SEPTEMBER 2006

findings INFORMING CHANGE

The poverty trade-off: work incentives and income redistribution in Britain

Two strategies that governments have to help people on low incomes – providing them with financial support directly, and encouraging them to earn more – generally conflict. This study, by Stuart Adam, Mike Brewer and Andrew Shephard of the Institute for Fiscal Studies, provides new evidence on the trade-off. It finds that:

- Two aspects of financial work incentives are important: the incentive to be in work at all, and the incentive to progress in work (i.e. increase earnings).
- Work incentives are most weakened through the withdrawal of means-tested benefits and tax credits, not through high rates of income tax. Over two million workers in Britain stand to lose more than half of any increase in earnings to taxes and reduced benefits. Some 160,000 would keep less than 10p of each extra £1 they earned.
- Both incentives to work at all and incentives to earn more have strengthened, on average, since 1979. However, this strengthening has not been even over time, and work incentives have weakened on average since 2000. Not all changes in work incentives arise through reforms to taxes and benefits – wage growth and rent levels are also important, for example – but changes to income tax, employee National Insurance contributions, council tax, tax credits and benefits alone strengthened work incentives on average under the Conservatives and have weakened them under Labour.
- Simulations of hypothetical changes to taxes and benefits confirm that no easy solution exists to the trade-off between improving work incentives and redistributing income. Using universal benefits to redistribute income is very expensive, and using means-tested benefits damages the incentive to work; tax cuts tend to improve work incentives but do little to help people on low incomes directly. Ultimately, governments need to decide how much they want to redistribute income to low-income households, and how much they mind if people work a little less as a result.
- The Government has explicit and tough targets for cutting child poverty further. Its current strategy of increasing the child element of the child tax credit is effective at reducing poverty directly, but its indirect effect might be to increase poverty through weakening incentives for parents to work.

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There is generally a conflict between redistributing income and strengthening financial work incentives. Yet while there has been a great deal of research analysing and explaining trends in poverty and inequality, very little has been done to quantify work incentives in a similar way, or to examine in detail their relationship with redistribution in Britain. This study asks what has driven changes in work incentives since 1979, and how this compares with trends in poverty and inequality. It also looks at how various policy options for the future affect the distributions of both income and work incentives.

Measuring work incentives

The study quantifies two important aspects of financial work incentives:

The reward for working compared with not working
This can be measured by the *replacement rate* (out-of-work income as a proportion of in-work income, where income is measured after taxes and benefits) or the *participation tax rate* (the proportion of gross earnings lost in tax and withdrawn benefits). High numbers of either of these represent weak incentives to be in work; this situation is often referred to as the *unemployment trap*.

The incentive for those in work to progress, i.e. earn more
This can be measured by the *effective marginal tax rate* (EMTR), the proportion of a small increase in earnings that is lost in tax and withdrawn benefits. High EMTRs amongst workers in low-income families are often referred to as the *poverty trap*.

The study's measures of incentives incorporate income tax, employee National Insurance contributions, council tax, tax credits and social security benefits; they do not take account of taxes formally incident on companies (such as employer National Insurance contributions) or indirect taxes.

Work incentives in Britain

Table 1 shows the sort of EMTRs faced by workers in 2005. More than three-fifths of working adults have EMTRs between 30 and 40 per cent, mostly people paying basic-rate income tax and standard rate National Insurance contributions and with a family income sufficiently high that they are not facing withdrawal of means-tested benefits or tax credits.

More than two million working adults in Britain have EMTRs above 50 per cent, meaning that they get to keep less than half of any small increase in their earnings. The vast majority of these adults live in families with income such that they face withdrawal of means-tested benefits or tax credits. It is this withdrawal that is responsible for the weakest work incentives, not high rates of income tax. At the extreme, someone with a non-working partner, renting, paying council tax and working 35 hours per week at the minimum wage, would get to keep only 4$^{1}/_{2}$p of each extra £1 they earned, as the rest would be taken in income tax, National Insurance contributions and withdrawal of tax credits, housing benefit and council tax benefit.

