BUDGET 98

The Modernisation of Britain's Tax and Benefit System

Number Two

Work incentives: A Report by Martin Taylor

CONTENTS

FOREWORD

BY THE CHANCELLOR OF THE EXCHEQUER

We entered Government with a pledge to examine the interaction of the tax and benefit systems so that they could be streamlined and modernised so as to fulfil our objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening family and community life. Last May I asked Martin Taylor, Chief Executive of Barclays plc, to look at options for reform. This report sets out his proposals.

Martin's contribution has been invaluable. He has been closely involved throughout with the development of our thinking and I am sure that this report will prove to be an important milestone on the road to modernising Britain's tax and benefit systems.

Gordon Brown

GORDON BROWN

SUMMARY AND CONCLUSIONS

1.01 What follows is a report on the workings of the Task Force set up in May 1997 under my chairmanship to advise on the reform of the tax and benefits systems. It is intended to provide information on the workings of the Task Force and the way in which it has arrived at its conclusions.

1.02 I was asked by the new Chancellor of the Exchequer, Gordon Brown, to help provide input into policy making for what seemed likely to be a crucial area of concern for the new Government. My formal terms of reference arose from the Manifesto commitment to: ". . . examine the interaction of the tax and benefits systems so that they can be streamlined and modernised, so as to fulfil our objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening community and family life".

1.03 This clearly represented a very broad field of endeavour, and one in which many arms of Government were interested. The Task Force was therefore composed, apart from myself, of officials drawn from four departments: HM Treasury, the Department of Social Security, Inland Revenue and the Department for Education and Employment. This report is, however, my responsibility; hence the use of the first person singular.

1.04 My intention from the outset was to work as intensively as possible in order to provide some useful output within a year. I have worked with a core group of officials, with others being invited to discuss particular subjects.

1.05 The group has met regularly since May, and has considered submissions from a number of external bodies, as well as maintaining regular liaison with interested Ministers.

1.06 It was evident from the outset that the work of the Task Force was threatened by two considerable dangers. The first was that it might simply sprawl, given the size of the potential subject matter. I decided very early on to focus on the issue of work incentives – incentives, not necessarily just financial, for individuals to move from welfare into work and incentives for employers to take them on. I felt that improving work incentives would go a long way to meeting the other objectives in my terms of reference. This has been my main focus throughout the period of work.

1.07 The second danger was more insidious. The present welfare system is extremely complicated, and owes its complexity to the encrustation of masses of well-meaning reforms, mostly quite minor in individual impact. On the basis of my working assumption that significant new money would not be available, the provision of new incentives would necessarily involve an element of redistribution; there would be losers as well as winners.

The general political difficulties associated with inflicting cost on one group or other might be expected to be greater if the group were poor or in some other way vulnerable. So the room for manoeuvre might be limited, and I would run the risk of suggesting changes which, however well-intentioned, could have a very minor economic impact.

1.08 I have therefore tried to keep in mind the desirability of structuring reforms which, through encouraging people to move from welfare back to work, might be expected to have a positive impact on national output.

1.09 My concentration on work incentives did not arise just from a desire to fix on one crucial aspect of the broader welfare subject. I was also anxious not to duplicate work being done by other groups or, in the ordinary course of official business, within Government departments. I have therefore steered clear, in particular, of matters covered by the Government's Comprehensive Spending Review (CSR), which has looked at the conditions of payment of many individual benefits, although I have spent some time keeping myself abreast of the work being done, to ensure that the avoidance of duplication did not result in the formulation of inconsistent and contradictory advice.

1.10 At the time the Task Force was set up, there was much speculation, by the very nature of my remit, that I should be tempted to advise that the tax and benefits systems should be fundamentally merged. With the significant exception of my study of a tax credit for working families, which does indeed bring the two areas into close conjunction, I have not generally pursued the line of full-blown integration. It is worth saying at this stage why I did not.

1.11 For a start, the tax and benefits systems have traditionally had different objectives, the funding of Government expenditure and the relief of need, and although one can be seen as a negative version of the other, this inverse relationship is arguably superficial. Second, although many recipients of in-work benefits also pay income tax, more generally benefit recipients are not taxpayers. As a result of this, the collection and delivery functions, both in human terms and in terms of the technology used by the two systems, vary considerably. Finally, while taxation is paid by individuals, benefit is paid to household groups; both these arrangements are fiercely defended[1]. Some may find this perverse or paradoxical; I think it just shows that the tax and benefit systems reflect the differences in their traditional objectives. I see no reason, however, why both systems cannot contribute to the same objectives, providing the means to improve work incentives and relieve poverty.

1.12 Another aspect of the interaction of the two systems which has attracted much attention are the so-called unemployment and poverty traps. The unemployment trap arises because an individual, on taking work, may lose so much through tax and reduced entitlement to benefit as to make the marginal financial value of employment very low. The poverty trap arises in the same way when someone already employed is discouraged from taking a better paid job because of tax and reductions in entitlement to in-work benefits. (The annex to this report considers disincentives in more detail.)

1.13 The low financial returns from work reflected in the unemployment and poverty traps result from providing a benefit safety net for those who have few resources of their own. Once such a safety net is provided, it has to be reduced at higher income levels either directly through withdrawal of benefits or indirectly through the taxes needed to

[1] I note with interest, and understanding, that women – in different guises as individual earners and as mothers of families – lead the defence of both.

pay for these benefits. The trade-off between incentives and support for those without resources of their own cannot be avoided. The issue is how fast the safety net should be reduced. If withdrawn rapidly, it will mean a relatively small number of people face very high marginal rates; if withdrawn more slowly, a larger number of people will be affected by moderately high rates. There are also trade-offs between measures to help the unemployment trap and those that help the poverty trap.

1.14 These are essentially structural problems, to which no miraculous solution can be advanced, short of paying benefit to everybody or nobody. As long as benefits are paid and then withdrawn, there will be high effective "tax" rates at certain points.

1.15 Much of the academic literature on this subject implies that people on low incomes are constantly engaged in quite complex mathematical modelling. Although this does not seem very likely, it is probably reasonable to assume that people are able to work out whether they are clearly better off, clearly worse off or roughly even. It is also clear that claimants are reluctant to take up entitlements because of the need to claim and the hassle and stigma involved.

1.16 That said, the modelling of benefits matters, and I believe that there is room to improve the structure of tapers (which determine the rate of withdrawal of benefit as income rises) in the present Family Credit system, in conjunction with the introduction of the minimum wage, to improve work incentives for families with children.

Why work incentives?

