, a role he continues to this day. Under their leadership, IFS has grown to be the pre-eminent independent economic research organisation in the UK, focused on analysing and improving public policy, and doing so in a way that engages both policymakers and the media.

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The scope of our work is well illustrated in this commemorative double issue. We remain focused on microeconomic analysis but our work extends far beyond the focus on tax envisaged by our founders. As policy, data, economic tools and public interest have expanded, so has our remit, which now encompasses education, health, welfare, ageing, pensions, inequality, the labour market and much more besides.

Before saying a little more about some of that, though, it is worth asking a rather odd question. Why do organisations like IFS exist at all?

After all, there are thousands of economists and many thousands of other social scientists employed by UK universities, and thousands more in government. One of the many changes since the late 1960s has been the enormous expansion of economics as an academic discipline and as a profession within the civil service. The resources available to university-based social science and government-based analysis are a thousand fold greater than those available to us, or indeed the entire independent research and think tank sector.

Yet far from leading to a withering of independent think tanks and research institutes, the need and demand for what we do have only grown. There remains a yawning chasm between the work of most academic social scientists and the work of government. The cultures, the incentives, the values are utterly different, the mutual incomprehension often astonishing to behold. C. P. Snow wrote in 1959 about how the split between two cultures – the scientific and the artistic – was holding back advances in western societies. It is not absurd to suggest that the gulf between the cultures in government and in academia is having a similar malign effect.

Of course, these are different worlds with different objectives, and there are multiple exceptions to this general rule. But the combination of insularity and short time horizons in government and purism and focus on academic peers within universities means the two communities are far less than the potential sum of their parts. There is little movement between the two. It is all but impossible for an experienced civil servant to move into a social science department in a university, still too rare to see well-trained academics moving into government.

So there remains plenty of space for an organisation looking to span those worlds. That requires a deep understanding of academic research, literature, data and methodologies on the one hand and a clear focus on policy priorities, political constraints and the reality of the policymaking process on the other. Policymakers rarely have the former, academics all too often ignore the latter. In their absence, organisations such as IFS remain vital.

More openness within government would also make a huge difference. There are literally thousands of economists, statisticians, social researchers and others carrying out good and important work in government departments. They are constantly analysing data, building and running models, advising

ministers. In most areas of policy, more analysis probably happens within the relevant government department than the totality of analysis carried out by all external bodies. Yet little of it ever sees the light of day, and when it does it is often wrapped in a party political blanket. That is a waste of resource and a drag on the quality of public discourse and of public policy. Innovations such as the establishment of the independent Office for Budget Responsibility (OBR) are valuable in large part just because they are so much more open with data and analysis than traditional government departments.

If it is obvious why independent analysis is needed to hold government to account, the reason why more than just universities are required is more complex. Part of it is about focus, and part of it is about willingness and ability to engage in communication. Those could, in principle, be changed. But there is a deeper and more fundamental barrier to universities as organisations playing the role of trusted intermediary, of objective holder of government to account. They cannot generally talk with an institutional voice. Individual academics, quite rightly, have latitude to express views and interpret results with considerable freedom. So which ones to trust as genuinely expert and independent? Individual academics can and do build trust in themselves and in their own brand. It is much harder for an entire university to do the same. A crucial part of IFS's influence and role derives directly from the fact that we have established a reputation over a long period not just for excellence but for absolute impartiality, objectivity and independence from political influence.

It is this combination of what IFS does which is so important – the combination of academic rigour and excellence, focus on policy and communication, and absolute independence.

II. Four sets of challenges

Later in this special issue, my colleagues James Banks and Richard Blundell look at how IFS has taken a role in leading developments in applied microeconomics, data analysis and public economics over the past five decades. Here I am going to very briefly look at some key messages from four big areas of our policy work over those decades: tax, working-age benefits, pensions and retirement, and education. It was on these four themes that we focused our 50th anniversary year events, and much of what is written here reflects the discussions we had on those days. More details, along with presentations, charts and articles, can be found at <https://www.ifs.org.uk/50th-anniversary>, as can references to the facts, figures and research quoted below.

1. Tax

As Banks and Blundell make clear, analysis of tax policy has been at the centre of IFS work since its founding. We have been responsible for by far the two

biggest reviews of tax policy in the UK in that period – the Meade Report and the Mirrlees Review – and our work has encompassed tax design, distributional effects of tax policy, labour supply, the design of corporate taxes and much more.

