

Integrating Personal Taxes and Benefits

The last chapter discussed how we might alter rates and thresholds of the existing set of taxes and benefits in order to improve work incentives where it matters most. In this chapter, we focus on reforms to the architecture of the system: the instruments used to implement taxation of earnings. Specifically, we look at whether and how the different direct taxes and benefits in the UK system might be integrated.

How the taxation of earnings, and the payment of benefits, are delivered matters. Taxes and benefits are costly for the government to administer and costly for taxpayers and benefit recipients to deal with; we would like to keep those costs as low as possible.

Effective delivery is also essential to ensure that people pay the tax, and receive the support, that policymakers intend. Tax evasion and avoidance, benefit fraud, innocent errors by government or individuals, and non-take-up of entitlements all prevent the tax and benefit system that is written down on paper from translating into outcomes in the real world.

To some extent, these kinds of frictions can be measured. For example, according to the UK government's most recent estimates:

- The government spends about 4p on administration for each £1 it pays out in working-age benefits and tax credits. Collecting income tax and National Insurance contributions (NICs) costs the government 1.24p and 0.35p respectively per £1 collected.¹

¹ Sources: Department for Work and Pensions, 2010b; HM Revenue and Customs, 2009. The figure for benefits and tax credits is only approximate, since the amounts spent on

- The cost to employers of operating PAYE (see Box 5.1) is around 0.6p per £1 paid.² Compliance costs for individuals who fall under self-assessment are unknown but likely to be far higher.³
- For every £1 of revenue from income tax, NICs, and capital gains tax, 5.4p is lost to evasion, avoidance, and error, while for every £1 of entitlements to benefits and tax credits, 3p is overpaid and 1p is underpaid due to error and fraud.⁴
- Out of each £1 of entitlements to means-tested benefits and tax credits, 20p goes unclaimed by eligible families.⁵

But keeping the delivery mechanism simple also matters for reasons that are harder to quantify. Transparency is a virtue in itself. We would generally prefer people to understand the consequences of their decisions. Transparency can also help to make work incentives effective. Carefully designed patterns of work incentives are of rather less value if people do not understand the financial implications of changing the work they do. And having a simple set of instruments makes it easier to achieve coherent policy design. Policymakers are only human; with a complicated set of interacting taxes and benefits, it is more likely that well-intentioned reforms will have unintended consequences, creating anomalies and an irrational rate schedule. Well-designed tools are easier to use.

administration are heavily rounded, HMRC's administration costs are a lower bound, and the administration costs seem to include the whole of Housing Benefit and Council Tax Benefit while the benefit spending might include only payments to working-age recipients.

² Sources: Cost of operating PAYE—HM Revenue and Customs (2010c); total PAYE receipts—HM Treasury (2010b).

³ The cost to individuals of claiming benefits and tax credits has never been quantified, but see Bennett, Brewer, and Shaw (2009) for a discussion.

⁴ Sources: HM Revenue and Customs, 2010a and 2010d; Department for Work and Pensions, 2010c. Note that tax credit overpayments and underpayments due to error and fraud are not the same as the much larger amounts that are overpaid and underpaid in the normal course of operation of tax credits but reconciled at year-end, as discussed in Section 5.3.1.

⁵ Source: Authors' calculations from Department for Work and Pensions (2010a) and HM Revenue and Customs (2010b). Midpoints of ranges used where point estimates not provided.

Box 5.1. PAYE

The Pay-As-You-Earn (PAYE) system of withholding income tax from earnings (and from private and occupational pensions) is unusual internationally in that it involves exact cumulative deduction: that is, when calculating tax due each week or month, the employer considers income not simply for the period in question but for the whole of the tax year to date. Tax due on total cumulative income is calculated and tax paid thus far is deducted, giving a figure for tax due this week or month. The cumulative system means that, at the end of the tax year, the correct amount of tax should have been deducted—at least for those with relatively simple affairs—whereas under a non-cumulative system (in which only income in the current week or month is considered), an end-of-year adjustment might be necessary.

About 85% of income tax revenue is collected through PAYE.^a Tax on some other sources of income such as bank interest is collected through a simpler withholding system that operates under the assumption that this income is not subject to higher-rate tax. Those with more complicated affairs—such as the self-employed, those with very high incomes, company directors, and landlords—must fill in a self-assessment tax return after the end of the tax year, setting down their incomes from different sources and any tax-privileged spending such as pension contributions or gifts to charity; HM Revenue and Customs will calculate the tax owed, given this information.

PAYE works well for most people most of the time, sparing two-thirds of taxpayers the need to fill in a tax return. However, in a significant minority of cases the wrong amount is withheld—typically when people have more than one source of PAYE income during the year (more than one job/pension over the course of the year, for example), especially if their circumstances change frequently or change towards the end of the year. Such cases can be troublesome to reconcile later on, which is one reason the government has embarked on a substantial, and potentially very important, PAYE modernization programme.^b

National Insurance contributions for earnings from employment are not an annual system; thus liability is calculated separately for each pay period, with neither cumulation during the year nor an end-of-year reconciliation.

^a Source: HM Treasury, 2010b, table C11.

^b On the PAYE modernization programme, see HM Revenue and Customs (2010c and 2010e). For an assessment of PAYE, see Shaw, Slemrod, and Whiting (2010) and the associated commentaries by Highfield (2010) and Mace (2010).