1.17 Three major disadvantages arise from having large numbers of people outside the labour force. Aside from the cost to the public purse (and some items of the social security budget are increasing irrespective of the cyclical position of the economy), long periods out of work reduce the chances of future employment for many, entrenching low self-esteem and – since the phenomenon is widespread – entrenching the view that it is acceptable for able-bodied people to live off the state. I believe these psychological factors are significant. And of course the shortfall in the level of national output implied by below-par participation in the labour force affects the economy's potential. This factor is likely to become more significant over the next two decades, given present demographic trends.

1.18 These issues affect groups well beyond the registered unemployed. Indeed, attempts to tackle the problem are likely to lead to increases in the published unemployment figures as economically inactive people pass through the unemployment register on their way back to work. I urge the Government not to be deterred by this presentationally awkward statistical effect from taking the necessary action, which I see as essentially taking four forms:

- making work more financially attractive to the non-employed;
- making it easier for the non-employed to take work by environmental changes (for example better childcare for lone parents, improved training and guidance);
- requiring those who can work to participate in the labour market (for example by tightening the qualification rules for benefits);
- increasing the availability of work at the lower end of the labour market.

1.19 I do not believe that the number of fundamentally unemployable people is as large as some argue. But I have particularly borne in mind the large number of people whose labour is not sufficiently well rewarded to allow them to support their families in an acceptable way. It seems to me far better that these people should be working, and receiving in-work benefits to top up their net pay, than that they should be idle. Moreover, once in work there is a greater likelihood that they will remain there. In general, therefore, I regard the expansion of relatively low-paying jobs as beneficial.

A tax credit for working families

1.20 At present, couples with children and low household incomes receive a top-up payment through Family Credit, introduced as part of the Fowler reforms and implemented in 1988 to replace Family Income Supplement. I considered proposals to replace Family Credit by a tax credit system, and, at Gordon Brown's request, looked at what lessons could be learned from the experience of the Earned Income Tax Credit (EITC) in the US. (The tax credit is considered in detail in Chapter 3.)

1.21 It may be argued that the disruption involved for employers, as well as the State, in moving from benefit payments to a tax credit is unjustifiable, given the modest size of Family Credit (expected to be around £2.3 billion in 1997-98). If that were the extent of the change, I should agree that the reform was not worthwhile. But the expectation that the number of in-work benefit recipients will rise as welfare-to-work succeeds changes the equation considerably.

1.22 I believe the Government should replace Family Credit with a tax credit. A tax credit will associate the payment in the recipient's mind with the fact of working, a potentially valuable psychological change. I believe that a payment through the tax system, associated with the recipient's work, is likely to prove more acceptable to society at large. And the establishment of a tax credit system is likely to come in useful in future as a broader delivery mechanism, eventually allowing closer integration between the benefit system and conventional income tax.

1.23 But I also believe it is important that the design of the tax credit should build on existing features of the UK tax and benefit systems, and should not simply attempt to replicate the very different structures on which the EITC is based. In particular the EITC is designed around the fact that the unit of assessment for income tax in the US is generally the couple and not the individual as in the UK. I do not believe it would be necessary for the introduction of the tax credit to revisit the reforms of the late 1980s which led to individual taxation in the UK. Building on the existing system should also allow the most rapid and least disruptive introduction for the tax credit.

1.24 I considered at some length the case for a tax credit assessed on individual income, which would be aligned closely with other parts of the tax system, but concluded that there was a strong case for the credit to be targeted on low-income households rather than low-earning individuals.

1.25 The tax credit aside, the Task Force has worked on two areas of policy on which I have made firm recommendations to Government:

- changes to the national insurance system to improve work incentives;
- changes to the benefit rules concerning spouses or partners of the unemployed, in order to remove a potential work disincentive.

National insurance contributions

1.26 I believe that the burden of national insurance contributions (NICs) on low earners and their employers should be considerably reduced, resulting in positive effects on work incentives and some deregulatory impact.

1.27 At present, although many of the low paid escape income tax, the numbers paying national insurance have tended to rise because of the decline relative to earnings of the threshold at which NICs become payable (the Lower Earnings Limit or LEL). Those who earn above this level pay some NICs ("the entry fee") in respect of their whole earnings, not just the amount above the LEL. This effect is more burdensome still for employers.

1.28 I believe the LEL should be raised and the entry fee abolished, for both employers and employees, considerably increasing the attractions of offering and taking low-paid work. Combined with a low starting rate of income tax, this should so increase the financial attractiveness of low-paid jobs as to allow the minimum wage to be set at a lower level than would otherwise be the case. I urge the Low Pay Commission to take this reform into account in their deliberations.

1.29 I recommend similar changes to NICs paid by the self-employed which should boost work incentives and cut red tape. I also recommend progressive alignment of the NICs legislation with income tax, including bringing NICs operational and policy functions into the Inland Revenue. (Chapter 2 provides more detail on my proposals for NICs.)

Partners of the unemployed

1.30 At present, if one partner in a couple loses his or her job, the incentives for the other to work are greatly reduced, especially if the couple are childless and therefore do not qualify for Family Credit. I regard this effect as perverse and undesirable.

1.31 I recommend that, in order to receive Jobseeker's Allowance (JSA) or Income Support (IS) at the rate applicable to a couple, both partners in a childless couple should be required to present themselves for work. Such a change would not mean that both partners had to work. Once one of them had found a job, it would be up to them whether both worked. This may at the same time hasten the return to work of one partner in a couple with neither working, and remove the incentive in cases where both have been working for one to give up work because the other does. (This proposal is discussed in Chapter 4.)

1.32 The arrangements for lone parents have been much discussed elsewhere. While they have not been a particular concern of the Task Force, I believe that one particular and one general point are worth making.

1.33 In particular, I believe that it would be wrong to treat lone parents more harshly than childless couples in the way that they are required to present themselves for work.

1.34 In general, I believe that wherever possible Government should avoid framing special rules for categories of people based on their social or family arrangements. These tend either to encourage people to structure their households in a particular way in order to receive money from the state, or else to make it more expensive and onerous for them to live in the way that suits them. Neither outcome would be desirable.

