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Taxation as an instrument of social policy

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Queen’s International Institute on Social Policy

Kingston, Ontario, 21 August 2012

The Mirrlees Review

- Major review of taxation from first principles
- Set up by IFS; chaired by Nobel laureate Sir James Mirrlees
- Final report published last year
- *www.ifs.org.uk/mirrleesReview*

Taxation as an instrument of social policy

1. Raising money for expenditure on social programmes
2. Redistribution
3. Taxes intended to change behaviour
   – Alcohol & tobacco taxes
   – Environmental taxes
   – Reduced VAT/GST rates for books etc
   – Tax breaks for charities
   – Tax breaks to promote particular industries
   – Tax-privileged savings accounts
   – Tax breaks for marriage or children
   – Mortgage interest relief to promote home-ownership

Achieve progressivity as efficiently as possible

- Economic efficiency – minimise undesirable distortions to behaviour
  - There is a trade-off between progressivity and work incentives
  - Target work incentives where they matter most

- Operational efficiency – keep it simple!
  - Administrative cost to government
  - Scope for fraud, manipulation and error
  - Burdens for taxpayers and benefit claimants
  - Transparency is valuable in its own right

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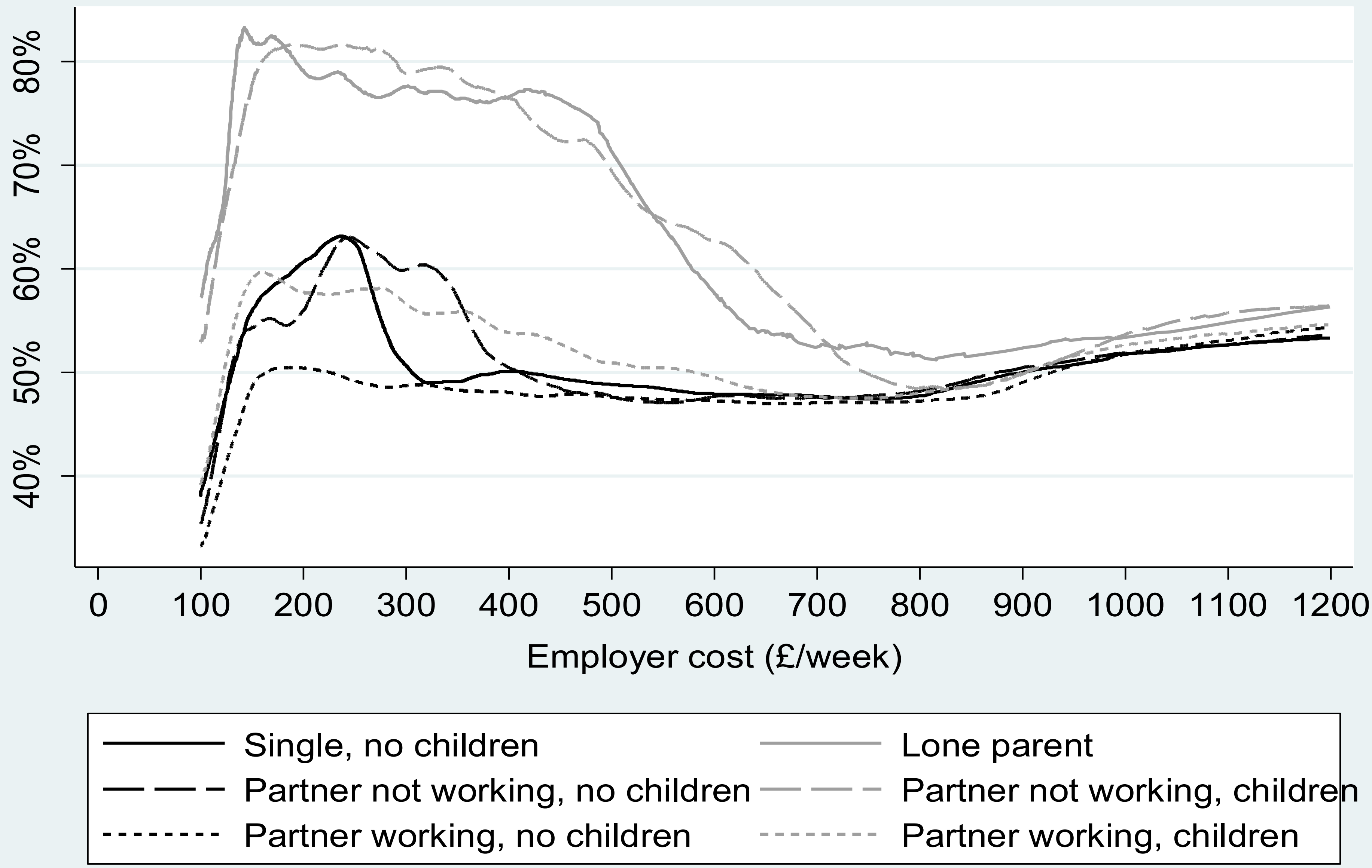
Two kinds of financial work incentives