There are some basic principles against which we might want to assess mechanisms for delivering earnings taxation. We should probably aim to do the following:

- *Maximize transparency*: as few programmes as possible, as simple as possible. People should know what they are paying/receiving and ideally why (i.e. how it has been calculated).
- *Minimize the number of different returns or applications that must be submitted, and their length.*
- *Minimize the number of different things that need to be measured or calculated*: for example, avoid multiple definitions of income, assessment periods, and so on where possible.
- *Minimize duplication of information provision and processing*: do not collect the same income information, for example, for several benefits, tax credits, and taxes.
- *Deal with as few agents as possible*: for example, it is easier for the authorities to deal with one employer than many employees.
- *Ensure people are dealing with the same organization, and even the same named official, as much as possible.*
- *Obtain information from verifiable market transactions where possible*: for example, use payslips rather than self-declaration of income.⁶
- *Minimize 'gaps' between programmes*: for example, reduce delays between stopping payment of out-of-work benefits and starting payment of in-work benefits.
- *Ideally, avoid separating out a few people as needing to apply for special help*, which can be stigmatizing and demeaning.

These guidelines could inform many aspects of policy design at a level of detail we do not pursue here. However, one more general conclusion seems to follow almost directly from them: integrate separate but similar programmes into a single programme. The UK has a plethora of different taxes, tax credits, and benefits, apparently aiming to achieve very similar objectives. This makes the system complicated for people to understand and comply with, hard for the government to administer, and not conducive to

⁶ The crucial role of third-party monitoring as a deterrent to evasion is discussed in Kleven, Kreiner, and Saez (2009a).

coherent design and desirable outcomes. Simply reducing the number of separate schemes has the potential to bring improvements on almost every one of the criteria listed above. This chapter discusses the options for integrating parts of the tax system, parts of the benefit and tax credits system, and the tax system with the benefit system.

5.1. INCOME TAX AND NATIONAL INSURANCE⁷

The UK has two taxes on income—income tax and National Insurance contributions. Though different in origin, they are now very similar. Maintaining separate systems yields little benefit, but makes their combined effect less transparent and imposes extra burdens on employers, who must calculate earnings on two definitions, duplicate record-keeping, and so on. There is therefore an obvious case for merging them. Remaining differences between the two taxes could be retained if that were considered desirable (for example, a combined tax could be charged at a lower rate on items that are currently subject to one tax but not the other); but integration would underline the illogicality of most of the current differences between the two taxes and provide an opportunity to remove them. It is patently absurd, for example, to have one tax assessed on earnings in each individual pay period and another assessed on income over the whole year.

Successive governments have rejected integration of income tax and National Insurance (NI).⁸ The main reason given is the so-called ‘contributory principle’—the idea that NI is supposed to embody a form of social insurance in which contributions create rights to benefits. Certainly, NICs originated as a payment made in return for specific benefit

⁷ The discussion here draws heavily on work by Adam and Loutzenhiser (2007), who discuss these issues in more detail and provide full references.

⁸ As this text was being finalized, the government announced that it would consult on ‘options, stages and timing of reforms to integrate the operation of income tax and NICs’ (HM Treasury, 2011). At the time of writing, it is not clear what this might involve, but it seems that the crucial phrase is ‘the operation of’: initial indications are that reforms will be restricted to operational matters rather than more fundamental integration.

entitlements. But, in practice, the link between contributions and entitlements is now vanishingly weak. Contributions rise with earnings, benefits do not. By far the biggest NI benefit is the state pension. But it is now rather hard to live in the UK and not earn entitlement to a full basic pension. The unemployed, the sick, and those caring for children are credited with contributions, and recent changes mean that only 30 years of contributions or credits are required to earn a full pension. As a result, the government estimates that 90% of those reaching state pension age in 2025 will be entitled to the full pension.⁹ And those who are not entitled to full contributory benefits will often be fully, or almost fully, compensated through entitlements to means-tested benefits. The incremental value of additional NI benefits is often very small. There may be a case for a social insurance system. It is just that we don't have one.

This matters. If NI were real social insurance in which additional contributions earned additional benefits, there would be a case for keeping it separate from income tax. And there would be a case for analysing its effects on incentives and labour supply differently since it might act more like an insurance or savings vehicle than a tax. But that is not the world in which we find ourselves.

By simplifying the system, integration would bring two main benefits: reduced administration and compliance costs—likely to be significant, albeit difficult to quantify¹⁰—and greater transparency.

The tax schedule that people actually face on their earnings reflects the combination of income tax and NICs. Transparency requires that it is the combined schedule that should be described and debated. When politicians debate whether the current 20% basic rate, 40% higher rate, and 50% additional rate of income tax are appropriate, people should not have to

⁹ HM Treasury, 2007.

¹⁰ A report for the government (KPMG, 2006) put the incremental cost to employers of operating NICs on top of income tax at £179 million per year. But this study focused on only a narrow range of costs, excluding e.g. costs for employers associated with determining what their obligations were, dealing with changes, and tax planning, as well as all costs borne by employees, the self-employed, and the government itself. See Adam and Loutzenhiser (2007) and Shaw, Slemrod, and Whiting (2010) for more detail.

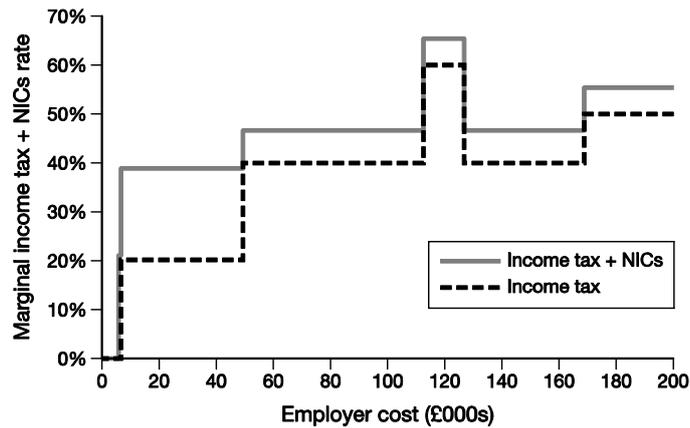


Figure 5.1. Combined income tax and NICs schedules for those aged under 65, 2010–11

Notes: Includes employer and employee NICs. Assumes individual not contracted out of State Second Pension.

remind themselves (or be reminded) that the true rate schedule includes NICs on top of that, nor should they have to do the calculations. It is rare in popular discourse to hear discussion of the 31%, 41%, and 51% rates that (in 2010–11) apply once employee NICs are taken into account, let alone consideration of the effect of employer NICs (or the different rate schedule that applies to the self-employed). Because attention is often restricted to headline income tax rates (which rise from 20% to 40% and then 50% at higher incomes), ignoring NIC rates (which fall from 11% to 1% for employees), the degree of progression towards the top of the distribution is easily overstated. Figure 5.1 shows that the gap between the rates of income tax alone and the combined effective rates of income tax, employee NICs, and employer NICs is much larger at modest levels of earnings than for high earners. The two lines convey quite different impressions.