1.35 There are also a number of other areas on which the Task Force has done work but which I decided not to pursue. Briefly:

- the potential merger of in-work and out-of-work benefits. I considered the scope for bringing IS/JSA and Family Credit together so as to ease the transition into work for families. However, such an approach risks blurring the distinction between being in work and out of work. And many of the advantages of an integrated benefit system could be delivered by improvements in administration and IT systems or through detailed changes in benefits. I felt that this area should take a back seat in the group's work, which has been concerned principally with moving people into the labour market rather than from one form of welfare onto another. In short, I concluded not to recommend integrating IS/JSA with Family Credit;

- the case for "basic income" or "negative income tax" schemes, ie paying every person in the country a fixed amount regardless of whether they worked or not. While I can see the theoretical attraction of such proposals, the reality is that, for basic incomes to be sufficient to provide enough to support people out of work, they would have to be set at levels which would have enormous consequences for marginal and average tax rates. Such schemes also fail to distinguish sufficiently between participation in work and being out of work;

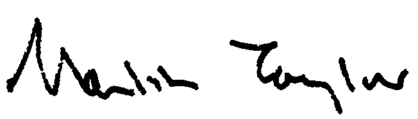
- reform of Housing Benefit – one of the three main income-related benefits that are paid to people in work. The withdrawal of Housing Benefit is an important factor behind the unemployment trap and, particularly in combination with the withdrawal of Family Credit, leads to very high marginal "tax" rates on increases in income for those on low earnings. I believe it is important that these work incentive effects of Housing Benefit should be addressed. But the Comprehensive Spending Review (CSR) is considering the relationship between benefits and rents and whether help with rents can be given in ways that improve incentives more effectively. I therefore concluded that I did not need to consider Housing Benefit in detail;

- the problem of older workers, in view of the fall in participation rates of the over 50s in the labour market in the last decade. Many of the older workers are males displaced from manufacturing industry and now receiving Incapacity Benefit. I think that this is another important issue to be addressed but as it is also being considered in the CSR, I decided not to pursue it further.

Conclusion

1.36 I believe that the measures outlined – the introduction of a tax credit for working families, reform of the national insurance system, and a review of the arrangements under which childless couples claim benefits – would give considerable support to the Government's policy of promoting work incentives. Over time this should reduce the costs of supporting unemployed people, and increase labour force participation, bringing significant social and economic benefits.

1.37 It would be wrong for me to make exaggerated claims to ownership of any of this work. I have tried to work in such a way as to assist the departments in framing policy choices, and thus to operate inside rather than outside the machinery of Government. I should like to record my personal gratitude to the officials who have worked on the Task Force, public-spirited people of great ability, and to the many bodies and individuals who have shared their ideas with me.



MARTIN TAYLOR

2 NATIONAL INSURANCE CONTRIBUTIONS

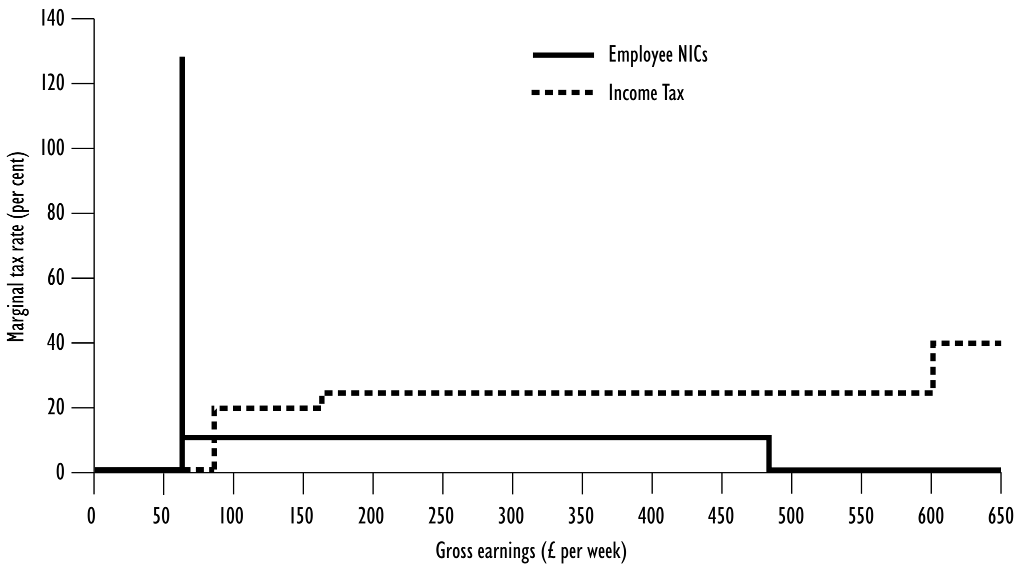
2.01 The best way to improve work incentives is to increase the gain from work. The introduction of the minimum wage will help greatly here. Another essential factor is lower taxation. Gordon Brown has made clear his intention to introduce a 10p starting rate of tax (along with changes to benefit tapers). I have taken this change as given and wholly endorse it. National insurance contributions (NICs) are in many respects a tax on labour. Changes in their structure offer the scope to improve work incentives and encourage job creation.

The current national insurance system

2.02 If an employee earns over the lower earnings limit (£64 a week in 1998-99), he or she pays NICs at a rate of 2 per cent on earnings up to the lower earnings limit (LEL) and 10 per cent on earnings over the LEL subject to a cap at the upper earnings limit (UEL) of £485 a week. Employees contracted out of the state earnings related pension scheme (SERPS) receive a rebate of 1.6 per cent on earnings between the LEL and UEL, ie a reduction in the rate of national insurance they pay.

2.03 Chart 1 shows marginal rates of NICs and income tax for a single person with income from employment only.

Chart 1: Marginal rates of employee NICs and income tax



2.04 Entitlement to some benefits is based on earnings on which employee NICs have been paid. These benefits include basic state Retirement Pension, SERPS, Jobseeker's Allowance, Incapacity Benefit and Statutory Maternity Pay. Typically they use "earnings factors", which relate benefit entitlement to the length of time when pay is above the LEL. For example, entitlement to Statutory Maternity Pay turns on average weekly earnings being at or above the LEL for eight weeks.

2.05 Employers pay a uniform rate of NICs on all earnings for employees earning above the LEL. The rate paid depends on the earnings of the employee as set out below:

- £64-£110 3%
- £110-£155 5%
- £155-£210 7%
- £210 and over 10%
- For those contracted out of SERPS, employers receive a 3 per cent rebate on earnings between the LEL and UEL.

2.06 With employer NICs, entry into each new band triggers the application of the higher rate to all earnings (unlike in income tax where the tax rate only applies to income in excess of any threshold). The result is that for employers there are steps not just at the LEL but at the three other thresholds. Chart 2 shows employer NICs over a range of employment income.

Issues relating to the current system

2.07 The current national insurance system imposes a burden on the low paid and distorts the labour market – there is clear evidence of bunching of employees below the LEL.

2.08 NICs place a greater burden on the low-paid than income tax in that they become payable on much lower earnings. A married employee only begins to pay more income tax than NICs at earnings of £165 a week.