Different groups in society face different work incentives. Lone parents face some of the weakest incentives to work at all, and face weak incentives to earn more, because many will be subject to withdrawal of a tax credit or means-tested benefit as their earnings rise: over two-thirds of working lone parents face an EMTR in excess of 50 per cent. On the other hand, single adults without children face some of the strongest incentives, mostly because they are entitled to relatively little support when they do not work, and because they are not likely to be entitled to tax credits or means-tested benefits when they are in work. People living with a partner and with dependent children tend to have weaker work incentives in general than those without children, partly because they are more likely to be older and earn more, and therefore subject to the higher rate of income tax, but also because they are more likely to be subject to tax credit withdrawal.

Both incentives to work at all and incentives to progress have strengthened, on average, since 1979, but have weakened on average since 2000. Only part of these changes in work incentives are the direct result of tax and benefit reforms: changes in average wages, wage inequality, rent levels and working patterns within two-adult families are also important explanatory factors. Separating out these various factors shows that real changes to income tax, employee National Insurance contributions, council tax, tax credits and benefits since 1979 have strengthened work incentives on average, although the precise trends vary by family type. Overall, reforms under the Conservatives acted to strengthen average work incentives whereas Labour's reforms to date have weakened financial work incentives on average: since 1999, tax and benefit changes have increased the average EMTR by almost three percentage points. However, these trends have not been uniform: the Conservatives' reforms weakened work incentives for a period in the early 1980s, and Labour's reforms have strengthened incentives to progress for some groups facing the weakest incentives.

Table 1: **Effective marginal tax rates (EMTRs) among working adults in 2005**

EMTR band	Number with EMTR within this band	EMTR range	Number with EMTR in this range
0%	560,000	All	17,800,000
0.1% - 10%	110,000	Over 0%	17,240,000
10.1% - 20%	250,000	Over 10%	17,130,000
20.1%–30%	1,640,000	Over 20%	16,880,000
30.1%–40%	10,900,000	Over 30%	15,240,000
40.1%–50%	2,130,000	Over 40%	4,340,000
50.1%–60%	240,000	Over 50%	2,210,000
60.1%–70%	1,390,000	Over 60%	1,970,000
70.1%–80%	180,000	Over 70%	580,000
80.1%–90%	240,000	Over 80%	400,000
90.1%–100%	120,000	Over 90%	160,000
Over 100%	40,000	Over 100%	40,000
All	17,800,000		

Notes and sources: Authors' calculations using Family Resources Survey (FRS) 2002–03 and TAXBEN under April 2005 tax and benefit system. Excludes families containing any adults aged over 55, self-employed, or receiving a disability benefit. Figures grossed up using FRS weights and rounded to nearest 10,000. Numbers may not add because of rounding. EMTRs calculated by increasing hours of work by 5%.

The trade-off between income redistribution and work incentives

While financial work incentives have strengthened on average since 1979, relative poverty and inequality have increased. Often they have seemed to move in step, work incentives strengthening most in years when poverty and inequality rose most. However, this should not simply be interpreted as the redistribution/work incentives trade-off in action: many things other than tax and benefit policy affect work incentives and the income distribution. Indeed, analysis appears to show that real tax and benefit changes alone acted both to improve work incentives and to reduce poverty and inequality – although it would be equally naïve to conclude that no policy trade-off exists. There are simply too many complications and conflicting influences at work to draw firm conclusions about the policy trade-off from broad historical trends.

Simulations of particular reforms can be more informative about the policy trade-off. This project simulated the effects of nine tax and benefit reforms on measures of financial work incentives and the income distribution. All of the changes cost the same amount of money, £2.2bn, ignoring the revenue impact of any change in behaviour that the reforms might induce; and the researchers also considered the impact of a 1/2 percentage point increase in all rates of employee and self-employed National Insurance contributions, which raises about the same sum.