We go into the new decade with numerous challenges for the tax system. It has become extraordinarily complex. It is far from neutral, charging very different rates of tax on income derived in very similar ways; for example, the amount of tax charged on income earned by a business owner can be 40 per cent less than that charged on the same income earned by an employee for doing essentially the same job. These sorts of distortions open up opportunities for avoidance. It is no surprise that the numbers registering as business owners have risen dramatically in recent years. That matters because it creates inequities and is inefficient. It also matters because it makes raising tax more difficult. Tax receipts in the UK are at historically high levels today. In all likelihood, they will have to rise further as the pressures on health and pension spending rise inexorably with population ageing and the growing costs of healthcare.

It is clear from international experience that higher taxes are possible. The tax burden in the UK is roughly at the OECD average and well below that in many other West European countries. In addition to the challenges posed by the current inefficient system with its obvious loopholes, though, there are at least three other big structural issues we will need to grapple with over the coming years if we are to retain an effective tax system that can raise the revenue we need without doing too much damage.

The first is the issue examined in detail by Mike Devereux in this volume: how to maintain corporation tax revenues in an era of global corporations and international tax competition. As he says, with the best will in the world, that is likely to be extremely challenging given the current ‘source-based’ corporation tax regime, i.e. a regime that tries to tax profits where the company is located or the profit is earned. These are now extraordinarily difficult to define and identify and companies can and do shift both real activity and paper profits such as to minimise tax liabilities. Partly in response, the headline rate of corporation tax in the UK has fallen from 52 per cent to 19 per cent over the past 40 years, though receipts have held up much better than that would suggest, partly as the tax base has broadened and partly as profits have risen. The pressures from globalisation and tax competition are not going to abate, not least as new technology companies become increasingly important. The source of their profits is even harder to pin down than is the case for more traditional corporations, and this is already causing tensions between several European countries, where they are perceived as paying too little tax, and the US, where they tend to be based. Devereux favours a radical shift to a ‘destination-based’ tax such that tax is levied where sales are made rather than trying to identify

the source of profits. But to move there will require international agreement and cooperation on a grand scale. In any case, the challenge of raising a tax based on profits at a national level in the current globalised world is likely to remain with us for the next 50 years at least.

The second challenge relates to taxing those on very high incomes. This matters because we are so very dependent on them for tax revenues, because they receive so much income. The top 1 per cent receive nearly 15 per cent of income in the UK, up from about 6 per cent at the end of the 1970s. And despite the fact that top rates of income tax have fallen from 83 per cent (98 per cent on unearned income) to 45 per cent today, the share of income tax paid by the top 1 per cent of income tax payers is now approaching 30 per cent, far higher than it was 40 years ago. This arises directly from the great inequality in income that now exists, which is going to be a substantial challenge in itself in the coming decades. But this dependence on the top 1 per cent creates challenges of its own. It means that shocks affecting a small number of people can have big effects on overall tax revenues. This is also a group that is likely to be particularly able to change behaviour in response to tax changes – for example, the very richest are already much more likely than the rest to have business and dividend incomes, which are both less heavily taxed and more easily shifted over time than are earnings. Our dependence on this group means that policymakers will increasingly have to focus on the design of tax at the top, taking account both of the need for appropriately ‘fair’ taxation and of the need to tax in a way that does not put the tax base itself at risk.

A third set of challenges relates to the taxation of wealth. The vast majority of taxes in the UK are taxes on income or expenditure. Income tax, National Insurance and VAT account for nearly two-thirds of tax revenues, a fraction which has if anything risen a little over the last 40 years. Over the same period, wealth holdings have risen much faster than incomes, but taxes on wealth have remained steady as a fraction of both national income and total tax revenues. Huge increases in housing wealth, for example, have gone largely untaxed, offering windfall gains to those fortunate enough to benefit, and no share in that increase in wealth accruing to the exchequer. Inheritance tax receipts and receipts from council tax have increased little as a share of national income over this period. In sharp contrast, we have seen that the much higher incomes received by high earners have resulted in higher taxes. One reason for that may be that people are more likely to perceive council tax and, in particular, inheritance tax as unfair. There are also challenges to designing effective taxation of housing, returns to savings and inheritances. But, as the Mirrlees Review shows, they are not insurmountable challenges, and there is little doubt that the taxation of housing, pensions and savings in general remains in need of a radical overhaul.

2. Working-age welfare

The revenues raised by the tax system are broadly used in two ways. One is to provide public services and infrastructure, the other is to redistribute directly through cash payments. Nearly £100 billion is spent each year on working-age welfare. For at least the last 40 years, IFS has been investigating the distributional and behavioural effects of this spending as well as looking at the changing structure of the welfare system itself.