2.09 In addition, there are a number of steps in the system where a small increase in earnings can result in a significant increase in NICs. The step at the LEL has the greatest impact, since the employee will incur a NIC charge of £1.28 per week in 1998-99 and the employer a charge of £1.92 per week, resulting in a combined 5 per cent charge on earnings of £64 a week. The employer also faces the administrative burden of having to calculate and account for NICs.

2.10 As a result of the entry fee at the LEL, low paid individuals face high marginal tax rates. This is one of the few remaining causes of marginal rates in excess of 100 per cent. The minimum wage may very well mean this is not an issue for full-time workers. But it will remain an issue in attracting people into flexible work – for example, women with children looking for work fitting their childcare opportunities.

2.11 Moreover there is a lack of alignment between the income tax system and the national insurance system. The main areas of difference are:

- base of charge. Income tax is paid on total income including savings and investment income, state and occupational pensions and earnings replacement benefits. NICs are paid only on earnings from employment and self-employment and excludes many taxable benefits in kind;

- reliefs and rebates. The income tax system has a wide range of allowances and reliefs, whereas no reliefs can be set against earnings for NICs. NICs are, however rebated for both employer and employee, where the employee is contracted out of SERPS;

- period of assessment. PAYE may be deducted each time an employee is paid but the employee's final income tax is based on total taxable income from all sources for the tax year. NICs are calculated fully and finally for each pay period on the basis of earnings in that pay period;

- structure of charge. Particularly with the 10p rate, income tax would be a progressive tax, charged at graduated rates above the personal allowance. NICs are charged as above.

Possible changes

2.12 There is a strong case for reforming the structure of NICs, so as to improve work incentives, cut red tape and encourage job creation.

Full integration

2.13 Some employers and representative bodies have in the past argued that NICs should be completely merged with income tax. This would save them the work of separately recording and accounting for two sorts of NICs as well as tax. This is an understandable suggestion, particularly for small employers who face relatively high unit costs for operating PAYE and NICs. However, full integration of employee NICs would require a substantially higher, basic rate of income tax. This could have very large redistributional effects, particularly if this higher rate were applied to other sources of income, such as pensions. Abolishing employer NICs would leave a large gap of £27 billion in government revenue, which would need to be filled. This would be equivalent to, for example, a rise in the rate of corporation tax to over 50 per cent. Full integration would also mean a complete redefinition of the contributory principle for short term benefits and for pensions. It seems more worthwhile to focus on changes which would reduce the disincentives in the NICs system without raising such major policy questions.

2.14 Employers have also suggested a less radical overhaul – letting NICs liability depend on the individual employee's PAYE code. That could simplify appreciably the tax and NICs tables, by giving a common starting point for tax and NICs. However, it would mean that both the employee and employer NICs charges would depend on items in the tax code; for example, employer NICs, and employee benefit entitlements would be affected by marital status. Currently, the PAYE system is also used to deal with a number of items in the tax system – such as untaxed investment income or higher rate relief for charitable giving. Without major change to PAYE, such items in the code would also affect hiring incentives and benefit entitlements.

Possible changes to employee NICs

2.15 So I focused directly on the disincentives in the NICs system – starting with alignment with the income tax system and the current entry fee and steps. Reform of employee NICs to deal with this could involve :

- aligning the LEL with the personal allowance. In 1998-99 that would mean raising the LEL from £64 per week to £80 per week;
- turning the LEL into an allowance, thereby abolishing the entry fee step of £1.28 for employees.

2.16 This has a substantial cost (some £2 1/2 billion a year). The simplest option for funding it would be to increase the 10 per cent employee NICs rate to something like 11.4 per cent. (This figure assumes that a contracted-out rebate like the present 1.6 per cent would be kept.) Other funding options include:

- increasing the UEL, though I recognise the Government is bound by undertakings, which I support, not to abolish the UEL;
- increasing NICs paid by the self-employed, who currently pay less than employees. This is discussed further in paragraphs 2.25-2.28 below;
- bringing benefits in kind fully into NICs. At present, benefits in kind are not subject to NICs, other than the employer-only Class 1A charge on company cars and car fuel. This gives employers an advantage in offering benefits in kind, so reducing the NICs yield and distorting competition. However, it does not look straightforward to value benefits in kind, at least on anything like the income tax rules, on the current NICs pay period basis. So a full employee and employer NICs charge may not be easy for employers to handle. The pragmatic solution may be to extend, perhaps at a higher NICs rate, the Class 1A employer-only charge.

2.17 Aligning the LEL with the personal allowance would take up to 1 million people out of NICs altogther. However, it would also affect their entitlement to contributory benefits. This could be resolved by moving to a new definition of the contributory principle, which might be desirable in its own right, as a replacement for rules dating back to sticking national insurance stamps on cards. However, both employers and the Government would need some lead time before the changes could be brought in.

Possible changes to employer NICs

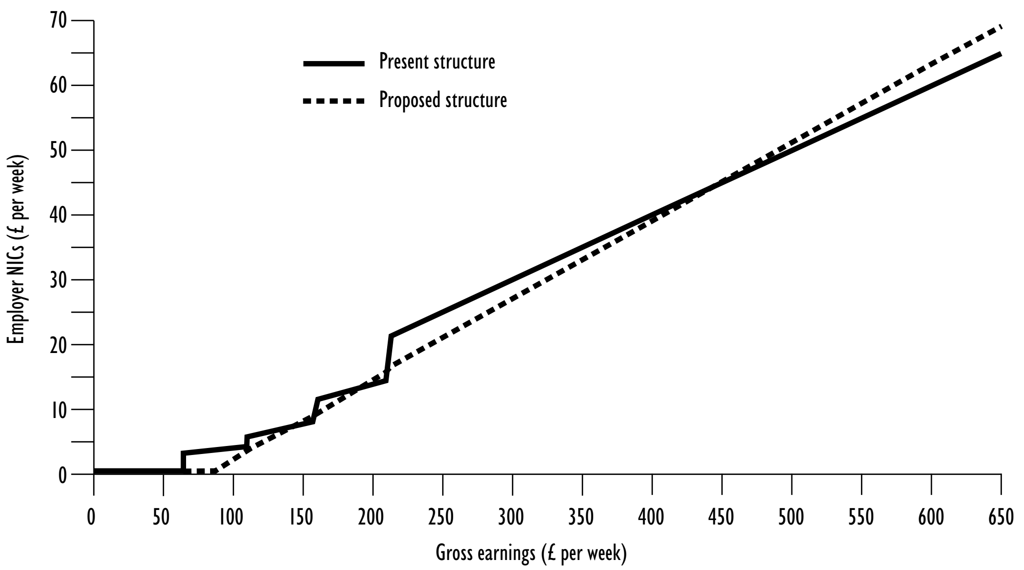
2.18 The change above would remove the "steps" in the employee NICs system. The following package would remove the steps in employer NICs:

- raising the point at which employers begin to pay NICs from £64 a week to around £80 a week;
- turning the LEL into an allowance, thereby abolishing the entry fee step of £1.92 for employers;
- abolishing the steps at £110, £155 and £210.