Using universal benefits to redistribute income is very expensive, and using means-tested benefits weakens work incentives; tax cuts tend to strengthen work incentives but do little to help those on low incomes directly. The Government has explicit and tough targets for cutting child poverty further: its current strategy of increasing the child element of the *child tax credit* is effective at reducing poverty directly, but its indirect effect might be to increase poverty through weakening incentives for parents to work. Increasing *working tax credit* would encourage adults in workless families to work, but weaken incentives to progress by increasing the range of earnings over which workers face a withdrawal of tax credits; it would also weaken the incentive for families to have two workers. *Housing benefit* recipients face some of the weakest work incentives, and a reform in keeping with changes since 1997 would be to cut the 65 per cent withdrawal rate. This would help some families on low income, and strengthen incentives to progress for those currently facing housing benefit withdrawal, but its impact is not unambiguously good because a cut in the withdrawal rate would mean that many more families would become entitled to housing benefit and therefore see incentives to progress weaken.

A different way of redistributing income is to direct money to the sort of families who are likely to be poor, rather than directly to those that are poor. One example would be an *extra credit for families with three or more children*: this would be well-targeted on the poorest children, and would hardly affect work incentives. This approach does escape the trade-off between income redistribution and work incentives, but it is not without drawbacks: it might be considered unfair on those who are poor but do not fit into the categories usually associated with poverty, and it might affect families' child-bearing decisions.

This comparison does not suggest an obvious way forward. The best policy depends partly on how far different types of people respond to incentives – something that was beyond the scope of this project to assess – and ultimately on how much governments care about different types of people: rich and poor, singles and couples, those with and without children.

The Government argues that its 'making work pay' strategy is designed to tackle both the unemployment trap and the poverty trap, although its targets relate specifically to employment rates: the Government has an aspiration to raise the working-age employment rate to 80 per cent (from around 75 per cent now), and for particular disadvantaged groups to catch up with this. This research says little about the effectiveness of some of the measures to strengthen work incentives that are either being piloted now or have recently been announced, including reforms to incapacity benefits, plans to increase the state pension age, and the New Deal Plus for Lone Parents. This is either because these measures affect older workers or disabled people, who are excluded from this project because their work incentives are difficult to model and their work incentives raise rather different issues from the main subject of this report; or because the reforms involve time-limited changes to financial work incentives. Targeted measures such as these, though, may well be an important part of future reforms to 'make work pay' under the current government.

About the project

The project team comprised Stuart Adam, Mike Brewer and Andrew Shephard of the Institute for Fiscal Studies. Much of the analysis is based on measures of incomes and work incentives produced by the IFS tax and benefit micro-simulation model, TAXBEN, using data from the Family Resources Survey (1994–95 to 2002–03) and the Family Expenditure Survey (1979 to 2000–01). The analysis is restricted to families living in Great Britain in which no one is aged over 55 or receiving a disability benefit.

For more information

More information can be obtained by contacting Stuart Adam, Institute for Fiscal Studies, 7 Ridgmount Street, London, WC1E 7AE, 020 7291 4800.

The full report, **The poverty trade-off: Work incentives and income redistribution in Britain** by Stuart Adam, Mike Brewer and Andrew Shephard, is published for the Foundation by The Policy Press.

A companion report produced for this project containing more detailed analysis of work incentives by the same authors, *Financial work incentives in Britain: comparisons over time and between family types*, is available from www.ifs.org.uk/projects_research.php?project_id=60 The impact of increasing the child tax credit on work incentives as part of a possible strategy to reduce child poverty is also shown in *Micro-simulating child poverty in 2010 and 2020* by Mike Brewer, James Browne and Holly Sutherland.

Published by the Joseph Rowntree Foundation, The Homestead, 40 Water End, York YO30 6WP. This project is part of the JRF's research and development programme. These findings, however, are those of the authors and not necessarily those of the Foundation. **ISSN 0958-3084**

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