- Incentive to be in paid work at all
  - Measured by the Participation Tax Rate (PTR) – the proportion of total earnings taken in tax and withdrawn benefits

- Incentive for those in work to increase their earnings
  - Measured by the Effective Marginal Tax Rate (EMTR) – the proportion of an extra £1 of earnings taken in tax and withdrawn benefits

Average EMTRs for different family types in the UK, 2009



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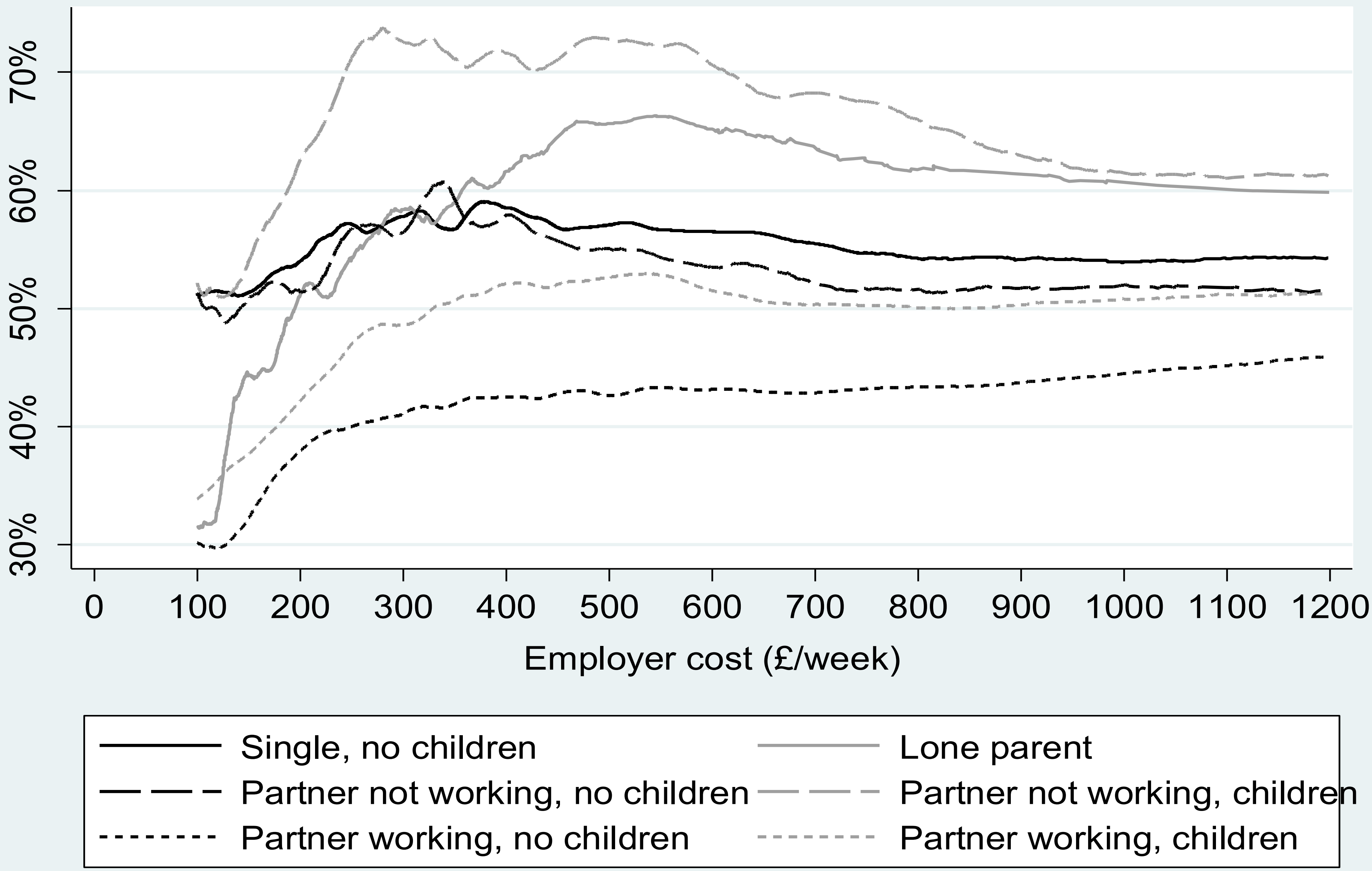