2.19 The cost of abolishing the entry fee is £5¾ billion for employers, compared with just over £1¼ billion for employees: a reflection of the much higher employer rates which currently apply to this band. To recover the cost, it would be necessary to increase the headline employer rate payable on earnings above the LEL. The revenue neutral rate would be 12.2 per cent. (The figures assume that a contracted-out rebate like the present 3 per cent would be kept.)

2.20 Chart 2 shows the structure of employer NICs for those not contracted out, under this change:

Chart 2: Present and proposed structure of employer NICs.



Distributional effects

2.21 The key effects for employers are:

- employer contributions in respect of the one million employees taken out of NICs would be reduced by up to £2.40 per week;
- for the 5 million employees earning between the new LEL and £210 per week, contributions would generally fall by £1 to £2 per week, but there would be very small rises affecting around two million employees close to the existing steps at £110, £115 and £210;
- for those earning between £210 and £450, contributions would generally fall, and by fairly large amounts – up to about £5 per week;
- for those earning above £450, employers' contributions would rise unambiguously with earnings.

2.22 These effects do not include any extension of the Class 1A charge as described in paragraph 2.16. If this was included in any package of reform, employers offering a lot of benefits in kind would pay more, since the NICs shelter would be removed. That would tend to affect employers of the higher paid more, since the value of benefits in kind offered tends to rise with cash pay.

Industry views

2.23 I asked a number of organisations for their views on an employer NICs package of this sort. The responses were generally very supportive, both in terms of the incentive effects for low-paid jobs and in terms of reducing the regulatory burden on employers by reducing the NICs population. There was, though, concern about solving the benefit entitlement issue from an employee LEL increase, and hence getting early deregulatory benefits from a smaller NICs population. Some responses showed a clear awareness that it would not be easy to reform the present system because of the inter-relations that exist between the UEL and the LEL, and SERPS and the contracted-out rebate. There were also concerns over the hiring costs of the higher paid. While I recognise those concerns, the maximum increase is typically well short of six months' wage inflation at this pay level.

2.24 Understandably, some employers and representative bodies argue for closer alignment of the detailed charging rules for tax and NICs, as well as for broader alignment. Bringing benefits in kind generally into a Class 1A NICs charge would be such an alignment, assuming it also followed income tax rules. There are strong arguments for looking for further alignment of NICs with the employment income charge and with the boundaries of the PAYE charge. This could be started by bringing NICs operational and policy functions together with their tax equivalents in the Inland Revenue. Such a move would send a strong signal that the Government was serious about reducing business costs by progressive alignment over the longer term.

The self-employed

2.25 The self-employed will pay a flat rate Class 2 charge of £6.35 a week in 1998-99. That will be paid by everyone with earnings over about £69 a week. They also pay a 6 per cent Class 4 charge, based on their taxable profits, between the Lower Profits Limit (LPL) at around £140 a week and the Upper Profits Limit (UPL) at £485 a week. Only the Class 2 charges gives entitlement to contributory benefits.

2.26 The Class 2 charge is analogous to an entry fee. Indeed, it is markedly larger than the entry fee at the LEL for employees. At 6 per cent, the Class 4 rate is below either the employee or the employer headline rate, let alone both together.

2.27 Taking these factors together, it would be consistent with my proposals for employees:

- to abolish the Class 2 charge (which means inventing a new benefit entitlement test, such as a minimum profits test or a minimum Class 4 payment, for contributory benefits);

- to align the LPL with the revised LEL;

- to increase the Class 4 rate nearer to the employee rate, so as at least to restore the Class 2 yield. (There are timing issues for the year of introduction, since Class 2 is paid in-year and Class 4 essentially end-year.)

2.28 Although the self-employed have less entitlement than employees to contributory benefits, they substantially under-contribute to the National Insurance Fund, even allowing for their reduced entitlements. So there would be an argument for making the self-employed component of such a package revenue-raising, rather than revenue-neutral.

Conclusion

2.29 A package of reforms on the lines set out above would represent the biggest reform of NICs since the 1970s. It would remove one of the few remaining causes of marginal rates in excess of 100 per cent and it would reduce labour market distortions.

2.30 Since the package would reduce the tax paid on low to moderately paid jobs, it would improve the incentive to take and offer such jobs, thus alleviating the unemployment trap. The combined reduction in employee and employer NICs for someone earning around £160 per week (the median wage for someone working over 16 hours a week) would be over £3 per week.

2.31 **I recommend:**

- **increasing the LEL to the level of the income tax personal allowance for employer NICs and (subject to ensuring people do not face unacceptable losses of benefit entitlement) employee NICs;**

- **abolishing the "entry fee" and "steps" for both employee and employer NICs;**

- **progressive alignment of the NICs legislation with income tax, and bringing NICs operational and policy functions into the Inland Revenue;**

- **abolishing the Class 2 charge for the self-employed, increasing the Class 4 rate and aligning the LPL with the LEL;**

- **considering the extension of NICs to all taxable benefits in kind (for practical reasons, by extending the current tax-aligned Class 1A employer-only charge).**

3 A TAX CREDIT FOR WORKING FAMILIES

3.01 For much of the century the roles of income tax and social security have been perceived to be different. According to the traditional model, the main purpose of income tax is to raise revenue. Its unit of assessment is the individual, and its structure pays little regard to individual or family circumstances. By contrast, the main purpose of social security is to help those in financial need. Its unit of assessment is the household, and it is administered by a separate department from the Inland Revenue: the Department of Social Security. Although this apparent division of functions is useful for some purposes, there is no reason why both systems should not contribute to the same objectives, providing the means to improve work incentives and relieve poverty.

3.02 The Task Force's remit was to examine the interaction of these two systems. In particular, Gordon Brown asked me to look at what lessons could be learned from the Earned Income Tax Credit (EITC), the US payable tax credit that provides financial support for low-paid working people.

3.03 This chapter looks at the case for greater integration of the tax and benefit systems. It then looks at the structure of the US EITC, the differences between the US and UK tax and benefit systems and the introduction of a tax credit in the UK for working families.