Regrettably, governments may see the lack of transparency in the current system as a positive rather than a negative. Just one example of the way in which the separation of the systems can lead to confusion (to put it generously) was the Labour Party's 2001 general election manifesto. This included a pledge not to increase rates of income tax, but contained no such pledge on NICs. Labour was re-elected and, in its first Budget after the election, promptly announced an across-the-board increase in NIC rates. It is hard to believe that the government had decided after careful deliberation

that tax rates on earnings (subject to NICs as well as income tax) should increase but that the tax rate on other income (subject only to income tax) should not, and that the manifesto pledge had been intended to guarantee the latter while leaving open the former. Such an intention was certainly not made clear to the public during the election campaign. Whether the shortcoming was duplicity, incoherence, or merely poor communication, we should strive to make such episodes unrepeatable.

The separation of income tax and NICs is also an obstacle to making the combined rate schedule sensible and straightforward. For example, a simple combined rate schedule would have the thresholds for income tax and NICs aligned, so as to minimize the number of bands of earnings to which different rates applied. After many years of gradual convergence, the alignment of income tax and NI thresholds was finally announced in the 2007 Budget.¹¹ But only a few weeks after this had been implemented in April 2008, it became politically expedient to break it again. The government preferred to compensate losers from the abolition of the 10% tax rate by increasing income tax allowances alone, leaving NI thresholds unchanged. Further changes have been announced since then, so that from April 2011 income tax, employee NICs, and employer NICs will all become payable at different levels of earnings. The ease with which alignment was abandoned demonstrates that it is a poor substitute for genuine integration.

In so far as income tax and NICs are fundamentally the same, transparency and administrative simplicity would clearly be well served by merging them. But the differences that do remain between the two tax bases arguably make the case for integration even stronger.

Some categories of income are subject to income tax but not to NICs (or only to employer NICs): savings income, certain state benefits, most non-tradable forms of remuneration, gratuities, and the earnings and pension income of individuals over state pension age (or under 16).¹² These

¹¹ Subject to the significant limitations that the alignment was still between weekly thresholds for NICs and their nearest equivalents for an annually assessed income tax and that the two taxes continued to be levied on different bases.

¹² Similarly, some items are deductible for income tax but not for NICs: most importantly, employee pension contributions, but also e.g. employment-related expenses not reimbursed by

categories of income are in effect taxed at an intermediate rate, above zero but below the full (combined) rate charged on ordinary earnings. It may be that an intermediate tax rate is appropriate (for example, in the last chapter we suggested that there might be a case for applying a lower tax rate to older workers), though in practice it is hard to see a justification in most cases.¹³ But, at present, the level of the intermediate rate is an accidental by-product of decisions made for other reasons, driven largely by misperceptions that make NICs politically easier to increase than income tax.

The level of the intermediate rate applied to forms of income subject to one tax but not the other is not only an unintended feature of the system; it is also a particularly opaque one. If some forms of income are to be taxed at an intermediate rate, this treatment should be made explicit. A single integrated tax would achieve this, and thereby prompt open debate about whether each form of income should be taxed in full, not at all, or at an intermediate rate. The level and coverage of the intermediate rate are little discussed at present because they are largely invisible.

One central difference between income tax and NICs is that NICs are levied 'on employers' as well as 'on employees'. The previous chapters have made clear that this distinction in law and terminology has little economic significance. Both are taxes on earnings, driving a wedge between the cost to the employer of hiring someone and the take-home pay the employee receives. With a given overall tax wedge, employer cost and take-home pay will, in the long run, be determined by the supply of and demand for labour, not by whether the wedge in between is labelled an 'employer' or an 'employee' tax.

Aside from increasing administrative and compliance costs, having separate employer and employee taxes disguises the size of the overall tax wedge and hinders sensible discussion of the appropriate shape for the overall rate schedule. It invites people to treat the employer tax as somehow

the employer, the business-use component of assets used for both business and private purposes, and entertainers' agents' fees.

¹³ The appropriate tax regime to apply to savings and pensions is discussed in Chapter 14.

fundamentally different, or else to ignore it entirely. There is therefore a strong case for phasing out the employer contribution altogether, merging it with income tax and employee NICs to form a single tax levied on the individual.¹⁴ If we did not already have separate employer and employee taxes, we would certainly not want to introduce them.

That said, given where we start, such a transition would be painful. The immediate effect of an overnight shift from employer to employee taxes is that take-home pay would fall and employers' profits increase. Earnings would eventually rise to return take-home pay and employer cost to their previous levels, but this could take a long time. The transition could be made easier by announcing and publicizing the change well in advance of its implementation, allowing earnings to adjust in tandem with the shift; indeed, the government could explicitly advise employers and employees what adjustment to earnings would be needed to offset the reform. But it would still be likely to cause friction, particularly if there were a perception that employers were taking advantage of the reform to short-change their employees.