In real terms, spending on working-age welfare has trebled over that 40-year period, doubling as a fraction of national income. Getting on for a third of working-age households will be eligible for the main, means-tested, working-age benefit – universal credit. Today, over 60 per cent of working-age welfare is means tested as opposed to being based on contributions or dependent on status (such as having children or living with a disability). This is a huge change from the late 1970s when means-tested benefits accounted for only a small fraction of the (much smaller) total working-age welfare budget.

Redistribution on this scale, in the context of much greater income inequality than existed prior to the 1980s, poses enormous challenges, illustrated not least by the decade-long process of introducing universal credit. Three in particular stand out.

One of the most remarkable changes of the last two decades has been the shift in the nature of poverty. For most of the 20th century, poverty was closely associated with old age and with unemployment. That is no longer true. More than two-thirds of those now in poverty, on the standard definition of having income below 60 per cent of the median, are in work or live in a household where someone is in work. That despite the fact that the in-work benefit system has become much more extensive over the last 20 years. Almost 60 per cent of working-age benefits are today paid to people living in a working household, up from 40 per cent in the mid 1990s. That change has been effective in one important sense: it has supported the incomes of low-earning households. Without this intervention, their incomes would have fallen well behind those of higher-earning households. In fact, while earnings have grown more slowly towards the bottom of the distribution, household incomes have kept pace. While not by themselves enough to prevent increases in in-work poverty, in-work benefits have done a great deal to mitigate what would otherwise have been a substantial increase in household income inequality.

There are limits, though, to the capacity of in-work benefits to keep inequality in check. Those limits are set by their cost, their impact on work incentives and their political acceptability. That is one reason why attention has increasingly shifted to raising minimum wages. It also explains the renewed interest in more radical change towards some form of universal basic income. The relative roles of means-tested benefits, minimum wages and other labour market interventions, and more radical redistributive policies form a core set

of policy choices over the coming decades. Analysis of these choices will be at the centre of the current IFS Deaton Review of inequalities.¹

While the need to support millions of people in paid employment formed no part of the problem that William Beveridge expected the benefit system to have to cope with, he was well aware of the challenges posed by what has become a second major problem for today's welfare system – the problem of housing costs. We spend around £20 billion a year on housing benefit alone, a real increase of more than 100 per cent since the early 1990s. The two most important drivers of this increase are the policy-driven increases in social rents and the huge expansion of the private rented sector at the expense of both social renting and owner-occupation.

Increases in housing benefit costs would have been even greater had the system not been made considerably less generous. Entitlements are much less closely related to actual rent payments than ever before. The maximum that anyone renting in the private sector can receive is set at what was the 30th percentile of local rents in 2012, uprated for CPI inflation. On average, rents have risen faster than the CPI and they have risen differentially across the country with the result that benefit entitlements and rent levels have not only diverged, they have diverged differentially. The cuts were made in large part to save money, but they also address a real trade-off in the design of housing benefit. If it is paid at full market rent, and adjusts with market rents, then it provides neither households nor landlords with any incentive to reduce rents. But if the benefit fails to cover the full rent, serious hardship can be caused. Not only have we failed to solve 'the problem of rent', as Beveridge called it, within the welfare system over the past 70 years; it has become much more severe. It remains a serious challenge.

A third issue is raised by another set of benefits that have become more widespread and expensive in recent decades: incapacity and disability benefits. Incapacity benefits are paid to those who are sick or disabled and unable to work as a result. Disability benefits are paid in recognition of the additional costs or needs associated with disability, and are paid irrespective of work status. Between them, they account for well over £30 billion a year in state spending. Spending on disability benefits in particular has increased dramatically, trebling as a fraction of national income since 1990 following the introduction of disability living allowance (DLA), and continuing to rise in the 2010s despite the attempt to bring it under control as DLA was replaced by personal independence payment (PIP). In Autumn 2012, spending on disability benefits was forecast to have fallen by 5 per cent by 2017–18. In fact, it rose by 49 per cent. Spending on incapacity benefits did fall as a fraction of national income after their generosity and eligibility criteria were sharply curtailed in the mid 1990s, but government hopes of reducing real spending over the last

¹<https://www.ifs.org.uk/inequality/>.

decade have also not been met. Rather than falling by 27 per cent as forecast in 2012, spending actually rose by 5 per cent in the period to 2017–18.