Criticisms of the existing system

3.04 The existing tax and benefit systems perform most of their functions effectively. But there are a number of criticisms of their effect on work incentives and the incomes of the low paid. In particular, it has been argued that:

- in-work support is not sufficient to make work worthwhile – the unemployment trap – or provide adequate incomes for the low paid;
- the high rate of withdrawal of benefits as incomes rise deters the low paid from seeking to increase their earnings – the poverty trap;
- the impact of in-work benefits is blunted by:
  - reluctance to take up entitlements because of the need to claim and the hassle and stigma involved;
  - insufficient recognition of the costs associated with work, in particular childcare;
  - concerns about the disruption to income and resulting cash-flow difficulties while benefit entitlements are re-assessed;
  - uncertainty about the level of in-work income.

The case for greater integration

3.05 There are a number of arguments in favour of greater tax and benefit integration.

3.06 It would simplify and streamline the tax and benefit system, making it easier for the taxpayer and benefit recipient to understand and for the Government to administer. A working family can be paying income tax and making national insurance contributions, as well as receiving Family Credit, Housing Benefit, Council Tax Benefit and Child Benefit: administered by several agencies. As well as making the system more transparent for the recipient – in the case of in-work benefits, putting into starker relief the rewards of work over welfare – greater integration has the potential to unlock administrative savings both for the Government and the individual.

3.07 It would reduce the stigma associated with means-tested benefits and could therefore increase take-up. Although the less well-off are more likely to take up their entitlements to means tested benefits than they were 20 years ago, take-up still falls well short of universal benefits, such as Child Benefit, or personal income tax allowances. Around 70 per cent of those entitled to Family Credit claim it, while take-up of Housing Benefit by those in work is lower still.

3.08 It would ensure greater acceptability to both the claimants and taxpayers. It is noticeable that the US Administration has secured widespread political support for the EITC at a time when the US welfare budget more generally has been under remorseless attack.

3.09 It could improve work incentives for those caught in the poverty trap. The interaction of Family Credit, Housing Benefit and Council Tax Benefit can give rise to marginal rates of 97 per cent. Ending penal marginal rates would clearly be right and equitable.

The US Earned Income Tax Credit

3.10 I considered the EITC in detail.

3.11 The EITC is a payable tax credit that provides support to working, low income people. The amount of the credit depends on total family income in the tax year as a whole: the joint income, including savings income, of couples is taken into account. It is usually received as part of the taxpayer's annual tax refund. Claimants are eligible to receive part of the credit during the year as part of their pay, although very few in fact do so. It is estimated that between 80 and 86 per cent of EITC eligible taxpayers actually receive EITC.

3.12 The credit is larger for families with two or more children than for families with one child. Lone parents and married parents receive the same amount of credit. There is also a small credit available to childless couples. The credit is phased in and then paid at a flat rate over a range of income before finally tapering out. When a taxpayer with two or more children earns $550 a week (about £330), close to median male earnings in the US, he or she is no longer eligible for the credit.

3.13 In 1996 the total cost of the EITC to the federal Government was $25 billion and 18 million families received the credit. In comparison, the federal Government spent $13 billion on Aid to Families with Dependent Children (now replaced by Temporary Aid for Needy Families), the main cash welfare programme for lone mothers and their children.

3.14 But to understand the role the EITC plays in the US, it is important to recognise the substantial differences between the UK and US tax systems. In the US system for example:

- the unit of assessment is generally the couple, not the individual – and always the couple for EITC claimants;
- most income taxpayers fill in tax returns every year, as against 30 per cent in the UK, few of whom are low paid. In the UK there is much greater reliance on PAYE and the employer deducting the right amount of tax, generally without the need for a tax return;
- tax is normally over-deducted during the year so most taxpayers receive a refund at the end of the year, whereas the UK PAYE system attempts to deduct the correct amount of tax during the year.

3.15 These features enable the EITC to be assessed and paid as a matter of routine. To receive EITC a family has to submit the appropriate tax return. When this is processed, the Internal Revenue Service (IRS) includes any entitlement in the assessment and pays it more or less automatically as a refund of tax (or deducts it from tax due).

3.16 It is also important to appreciate some important differences between the benefit systems in the UK and US. The US out-of-work benefit, Temporary Aid For Needy Families is much less generous and largely confined to lone parents. Moreover although there is no US benefit directly comparable with Family Credit, poor families are entitled to food stamps. These provide contemporaneous support for families and, while the value of the stamps is tapered away as income rises, they still provide a substantial and regular supplement to the incomes of low paid working families, as well as to the unemployed.

Family Credit and the EITC

3.17 Although the EITC is similar in purpose to the UK's Family Credit and has a broadly similar structure (entitlement to both is steadily withdrawn as total family income rises above a threshold), there are also some important differences between the two:

- **payment**: Family Credit is paid weekly usually to the mother. The EITC can be partly paid by employers, though in practice it is generally paid in a lump sum at the end of the year as part of the overall income tax settlement;
- **coverage:** Family Credit is only available to families with children, whereas the low paid without children are also entitled to a small EITC. Family Credit is also more closely tailored to individual family circumstances, for example varying with the age of children;

- **assessment:** entitlement to Family Credit is assessed for the next six months on the basis of past income, normally over a six week period. EITC is assessed retrospectively on the basis of actual income in the tax year as a whole;

- **structure:** Family Credit can only be claimed by those working 16 or more hours a week. EITC is available from the first $1 of earnings and rises with earnings up to a maximum;

- **value:** Family Credit has a larger maximum payment than the EITC, but payments from Family Credit fall much more quickly as earnings rise than do payments from the EITC. The effects of these differences on the unemployment and poverty traps are, however, partly offset by the other differences in social security benefits, especially the effects of food stamps and the less generous out-of-work benefits.

3.18 And of course the EITC is paid and administered by the IRS through the income tax system while Family Credit is paid by the Benefits Agency through the social security system.

A tax credit for working families

3.19 I concluded that the US EITC had much to recommend it. Although the differences between the UK and US tax and benefit systems need to be recognised, there is no overriding reason why the UK should not have a tax credit payable through the pay packet to families in work. The advantages were clear:

- as a tax credit rather than a welfare benefit, it would reduce the stigma currently associated with claiming in-work support;

- it would prove more acceptable than social security benefits to most claimants and taxpayers as a whole;

- paid through the wage packet, it would reinforce the distinction between the rewards of work and remaining on welfare;

- it could help to lower marginal tax and benefit withdrawal rates.

3.20 A tax credit should replace Family Credit, so as not to duplicate it. It could be designed in a number of ways:

– it could be administered in the existing tax system, but with a structure broadly similar to Family Credit;

– the credit could be "individualised", to fit more closely with the UK's tax system, perhaps retaining some residual family characteristics;

– it could be based on a restructured tax system which recognised households and required everyone to complete tax returns.