In addition, while the new regime would be simpler than the current one, the changes required to get there would not be simple. Offsetting the abolition of 12.8% employer NICs would not simply require a 12.8 percentage point increase in employee NICs. Because of the way employer NICs fit into the current system (specifically, being assessed sequentially rather than simultaneously, a distinction discussed in Section 5.3.2), it would require changes of different sizes to several rates and thresholds.¹⁵ Further adjustments, such as to the minimum wage and to certain state benefits, would also have to be considered.

¹⁴ The logic of the irrelevance of formal incidence suggests that they could equally well be merged into a single tax levied on the employer. This would not work, however, if we wished to levy a progressive tax on the individual's entire income, since, where someone has more than one income source (e.g. income from a second job or from savings), there is no good way to determine which slice of income falls within the tax base of any given employer.

¹⁵ Adam and Loutzenhiser (2007, 25) identified no fewer than nine adjustments that would be needed, and there would now be more. But that was for a shift from employer to employee NICs, holding everything else unchanged; if there were not separate income tax and NICs thresholds, and if tax credits were assessed on after-tax rather than before-tax income (both changes proposed in this chapter), then far fewer adjustments would be needed.

If such transitional difficulties were thought prohibitive, income tax and employee NICs could be merged while leaving a separate employer tax in place. But retaining an employer tax has a price beyond simply forgoing part of the benefits of integration. Since it is necessarily confined to employment income, it has consequences for the tax system as a whole. For example, suppose we wanted to apply the same overall tax schedule to all forms of income, not just employment income—something we will argue for in later chapters. Employment income is currently taxed more heavily than self-employment and capital income (and capital gains), largely because NICs apply only to earnings. For all forms of income to be subject to the same overall rate schedule, NICs or something equivalent to them would have to be extended to other forms of income. It is easy to see how this could be achieved for employee NICs, the scope of which could simply be extended. The same would apply to employer NICs if they too were brought within a merged tax. But if employer NICs were kept as a separate tax, it could apply only to employment income; so to achieve equal treatment, additional tax equivalent to employer NICs would have to be levied on capital income, self-employment income, and so on. This would add further complexity to the system, and it hardly seems politically appealing either. Whether it is a more attractive prospect than phasing out employer NICs and raising income tax instead is a moot point.

For the fiscal purist, a system with no separate employer payroll tax has strong attractions: it is simpler in itself, and makes it simpler to achieve coherence of the system as a whole. Political pragmatists may find the choice more finely balanced. Whether or not employer NICs remain separate, however, the case for some form of integration of income tax and NICs seems overwhelming.

5.2. INTEGRATING THE BENEFIT SYSTEM

The benefit and tax credit system is much more of a mess of complicated overlapping programmes than income tax and NICs. The list of programmes intended to provide support for low-income families currently includes Income Support, income-based Jobseeker's Allowance, income-based

Employment and Support Allowance, Housing Benefit, Council Tax Benefit, Pension Credit, Working Tax Credit, and Child Tax Credit—and these come on top of benefits intended to provide non-means-tested support for certain contingencies, such as Child Benefit, state pension, Winter Fuel Payment, contribution-based Jobseeker's Allowance, Disability Living Allowance, Carer's Allowance, and contribution-based Employment and Support Allowance. Many families claim several of these simultaneously.

One implication of there being so many programmes is that it is harder to achieve a sensible structure for the system as a whole. For example, the interaction of several means tests can create extraordinarily high effective tax rates on earnings for some people. The detailed rules are also different for different schemes (for example, what qualifies as 'work' and how income is measured), and there are swathes of complicated rules and design features that exist purely to deal with people claiming support under more than one scheme or moving from one scheme to another.

Another consequence of the plethora of programmes is that people often do not know what they are entitled to, let alone what they would be entitled to if their circumstances were different. Many out-of-work families are unaware that they could continue to claim Housing Benefit and/or Council Tax Benefit if they moved into low-paid work.¹⁶ People might therefore be discouraged from working by a perception of lost entitlements that exceeds the reality. And since many of those in work never find out that they can claim Housing Benefit and Council Tax Benefit, the support reaches only a limited proportion of the intended recipients: only around half of working families that are entitled to Housing Benefit claim it, compared with over 90% of non-working families.¹⁷ Similar problems arise because people do not realize that Working Tax Credit can be claimed by those without children and that Child Tax Credit can be claimed (for now) by those with relatively high incomes.¹⁸

Finally, the separation of the different programmes can lead to hassle for claimants and administrative problems for government. People have to make

¹⁶ Turley and Thomas, 2006.

¹⁷ Department for Work and Pensions, 2010a.

¹⁸ Up to £58,000 at the time of writing. See McAlpine and Thomas (2008) for details on people's understanding.

multiple applications, providing much the same information to different branches of government. Most benefits are the responsibility of the Department for Work and Pensions (DWP), but tax credits and Child Benefit are run by HM Revenue and Customs (HMRC), while Housing Benefit and Council Tax Benefit are administered by local authorities.¹⁹ And when families' circumstances change (starting work or recovering from illness, for example), not only do they often have to apply for support under a different scheme, but there is often a delay between the moment at which payment of one benefit ceases and the moment at which payment of another starts. This can lead to hardship for families at a time of transition and upheaval.

Of course, government agencies can take steps to ease the burden on claimants or to spread information. But such processes are costly, and most add to the complexity of the system rather than reducing it.

A more radical approach would be to integrate as many of these different structures as possible into a single benefit, with a coherent structure and a single set of rules. This is in fact an approach that was adopted in 2003 with the introduction of Child Tax Credit, which replaced all or part of no fewer than nine different benefits. Before 2003, families with children might have been entitled to Children's Tax Credit and/or Working Families' Tax Credit; furthermore, almost all other benefits, from Income Support to Incapacity Benefit to the Basic State Pension, included extra payments for children. The government's idea was to replace almost all of these child-related payments (though not universal Child Benefit) with a single means-tested programme. Thus the same programme would provide support for the vast majority of families with children from the time the first child was born to the time the youngest child became too old for eligibility, with entitlement continuing (albeit not at the same level) almost regardless of changing circumstances in the meantime. Since so many would be entitled, people would be more likely to know they were entitled and there would be less stigma attached to claiming; and since a single programme covered a wide variety of circumstances, people could be secure in the knowledge that their entitlement would continue even if their circumstances changed, with no

¹⁹ There are other variants too, such as war pensions operated by the Ministry of Defence and the Education Maintenance Allowance run by the Department for Education.

need to fill in different forms and no administrative problems moving from one programme to another.