These increasing levels of spending on such benefits are perhaps surprising in the context of generally improving health and longevity. They in part reflect changes in the nature of incapacity. In 1999, just under a third of incapacity benefit claimants were receiving benefit in respect of mental or behavioural problems. That proportion now exceeds a half. Wider social trends also appear important. Disability benefits were once overwhelmingly paid to those over the age of 50, but are now increasingly paid to the young and poorly educated. In 1999, more than 5 per cent of highly educated people (those who finished full-time education after 18) aged between 55 and state pension age were in receipt of disability benefits. That had fallen to 2 per cent by 2018. By contrast, the fraction of low-educated 25- to 34-year-olds who were in receipt of disability benefits more than doubled from 2 per cent to well over 4 per cent over the same period.

All three of these challenges illustrate the extent to which changing economic and social circumstances can have huge knock-on effects on the working-age welfare system. By their nature, welfare benefits are looking to overcome problems created elsewhere – by lack of employment, low wages, high rents, or increasing prevalence of certain kinds of physical or mental distress. The provision of such benefits also illustrates the difficult trade-offs that need to be made within the system, trade-offs that we will continue to research over the coming years.

3. Pensions and retirement

One undoubted triumph of the last century, and indeed of the last 50 years, has been the huge increase in life expectancy. Men who were born in 1900 and reached 50 in the middle of the last century could expect to live another 23 years. Men born in 1970, turning 50 this year, can expect to live another 36 years. The equivalent figures for women are 29 and 38 years. Despite these huge increases in life expectancy, state pension ages did not start rising for women until 2010 and for men until 2019. Men reaching state pension age today can expect to spend far longer in receipt of state pension than their fathers or grandfathers, with obvious consequences for the cost of state pension provision. Spending on the state pension and other pensioner benefits is forecast to stand at £114 billion in 2020–21 by the OBR. It expects the cost of the state pension to rise by another 2 per cent of national income between 2022–23 and 2067–68 as the population ages, despite intended increases in the state pension age.

A second triumph of more recent vintage has been the fall in pensioner poverty and increase in pensioner incomes. In the late 1960s, well over 40 per cent of pensioners were in poverty. They were much more likely to be poor than

any other age group. That situation has now reversed. Fewer than 20 per cent of pensioners now live in poverty, a poverty rate below that for any other age group. Taking account of family size and of housing costs, median pensioner income is now equal to that for non-pensioners. It had hovered around two-thirds of median non-pensioner income for the whole period between 1960 and 1990. This reflects growing levels of state pension, private pension and, for those in their late 60s and early 70s, earned income as well.

Given the pressures on state and private pensions – the cost of the former and demise of the generous versions of the latter in the private sector – one question for the future will be the extent to which retirement ages might rise and hence the contribution made by earnings to the incomes of those in their late 60s and early 70s continue to grow. What is rather remarkable in the context of increasing life expectancy is that, for men, employment rates for those aged between 55 and 64 actually remain lower today than they were in the early 1970s. They have been on a gradual upward trajectory since the mid 1990s, but have not yet recovered from the sharp falls of the 1970s and 1980s. Even now, only 60 per cent of men aged 60–64 are in work, compared with over 70 per cent in the mid 1970s. Employment rates of men in their late 60s are somewhat higher than they were 40 years ago, but remain below 30 per cent. On one measure – the probability of dying in the next 12 months – men in their late 60s today are very similar to men in their late 50s during the 1970s – death rates among the two groups are essentially the same. All this is at least indicative of considerable capacity for more employment among those in their 60s. In future research, we will be looking at the impact of the recent rise in male state pension age, just as we have looked at the impact of the rising female pension age since 2010, which we found to have had significant positive impacts on women’s employment levels.

One challenge of relying on higher employment levels is that by no means everyone in their 60s is healthy enough to work. A quarter of both men and women in their 60s and early 70s report that their health is only fair or poor. Others may struggle to find appropriate work for other reasons. Raising state pension ages can have particularly detrimental effects on those who cannot respond by working more and who are dependent on state benefits. A major trend of the last 20 years has been a decoupling of the generosity of state benefits for those just below and those just above state pension age. In the early 1990s, pension credit – the means-tested benefit available to pensioners with the lowest incomes – was set at a level about 30 per cent higher than jobseeker’s allowance, the minimum benefit available to those of working age. Pension credit is now worth nearly 130 per cent more than jobseeker’s allowance. Over the same period, the poorest fifth of those in the first five years over state pension age have moved from being 17 per cent better off than the poorest fifth of those just under pension age, to being 70 per cent better off than that slightly younger group. This big gap in state benefit entitlements,

according to which side of the state pension age one falls on, also explains why it is the poorest households which have been hardest hit by the increase in female state pension age. They have seen their incomes fall by more than 20 per cent.