Targeting incentives where they matter most

- We know people are particularly responsive at certain life stages
  - When youngest child is of school age
  - Around retirement age (55-70)

- We simulate reforms that strengthen incentives for these groups
  - Correspondingly weaken for under-55s and those with children under 5

- These could generate large increases in employment
  - With little or no extra complexity
  - Redistribution is largely over the life-cycle

Guidelines for efficient delivery

- Minimise number and length of returns/applications
- Minimise number of things measured
- Minimise duplication of information provision and processing
- Deal with as few agents as possible
- Connect people with a single official/organisation where possible
- Obtain information from verifiable market transactions
- Minimise ‘gaps’ between programmes
- Avoid separating out small groups to apply for special help

Tax credits in the UK

In line with international trends, the UK introduced refundable tax credits in the late 1990s / early 2000s.

Context: growing economy, fiscal policy loosening, child poverty targets

Two main aims:

1. Increase the generosity of support for low-income working families

2. Bring that support within the tax system

More support for low-income working families

- More help for those on low incomes
  - though not the very poorest

- Stronger incentives for families to have someone in work
  - though weaker incentives for working families to earn more
  - ➢ For low earners, employment is more responsive than hours of work

- Increased in-work support has arguably been a success
  - Higher lone parent employment
  - Substantial falls in child poverty (albeit missing ambitious targets)

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Bringing low-income support within the tax system

- Several steps to make this support feel like part of the tax system
  - Renamed as a tax credit
  - Paid via employers
  - Administered by revenue authority
  - Based on current annual income (while being responsive)
- Practicalities didn't quite work
  - Different basis of assessment prevented use of income tax administration → payment via employers proved cumbersome and ultimately abandoned
  - Payment by revenue authority didn't suit their culture
    → some rapid retraining attempted, with some improvement
  - Changing family circumstances meant attempt to base on current annual income led to massive over- and under-payments, causing real hardship
    → policy diluted – less responsive and less related to annual income
- Exacerbated by problems with IT system

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Universal Credit

- Radical reform, phased in between Oct 2013 and Dec 2017
- Context: economy stalled; big welfare cuts announced as part of fiscal consolidation, probably with more on the way
- One benefit to replace six existing means-tested working-age benefits and tax credits
- Two key advantages: simplification and rationalising work incentives