The advantages of this approach are clear, and we see no reason why they should apply only to child-related support.²⁰ There is a strong case for integrating all means-tested support—and possibly non-means-tested benefits as well—into a single benefit. The basic purpose of all of the different benefits and tax credits is to provide support for families with high needs and/or low resources. The logical approach is therefore to make a single integrated assessment of a family's needs and a single integrated assessment of its resources, and compare the two.

An integrated benefit could share many features of the current system, if that were thought desirable. Maximum entitlement could consist of a basic allowance (replacing Income Support, income-based Jobseeker's Allowance, income-based Employment and Support Allowance, and Working Tax Credit), plus additional elements for children (replacing Child Tax Credit), old age (replacing Pension Credit), local housing costs (replacing Housing Benefit and Council Tax Benefit), and disability (replacing disability components of existing programmes). Existing non-means-tested benefits could either be merged in as well or be kept separate.

The level of benefit could be conditional on actively seeking work or other work-related activities (like Jobseeker's Allowance and some Employment and Support Allowance), on working a minimum or maximum number of hours (like Working Tax Credit and Income Support / Jobseeker's Allowance respectively), or on past behaviour such as years living in the UK, paying taxes/NICs, or caring for dependants (like contributory benefits). And the means test could involve any range of different withdrawal rates at different income levels for different groups.

An integrated benefit need not imply a higher or lower cost to the government, or any particular pattern of winners and losers. But integration would be an opportunity to make the design of the whole system simpler and

²⁰ The problems associated with the implementation of Child Tax Credit (and Working Tax Credit) in 2003 were caused not by this integration, but primarily by the government's decision to use a complicated assessment system that involved making retrospective adjustments to people's entitlements (as discussed in Section 5.3.1) and by severe problems with IT in the first few months; see Brewer (2006).

more coherent and to think about whether the system is well designed to achieve its objectives. The transparency brought about by integration would focus a spotlight on anomalies and help rationalize the system.

Perhaps the greatest opportunity afforded by benefit integration would be to rationalize the pattern of effective tax rates for those on low incomes. In the previous chapter, we showed that the highest effective tax rates are created by the simultaneous withdrawal of several benefits or tax credits, often in conjunction with income tax and NICs as well. Even if individual withdrawal rates are not especially high, in combination they can be enormous. Benefit integration opens up options for moderating the very highest effective tax rates without necessarily expanding means-testing overall. Very high and low effective marginal tax rates (EMTRs) would no longer arise arbitrarily as a result of the way that withdrawal of different benefits starts and finishes at different points.

Instead, the income level at which support started to be withdrawn could be set the same for everyone, and the rate of withdrawal could be the same for everyone and at all income levels until support was completely withdrawn; or they could vary systematically according to the total amount (or the specific elements) to be withdrawn or according to the characteristics of the family. In short, the means test could be rationally designed. Integration would not remove the need to make trade-offs of the kind explored in Chapters 3 and 4, but it would make achieving a sensible rate schedule much easier.

Of course, integration cannot remove all complexity. A single integrated benefit would surely have a long and complicated application form. But, as with income tax returns, most sections would be irrelevant for most people and could be skipped. Designing the process appropriately, making it as easy as possible, and using appropriate online technology would be crucial.

The case for benefit integration has become increasingly influential among policymakers and commentators, and numerous proposals have been put forward.²¹ In November 2010, the government announced plans to integrate all or most means-tested working-age benefits and tax credits into a new

²¹ For example, Freud (2007), Sainsbury and Stanley (2007), Select Committee on Work and Pensions (2007), Martin (2009), Centre for Social Justice (2009), Brewer, Saez, and Shephard (2010), and Taylor et al. (2010).

Universal Credit.²² This will be a highly complex operation but the prize is substantial enough to make these hazardous waters worth navigating.

5.3. THE JUNCTION OF TAXES AND BENEFITS

So far, we have discussed integration of income tax with National Insurance and integration of different benefits into a single one. The holy grail of integrated design, however, has always been the integration of taxes with benefits.

This finds its purest expression in proposals for a ‘negative income tax’ or for a ‘social dividend’ (as described in Section 3.2.1). The defining feature of such proposals is that there is no distinction between income taxation and benefit withdrawal; instead, there is just a single schedule for how payments vary with income. This could mean that support for low incomes is achieved through tax refunds (as in the negative income tax) or that benefits are paid to everyone regardless of income, with tax rates correspondingly higher in order to finance them (as in the social dividend). Although typically described with a single flat tax rate and a single level of support for those with no private income, these systems can easily be modified to allow more than one tax rate and/or payments that vary with household characteristics.

The attractions of integrating taxes with benefits are similar to those of integrating taxes or benefits more narrowly: it makes the rate schedule more transparent, and hopefully more coherent as a result; and it removes the need to separate out means-tested benefits as a special mechanism whereby poor people must suffer the hassle and perceived indignity of asking the state for a handout.

The main barrier to integration in the UK is that the bases of assessment for taxes and benefits differ in two ways that make them hard to reconcile:

²² Department for Work and Pensions, 2010d. See Brewer, Browne, and Jin (2011) for a preliminary analysis. The proposals are contained in the 2011 Welfare Reform Bill, which is before Parliament at the time of writing.