It seems very likely that rising pension ages will be an important part of the response to rising longevity and an ageing population. There is clearly scope for longer working for many in their 60s. The sharp gap in welfare provision for those just below and just above state pension age could, however, mean that further increases in state pension age will lead to significant additional hardship. This is one of many challenges that will need to be faced as we continue to adapt to an ageing population.

4. Education

IFS has gradually expanded its scope beyond analysis of the tax, benefit and pension systems to look at other areas of public spending including on health, local government and education. The last of these has been a focus of IFS work for at least 25 years now and was the subject of the fourth and last of the 50th anniversary lectures.

In one sense, education has changed almost beyond recognition. Only around 15 per cent of those born in the late 1960s went on to gain a degree, compared with 40 per cent of those born in the early 1990s. There have also been very big increases in the numbers doing A levels or getting at least five good GCSEs. And yet there are continual concerns about education and skill levels in the workplace. As one example among many, the Industrial Strategy Council reported in October 2019² that UK productivity was being held back by skills gaps, that 28 per cent of workers were underqualified for their job and that half had only primary school numeracy levels. There is a puzzle here.

There are many possible culprits for this mismatch between increasing levels of qualification and under-skilling. One is that it remains the case that, despite increases in the numbers with degrees, a large fraction of the population have only very low levels of qualifications. Of those taking their GCSEs in 2003, nearly a quarter had not even achieved GCSE standard by the age of 28, and 40 per cent had achieved no more than GCSE standard. There was very little upgrading in educational qualifications after age 18 for those not going on to university. The fraction with level 3 (equivalent to A level) vocational qualifications by age 28 was less than 15 per cent, well below the level in many competitor countries, while the numbers with level 4 and 5 qualifications (between A level and degree) were disappearingly small. There has long been, and there remains, a missing part in the British education system,

²<https://industrialstrategycouncil.org/sites/default/files/UK%20Skills%20Mismatch%202030%20-%20Research%20Paper.pdf>.

a part that allows learning to a high level, but below degree level, in technical and vocational skills, a point made very strongly in the 2019 review of post-18 education and funding led by Philip Augar.³

A second related problem is the way the system makes it difficult for those who fail at one stage ever to move up. Only about one in twenty of those who fail to reach the expected standard in English and maths at age 11 go on to get five good GCSEs including English and maths at age 16. This is a problem for two reasons. First, there is no alternative measure of success for these children who are destined to fail from an early age. Second, not achieving those five good GCSEs makes further progress very hard. One striking illustration of that is work that shows that missing a C grade at GCSE English by a single mark reduces the probability of enrolling in a higher-level qualification by 9 percentage points, and increases the probability of not being in education at all at age 18 by 4 percentage points, each by comparison with someone who just made the C grade boundary, who in other words is only very marginally different in ability and achievement.⁴

A continuing challenge is the fact that it is those from poorer backgrounds who do least well in the education system and who therefore suffer most from its relative inflexibility. Those from the highest socio-economic class are more than ten times as likely to attend a high-status university as are those from the lowest socio-economic class. Even when less economically advantaged young people make it to university, they end up earning substantially less than their more advantaged peers even if they do the same courses at the same universities. This certainly suggests that there is more that universities could be doing to prepare less advantaged young people for work.

It is also clear that different universities and courses add very differently to people's earnings prospects. Estimates suggest that the 37,000 students who opt to study creative arts each year still have a substantially negative earnings premium by age 29 by comparison with similar young people who do not attend university at all. Because of the way the student funding system works, these low earners are precisely the ones who get the highest taxpayer subsidy. Whether this is the best way to allocate public funds is at least debatable.

All of this is at least suggestive of the following conclusions: first, just getting more and more people through qualifications is not enough – there needs to be more of a focus on skills actually needed in the labour market; second, finding better routes to useful higher-level skills for those not getting five good GCSEs must be a priority; third, we overfocus on the 'A level to university' route at the expense of an adequate focus on higher-level technical and vocational qualifications; fourth, there is far more that needs to be done

³https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/805127/Review_of_post_18_education_and_funding.pdf.

⁴https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3198482.

to create greater social equity in education, and that needs to go much further than just getting more poorer students into university; and finally, there is a case for reviewing the funding and incentive systems for universities in light of the fact that significant numbers of courses appear to render little or no benefit to the students, at least in terms of their future earnings.

III. Conclusion

Over the last 50 years, based on in-depth analysis, researchers at IFS have developed deep expertise in many areas of public policy, of which those discussed above are just four examples. The scale of complexity, the difficulty of the trade-offs, and the obvious need for continued research mean that our work will continue to be needed for the next 50 years and beyond. The details of the questions will change. Their scale, importance and relevance will not.