3.21 A system of tax credits based on the individual would be expensive and could produce some odd results. For example, partners of the rich and individuals with large investment incomes, might be entitled to the credit if they had a low-paid job.

3.22 And, if the credit was completely integrated into the tax system it might not respond quickly to changes in need. The tax system works by looking back on the whole year and it could only be made to respond to in-year changes by using estimates of entitlement with adjustments after the end of the year, and support would sometimes have to be claimed back.

3.23 I believe a credit based on the existing tax system but modelled on Family Credit is the most practicable option. It would enable relatively speedy introduction of the credit and would continue to provide support for periods of need while allowing sufficient flexibility for any future developments in the tax system.

Particular design issues

3.24 A number of design issues would need to be considered.

3.25 Family Credit is claimed by the mother, although both partners in a couple sign the claim form. And, although either partner can collect the payment, the fact that the order book is sent to the mother means that she is seen as the recipient of the financial support. Replacing Family Credit with a tax credit paid through the pay packet could be seen as a potential transfer of resources from women to men. (The labour market has of course evolved since the introduction of Family Credit in 1988. Most recipients no longer conform to the traditional paradigm of father working and mother staying at home caring for the children. In the majority of cases today, the main wage earner is the woman: one half of Family Credit recipients are lone parents (nearly all lone mothers) and a further 10 per cent are female breadwinners within couples.) But if this is seen as a problem, it could be avoided by introducing an element of choice and allowing a couple to opt for the mother to receive the credit where she was not the main earner.

3.26 It should also be possible to design mechanisms to pay a credit through the pay packet without revisiting the reforms of the late 1980s which led to individual taxation in the UK. Family Credit is of course assessed on a household basis.

3.27 Introducing employers into the payment process – so that a tax credit could be paid through the wage packet – would involve compliance risks that would need to be looked at carefully. Clearly, there would be a premium on minimising burdens on employers: for example, the Inland Revenue rather than the employer might calculate entitlement.

3.28 Administering a tax credit system using employers also raises issues of confidentiality. This is partly because confidentiality is seen as valuable in itself. But a particular concern is that if employers were part of the information gathering and assessment process, they would be in a position to use the information to depress wages. To a large extent, however, the minimum wage will protect employees by establishing a floor for wages.

3.29 More generally, it needs to be recognised that employers often already have some limited knowledge of the general circumstances of their employees. For example, Family Credit claimants currently get their employers to certify their wages. Attachments of earnings where unpaid debts or maintenance payments are recovered by employers directly out of employees' wages also gives some indication of the employee's personal circumstances. On balance, it seems unlikely that informing employers of the amount of a tax credit would significantly decrease the current level of employee/employer confidentiality.

3.30 Determining the means by which a tax credit is to be paid through the wage packet will be an area where employers have a valuable part to play. It will therefore be important that they are fully involved in considering the practical and operational issues involved; so as to make any system as efficient as possible for claimants and as little a burden as possible for the employers to administer. Any new burdens could be minimised or reduced for example by adopting the recommendations on national insurance contributions described in Chapter 2.

Conclusion

3.31 I recommend that Family Credit should be replaced with a tax credit. To facilitate its introduction, the tax credit should, in the first instance, be modelled on Family Credit.

4 Partners of the unemployed

4.01 Worklessness is damaging. People without work face reduced employment prospects in the future and risk low self-esteem. It results in lower economic growth, as well as worse public finances. The increase in the number of workless households, not simply workless individuals, is a great cause for concern.

4.02 The Government has already signalled its intention to make a big difference here, through its Welfare to Work agenda. The New Deals for the young and long-term unemployed should have a real and benign impact on their employability. And the New Deal for lone parents and the New Deal for disabled people will also help to re-connect to the labour market people who are currently excluded from it.

4.03 The statistics show that there are around 270,000 partners of the unemployed, strictly partners of people receiving means-tested Jobseeker's Allowance. Of these, 79,000 are childless. A further 86,000 are parents whose children are all over the age of five. Around 106,000 have one or more pre-school children.

Why partners of the unemployed?

4.04 Currently, only one partner in an unemployed couple has to be available for work, has actively to seek work, and is liable to lose benefit if, except in limited cases, he or she does not take any job offered. That person – the claimant – is paid all the benefit to which the family is entitled. Their partner does not have to look for work, does not have to be available for work, and receives none of the benefit. Claimants can choose which partner in a couple signs on, but it is the man in the vast majority of cases (95 per cent of couples receiving income-related Jobseeker's Allowance (JSA)).

4.05 The implicit presumption in the benefits system is therefore that partners of unemployed people cannot or do not want to work. The existing rules seem to be left over from the days when it was assumed that all men worked and their wives did not. Today, when 47 per cent of employees are women, basing benefit policy on such a notion is, to say the least, inappropriate.

4.06 The number of women in paid work has increased dramatically over the last 20 years. However, there is a marked and increasing disparity between employment rates among partners of the employed and among partners of the unemployed. Partners of people in work are much more likely to be in work than partners of unemployed people. The following statistics, which relate to couples whose youngest child is aged between 11 and 16, give some idea of this gap: 77 per cent of partners of the employed have a job themselves, while only 42 per cent of partners of the unemployed are in work. And the difference is increasing; in 1981 these employment rates were 71 per cent and 50 per cent respectively. The gap between partners of working and unemployed men has grown even faster among those with children under five.

4.07 There might be several possible explanations for these differences:

- those with relatively poor labour market prospects are likely to partner other people with similar prospects. A recent survey suggested that people were 53 per cent more likely to have a partner with a similar level of qualifications than would be expected on the basis of chance;

- the structure of means-tested benefits, although the most recent academic evidence suggests that the adverse impact of the means-tested benefits system is less than thought previously;

- unlike their partners, they are not placed under any obligation to be available for work, to look for work, or to take a job if a suitable one is offered.

Re-connecting people to the labour market

4.08 If partners of the unemployed were required to look for work, that would increase effective labour supply, which should in turn increase the level of sustainable employment and reduce worklessness. Less poverty and benefit dependency should also result.

4.09 I believe improving the effective supply of labour is a very important objective. Increases in labour supply help to maintain high and stable levels of employment, improvements in living standards, and economic growth. Moves to increase the labour market participation rate of partners of the unemployed could, therefore, play an important role in the Government's Welfare to Work strategy.