- First, income tax is largely based on individual income, while benefits and tax credits are assessed on the basis of a couple's joint income. A combined system could not be both at once.²³
- Second, income tax depends on actual annual income, in the sense that liability for a given year depends on income in that year. Benefits—particularly those providing a safety net for those with no other income—are usually assessed on a much shorter time horizon, typically on a week-by-week basis. The UK's attempt (discussed in Section 5.3.1) to provide tax credits for low-income families using a within-year income assessment, while remaining responsive to changing characteristics, shows how thorny this problem can be.

Of course, these differences in unit and period of assessment are not immutable. But there are good reasons for each. Tax payments should reflect individuals' overall ability to pay, best gauged by their income over a relatively long period. Benefits, on the other hand, are intended to meet immediate need: they should provide support to people in temporary hardship even if their income in other periods is higher.

The case for assessing benefit entitlement on a joint basis is also strong—it would be very expensive indeed for the state to provide support through the benefit system to individuals with high-income partners.

The case for using the individual, rather than the couple, as the basis for income taxation is less clear-cut. There are trade-offs. As we discussed in Chapter 3, a tax system cannot simultaneously be progressive, neutral towards marriage (or cohabitation), and tax all families with the same joint income equally. Individual taxation ensures that the tax system (unlike the benefit system) is neutral over marriage and partnership decisions—tax bills are not affected by marital status or cohabitation. But it does not tax families with the same joint income equally. Couples where incomes are unequally shared face higher tax bills than those where the two partners have similar incomes. There are incentives to ensure that income is received by the

²³ The distinction between individual and joint assessment collapses only in the special case of a single flat tax rate and a social dividend / break-even point that is twice as high for couples as for single people; governments might reasonably not want to accept such severe restrictions on the pattern of distribution and incentives they can achieve. See Adam and Brewer (2010).

spouse facing the lower marginal rate—particularly important for investment incomes and for those running small businesses. An individual basis for taxation also means that a couple will pay the same amount in tax as two single people with the same incomes, despite probably benefiting from some economies of scale in the household budget.

Ultimately, the choice between individual and joint taxation depends on political value judgements about how far people should be viewed as independent individuals and how far as couples. Rather than making a judgement of our own, in this book we simply take the current individual, annual assessment for taxes and joint, short-term assessment for benefits as given. In these circumstances, there is certainly no scope for full integration, but is there scope for making them fit together better? Routes to this target could involve either greater administrative integration or integration of the rate schedules.

5.3.1. Administrative Integration

The main feature of proposals for administrative integration tends to be the withdrawal of means-tested support through the tax system. Benefit withdrawal would not become indistinguishable from taxation—as now, benefits would be withdrawn until they were exhausted and thereafter only tax would be payable—but the two processes would be administratively combined.²⁴ Some proposals involve giving all claimants the maximum entitlement for their circumstances (that is, the amount they would be entitled to if they had no private income) and then using the tax system to administer the means test, clawing back ‘excess’ benefits from those with incomes high enough to reduce their entitlement. Other proposals involve using the tax system not just to withdraw ‘excess’ benefits but actually to pay out benefit entitlements, ‘netting off’ income tax and benefits so that employers pay wages with a single addition/deduction reflecting a net contribution from/to state coffers.

²⁴ This was a feature of the proposals of Dilnot, Kay, and Morris (1984), and more recently those of the Select Committee on Work and Pensions (2007), Centre for Social Justice (2009), and Brewer, Saez, and Shephard (2010).

But benefits and tax credits, unlike income tax, depend on a couple's joint income and on a range of other characteristics such as number of children, childcare costs, housing costs, and disability. Providing such support through the tax system—or ensuring that withdrawal of support stops at the right point—would require the tax system to respond to all these characteristics. The challenge is much greater now that it is the norm for couples to have two earners. If the right amount of support could not be delivered at the right time, underpayments and overpayments would presumably have to be rectified following an end-of-year reconciliation.

Tax credits in the UK have provided two instructive experiences in this context, illustrating both the difficulty of achieving administrative improvements and the problems that can arise if entitlements are not delivered accurately at the point they arise:

- When first introducing tax credits in 1999–2000, the then government considered integrating their administration with income tax by delivering tax credits through PAYE codes, but concluded that 'PAYE codes could not deliver the necessary accuracy and reliability'.²⁵ However, the government remained committed to paying tax credits via employers where possible, in order to make them look and feel like part of the tax system, so instead the government calculated entitlement and simply told employers how much to adjust salary payments. This 'effectively added an additional link in the payment chain without simplifying administration', and, faced with high administrative and compliance costs, payment via employers was abandoned in 2006.²⁶
- A new system for calculating and paying tax credits, adopted in 2003, based entitlements on circumstances in the current year, like income tax. It was intended to be responsive, with claimants encouraged (and, in some cases, obliged) to notify HMRC when their circumstances changed. But since claimants did not usually inform HMRC of changes in circumstances as they happened, provisional payments were based on past information, generating underpayments and overpayments to low-income families on a large scale. When actual circumstances had been confirmed,

²⁵ Inland Revenue (1999, 5), cited in Shaw, Slemrod, and Whiting (2010, 1140).

²⁶ Shaw, Slemrod, and Whiting, 2010, 1140.

typically at the end of the year, these underpayments and overpayments were corrected. The recovery of overpayments in particular gave rise to widespread discontent and in many ways undermined the whole tax credit system, providing a salutary warning of the dangers of relying on an 'approximate now, reconcile later' approach to support for low-income families. Reforms introduced in 2006 somewhat reduced the problem of overpayments, but at the cost of increasing the extent of underpayments, further increasing the complexity of the system, and retreating from the responsiveness that was supposed to be the hallmark of the 2003 reform.²⁷

The current UK income tax system is not well suited to making and withdrawing payments that need to adjust rapidly to changes in the recipient's circumstances and that depend on the income of the recipient's partner, the number of children, and potentially many other characteristics. That said, technology is advancing apace. As it becomes easier to transfer large amounts of information in real time, this should open up new ways to join up the administration of benefits with that of taxes. Recently suggested reforms to the PAYE system²⁸ would move in this direction. If employers (and others) who withheld tax notified HMRC monthly of their payments to each individual, it might become possible to link that information to any partner's income information and use it to check and adjust benefit awards. The longer-term suggestion that the government, rather than employers, would calculate and deduct income tax and NICs raises the distant prospect that the administration of tax and benefits could be more profoundly integrated. Full administrative integration does not seem practical at present, but administrative improvements should certainly be sought.