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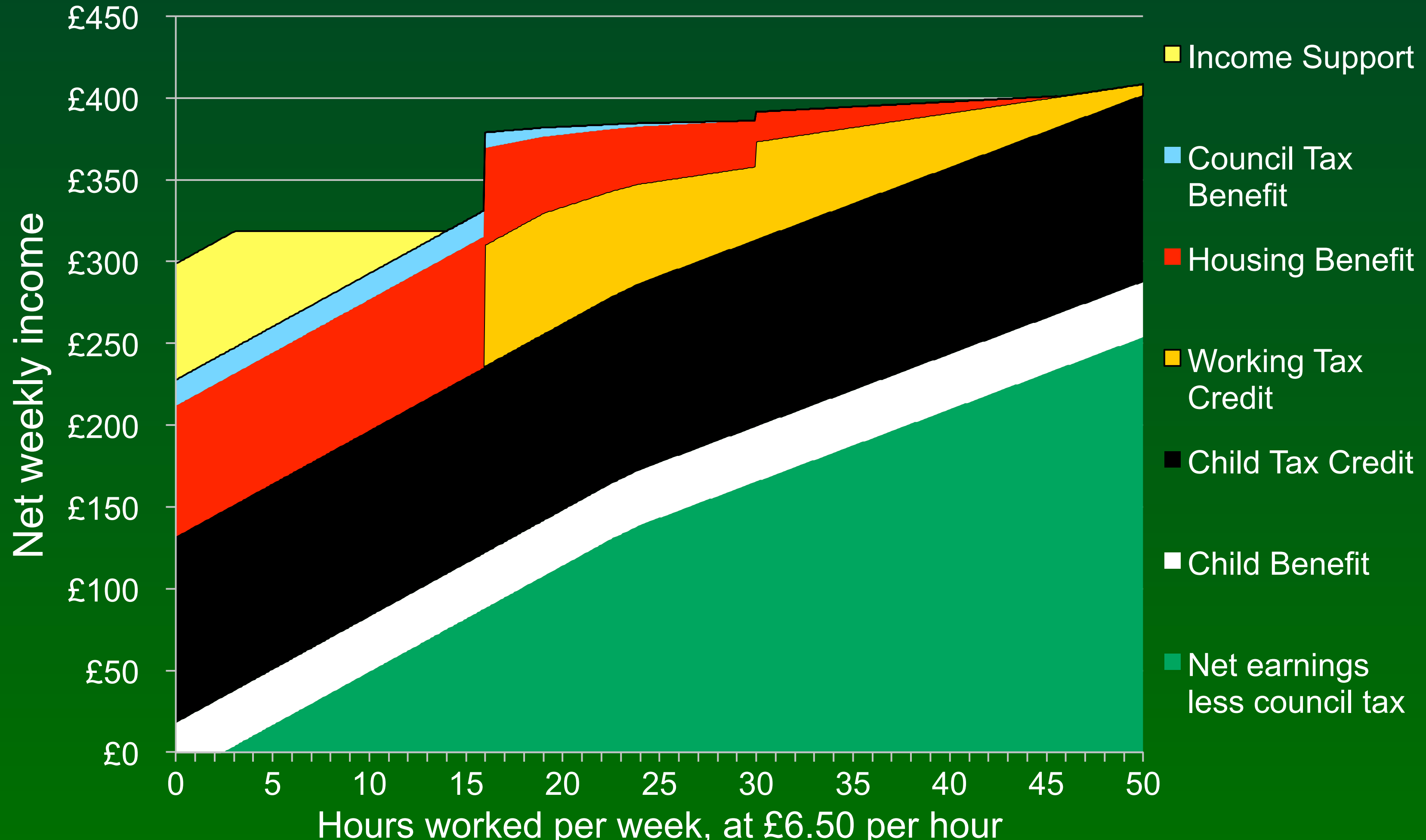
An example of the current system

Lone parent, 2 children, earning £6.50 per hour, £80/week rent



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Universal Credit and the tax system

- Universal Credit is unambiguously part of welfare system
  - Not ‘Universal Tax Credit’
  - No attempt at payment via employers
  - Administered by the Department for Work and Pensions
  - Assessed on monthly income

- But, ironically, now planning to draw on income tax administration
  - New requirement for employers to report pay & tax monthly
  - Use this ‘Real Time Information’ to adjust Universal Credit awards
  - Can they make this work smoothly?

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Conclusions

- Use what we know about how people respond to taxes
  - Mothers of school-age children and those around retirement age
  - For low earners, employment responds more than hours of work
  - Though policy always depends on distributional preferences
- Integrating separate but similar programmes is sensible
  - Want to support people with low resources and/or high needs
  - So have a single assessment of resources and needs
  - Avoid complicated interactions with perverse consequences
- Integrating taxes and transfers is harder
  - Intended to achieve different things, so assessed on different bases - short vs long run, individual vs family, relevant characteristics
  - ‘Approximate now, reconcile later’ problematic for those on low incomes
- Technology matters
  - Use it, but don’t rush it

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