5.3.2. Integrating Rate Schedules

A common complaint is that many people both pay taxes and receive benefits. The complaint is understandable: it is natural to think that a situation in which the government gives someone £100 while simultaneously

²⁷ See Brewer (2006) for details and analysis.

²⁸ HM Revenue and Customs, 2010c.

taking £50 from them (or vice versa) could be improved upon. There are attractions to approaching this in a more fundamental way than simply looking for administrative reform. Could income tax liability start only after benefits have been completely withdrawn?

Unfortunately, such a move would be hampered by just the same differences between the bases for taxes and benefits that we have already discussed.

The different assessment periods mean that some people with moderate incomes over the course of a year—enough to bring them into the income tax net—might still have periods in which their income is low enough to qualify for means-tested support (which is precisely the intention of policymakers).

More important is the fact that benefits and tax credits, unlike income tax, depend on family income and a range of other characteristics. To have no one paying tax and receiving benefits at the same time, the income level at which tax became payable would have to be at least as high as the income level at which benefit entitlement ran out. But the benefit run-out point varies widely according to family circumstances. In the UK in 2010–11, for a single under-25-year-old with no children and no housing costs, entitlement would run out at an income of less than £3,000 per year; in contrast, a working family spending £300 a week on formal childcare for their four children could have an annual income of over £70,000 and still be entitled to tax credits. Unless tax allowances are to vary with personal circumstances in similarly complicated ways, removing all overlap would require a tax allowance at least equal to the highest possible run-out point. Increasing the tax allowance to achieve this would, of course, be prohibitively expensive, and cutting benefits and tax credits dramatically enough to achieve it is equally implausible.

As long as taxes are assessed on a different basis from benefits, it is inevitable that they remain separate entities and that some people will face both tax and benefit withdrawal. The number of people in that position could be reduced—either by reducing the number paying tax or by reducing the number eligible for benefits—but the options for doing so all have downsides. For example, raising the income tax allowance and NICs thresholds to £10,000 (from their starting points of £6,475 and £5,720 respectively) in 2009–10, holding fixed the point at which higher-rate tax

becomes payable, would cost in the order of £40 billion (ignoring any changes to behaviour in response to the reform). Doing so would reduce the numbers entitled to means-tested benefits or tax credits while also paying tax by around 1.8 million, just a fifth of the total number in that position. Whatever its other merits, increasing the personal allowance is an enormously costly way to reduce the overlap between taxes and benefits.

Given this, one useful guideline which can help avoid the highest EMTRs is to make the income assessments sequential rather than simultaneous:²⁹ in other words, to calculate one of them on income measured after the other, rather than using the same income measure for both. If there is one tax and one means-tested benefit, this means either means-testing on after-tax income or making the benefit taxable. This makes the combined EMTR less than the sum of its parts.

Table 5.1 illustrates how this would work for someone earning an extra £100 if we had a tax rate of 31% (the current basic rate of income tax plus employee NICs) and a withdrawal rate of 39% (the current tax credit withdrawal rate). If the tax and the benefit were assessed simultaneously—both based on gross earnings—then someone facing both tax and benefit withdrawal would have an EMTR of 70%,³⁰ leaving them with only £30 from an extra £100 earned. But if, instead, they were assessed sequentially, the individual would be left with £42, an EMTR of only 58%.³¹

Table 5.1. Sequential versus simultaneous income assessments

	Simultaneous assessment	Tax assessed first (means test on after-tax income)	Benefit assessed first (benefit taxable)
Extra earnings	£100	£100	£100
Extra tax due	31% of 100 = £31	31% of 100 = £31	31% of (100-39) = £19
Benefit withdrawn	39% of 100 = £39	39% of (100-31) = £27	39% of 100 = £39
Extra net income	100 - 31 - 39 = £30	100 - 31 - 27 = £42	100 - 19 - 39 = £42

²⁹ Or multiplicative rather than additive.

³⁰ $0.31 + 0.39 = 0.7$.

³¹ $1 - (1-0.31) \times (1-0.39) = 0.58$.

Sequential assessment can sometimes be more complicated to understand and administer than simultaneous assessment, but its advantages in terms of moderating the highest EMTRs are clear from this example. And in situations with more than one tax and/or more than one means test, making sequential rather than simultaneous income assessments becomes even more important. If we added a 65% Housing Benefit withdrawal rate into the example above, the combined EMTR would rise from 70% to 135% under simultaneous assessment, but ‘only’ from 58% to 85% under sequential assessment.

Sequential assessment makes it impossible for individual withdrawal rates below 100% to combine into overall EMTRs above 100%. EMTRs above 100% were a problem in the UK before 1988, when income tax, employee NICs, and various means tests all operated simultaneously. Happily, much of the UK tax and benefit system does now operate sequentially. Employer NICs are first in sequence: all other taxes and benefits are assessed on earnings excluding (i.e. after deducting) employer NICs. The main means-tested benefits are assessed on income after deducting income tax and NICs and after adding tax credits. (And VAT is automatically last in sequence, since the money people spend is their disposable income after all taxes and benefits.)

The most significant case of simultaneous assessment now to be found in the UK is that tax credits are assessed on pre-tax income—a change introduced in 2003 which seems a step in the wrong direction.³² Reversing this would be a well-targeted way to reduce the highest EMTRs—much better targeted than simply reducing individual tax or withdrawal rates—since it addresses precisely the interaction between different taxes, tax

³² In fact, the then government reduced the tax credit withdrawal rate from 55% to 37% at the same time as introducing simultaneous assessment, to keep the combined EMTR at 70% for someone on the tax credit taper who was also paying basic-rate income tax and employee NICs. But for those not paying income tax (or paying it at the 10% starting rate which applied then), this was a genuine reduction in their EMTR, and thus a giveaway: in other words, rather perversely, the reform spent money on reducing EMTRs for everyone *except* those facing the highest EMTRs. This money could have been spent more efficiently by reducing the withdrawal rate from 55% while continuing to assess on net income, thus cutting EMTRs for all those facing tax credit withdrawal, including those paying tax as well and therefore facing the highest EMTRs of all.

credits, and benefits, which is what gives rise to the highest EMTRs. The effect is that shown in Table 5.1: it would reduce the EMTR from 70% to 58% for someone facing tax credit withdrawal at the same time as paying income tax and NICs, while not spending money to reduce EMTRs for those facing one but not the other.³³ Moving to sequential assessment delivers improvements where they are most needed.

The choice between simultaneous and sequential assessment affects more than just the EMTRs of those facing more than one assessment. For example, making benefits taxable is a reduction in generosity, and assessing them on after-tax income is an increase in generosity, to those who both pay tax and receive benefits. Offsetting this by simply adjusting tax or benefit rates would affect all taxpayers or all benefit recipients, not just those who fall into both categories. Some wider distributional and incentive effects are therefore inevitable, although with judicious adjustments to rates and thresholds of different taxes and benefits they can be kept small.

The UK already uses sequential assessment in most cases, and while, ‘pound for pound’, changing the measure of income on which tax credits are assessed would be a well-targeted measure, it is not a major reform and would not generate large improvements. The priority in terms of rationalizing the rate schedule and avoiding the highest EMTRs should be to integrate the different benefits and tax credits as discussed in Section 5.2—tackling the problem of people facing withdrawal of multiple strands of support at its source rather than just mitigating the worst of its consequences.

³³ This reform would also reduce EMTRs for those facing benefit withdrawal as well and therefore subject to even higher EMTRs at the moment: it would reduce the EMTR from 90% to 85% for those also facing Housing Benefit withdrawal; from 76% to 66% for those also facing Council Tax Benefit withdrawal; and from 96% to 94% for those facing both Housing Benefit *and* Council Tax Benefit withdrawal as well as income tax, NICs, and tax credit withdrawal. For consistency with the simple illustration in Table 5.1, these figures ignore employer NICs and indirect taxes.

5.4. CONCLUSIONS

The way in which any chosen rate schedule is delivered really matters. It matters particularly for those on low incomes who face the day-to-day complexity of the benefit system and may have the least ability to deal with it. The chaos—and that is not too strong a word—that accompanied the administration of tax credits in the UK after 2003 is just one of the most salient examples of the cost of getting policy and delivery wrong.

The UK has two separate taxes on earnings, their separation serving little purpose save to obscure the true effective marginal tax rate and increase employers' administrative burdens. We have multiple benefits designed to achieve the same objective—to provide an income to people currently unable to support themselves in the labour market. The benefit system, tax system, and tax credit system are designed and operated largely in isolation from each other. Indeed, different parts of the benefit system are administered separately and do not join together properly. This piecemeal approach is costly for the people dependent on benefits, it is costly for employers, and it dampens the effectiveness of reforms to the rate schedule designed to improve work incentives.

In this chapter, we have set out several changes to the UK tax and benefit system that would help:

- Income tax and employee NICs—and perhaps employer NICs as well—should be integrated into a single tax.
- As many benefits as possible, and certainly the main means-tested benefits and tax credits, should be integrated. But these integrated benefits should remain separate from the income tax.
- Having argued that the tax and benefit systems should remain separate, and accepting that achieving only one tax and one benefit may not happen in the short run, we should also ensure that we avoid the extremely high EMTRs that arise when multiple benefits overlap, or overlap with the tax system. We therefore recommend that, where possible, individual taxes and benefits should be assessed sequentially, not simultaneously. The most immediate reform that implies is that tax credits should be assessed on after-tax income (with appropriate adjustments to the rates and thresholds of tax credits, or indeed income tax, if they were thought necessary).

Finally, it is worth saying something here about the role of policymakers in delivering a transparent system. Structural integration might avoid, for example, the unfortunate experience of ‘keeping’ promises not to increase income tax rates and then promptly increasing the largely equivalent NICs rate. But incoherent rate schedules—such as those emanating from the tapering-away of allowances described in the last chapter—would still be possible however much integration there is. And no amount of administrative simplification and integration can stop a government using fiscal drag or other hidden measures to raise taxes in opaque ways. The number of higher-rate income tax payers in the UK has increased almost unnoticed from 763,000 in 1978–79 to 3.3 million in 2010–11,³⁴ in large part because governments have quietly failed to index thresholds in line with growing earnings, and the number is on course to rise more quickly in future as higher-rate tax affects increasingly dense parts of the income distribution.³⁵

In the end, if government chooses obscurity and incoherence over transparency and coherence, we are all losers. Too often, governments have chosen the wrong path.

³⁴ Sources: HMRC statistics, table 2.1, http://www.hmrc.gov.uk/stats/income_tax/table2-1.pdf; *Inland Revenue Statistics 1994*.

³⁵ Projections by Browne and Phillips (2010) suggested that there would be 5.4 million higher-rate taxpayers by 2015–16. This rise reflects pre-announced real cuts to the higher-rate threshold as well as ‘normal’ fiscal drag. Since this projection was made, the June 2010 emergency Budget announced cuts to the higher-rate threshold, which will increase the number even further.