4.10 It would also have desirable social effects. The current approach to partners of the unemployed implicitly writes them off, and assumes they are neither capable of, nor willing to take, paid work. In one-fifth of all working-age households, no-one has a job. The number of these workless households has more than doubled over the past 20 years, and now stands at 3.5 million. 40 per cent of these are couples in which neither partner is working.

4.11 Where neither member of a couple has paid work, this can lead to a number of problems – reduced employment prospects in the future, potentially low self-esteem, a shortfall in economic growth, as well as a higher social security budget. Workless households have, in some sense, twice the chance to change their situation because if either partner finds work, the couple will no longer be workless. But, at present only one partner has to fulfil the labour market conditions even if his or her skills are the less marketable of the couple.

Employment programmes and older workers

4.12 The aim of reconnecting both partners to work implies that employment programmes should be available to both partners. Some partners, such as older women whose children have grown up and who have been out of the labour force for some years, will require disproportionate help to re-connect them to the labour market. There is an argument for exempting – perhaps on a transitional basis, at the time when the requirement is introduced – those over a given age and who have been out of touch with the labour market for several years. (The Australian Government made an exemption of this sort when it introduced the requirement to seek work for partners in 1995.)

Couples with children and lone parents

4.13 Many of the above arguments apply to partners in couples with children, as well as to childless partners of the unemployed. For instance, the gains from re-connecting people to the labour market and increasing effective labour supply also accrue for those with children, as the Government's New Deal for lone parents recognises.

4.14 Other arguments are stronger in respect of childless partners than those with children. I would therefore focus any new requirement to work on childless partners, concentrating initially on the younger among them, for example the under 25s. More generally, it would be inappropriate to treat lone parents more harshly than childless partners. And I see considerable merit in treating partners with children in the same way as lone parents with children of the same age. The current rules impose a work requirement on a lone parent when his or her youngest child reaches the age of 16.

4.15 It is worth stressing that any requirement of both partners to look for work does not mean that both of them have to work. When either of the partners has found a job it will be up to them whether both of them work. Clearly, in many cases, it may be appropriate for one partner to concentrate on childcare.

Individualisation of benefit payments

4.16 The extension of availability requirements to both partners may strengthen the case for separate benefit payments. It would be consistent with the theme of modernisation of the welfare state if payments of Jobseeker's Allowance (JSA) were made to both members of a couple, rather than one partner as now. Such a change would emphasise that the benefits system was moving towards treating a couple as equal partners, while retaining assessment on joint household income. (A similar change was introduced in Australia.) As well as facilitating the extension of work requirements, this change might improve the income distribution within couples and, mainly by changing perception and psychology, enhance work incentives.

Conclusion

4.17 I think the Government should take steps to re-connect partners of the unemployed to the labour market. It is anomalous that the welfare state assumes that only one member of a couple is able to work. Requiring both partners in a couple to make themselves available for work – combined with measures to help them find work – would be a good way to tackle the problem of workless households. In particular, both partners in a childless couple should be required to make themselves available for work. Such a change would not mean that both partners had to work. But it should hasten the return to work of one partner in a couple with neither working, and remove the incentive, in cases where both have been working, for one to give up work shortly after the other has lost their job. Increasing the connection of partners of the unemployed to the labour force should (especially if supported by assistance to find work such as is offered currently to the unemployed) increase the effective labour supply, which should in turn improve aggregate employment. The number of workless households, and the numbers in poverty and welfare dependency, should also fall as a result.

4.18 **I recommend:**

- **in order for the couple to be entitled to JSA or IS, the partner of an unemployed claimant in a couple with children should be treated in the same way as a lone parent: the current rules impose a work requirement on a lone parent when his or her youngest child reaches 16;**

- **in order to be entitled to JSA, both partners in childless couples should make themselves available for work. The Government should consider applying the requirement to young partners first; for example the New Deal could apply to partners under 25.**

ANNEX: LABOUR MARKET AND INCENTIVES

A.01 The background to the Task Force's work, and the underlying analysis of the challenges posed by today's labour market, were set out in a paper published by the Government in November 1997[1].

A.02 This annex provides a brief analysis of the problems facing individuals trying to move into work or trying to move up the employment ladder. It looks at how the systems affect the financial return from different levels of earnings and highlights the wide ranges over which increases in earnings lead only to small increases in net income.

The unemployed and the economically inactive

A.03 The unemployed are a diverse group with substantial differences in the length of time that claimants have been receiving Jobseeker's Allowance.

A.04 Today unemployment in the UK stands at just over 6.5 per cent on the International Labour Organisation definition, or around 1.8 million people.

A.05 There are, on average, over 3 million separate new spells of unemployment every year:

- about half of those entering unemployment leave within the first three months – of whom about 80 per cent leave for jobs;
- about two-thirds leave within six months – two-thirds of whom leave for jobs;
- about a quarter are still unemployed after one year;
- those still unemployed after two years have only a 50 per cent chance of leaving unemployment for a job in the following year;
- of those that leave unemployment, about a quarter are back on the register within three months, and a half within a year.

A.06 The increase in unemployment over the last 25 years largely reflects increases in the duration of unemployment, rather than the numbers who become unemployed. The long-term unemployed are disproportionately older, disproportionately men and far more likely to be low skilled.

[1]HM Treasury (1997), The modernisation of Britain's tax and benefit system, Number one, Employment opportunity in a changing labour market.

A.07 There are also high numbers of people who are economically inactive as opposed to unemployed. Many of those outside the labour market are there voluntarily, because of their family responsibilities, because they have retired early or are in full-time education or training. But many would work if they had the opportunity and incentive to do so. Among benefit recipients the key groups are:

- One million lone parents on Income Support who are not required to register for work. The UK has one of the lowest employment rates for lone parents at just over 40 per cent;

- 270,000 partners of the unemployed. Around one-third of married women do not work, but the proportion is over a half for those married to unemployed men.

A.08 Lack of employment is increasingly concentrated in particular households. The Labour Force Survey suggests that, of households with adult members of working age, 3.5 million (18 per cent) are without any work. This could mean that they are either unemployed or economically inactive (lone parents, the disabled, early retirees). Working age, workless households contain about five million adults and 2.7 million children.

A.09 Over 80 per cent of workless households are dependent on benefits, and this rises to over 90 per cent for couples with children. The rising number of working-age workless households has had a significant impact on the bottom end of the income distribution, and has led directly to greater income inequality.

A.10 Earnings for those in work have been rising. But the gap between the high and low paid has gone up sharply in the last two decades. Moreover, there is evidence of many people cycling between unemployment and low paid jobs. For many groups, income mobility is low. Living on income well below the average for the propulation as a whole is increasingly a problem for people below pension age, mainly through lack of work, but also through low pay. Many of those who suffer most are families with children.

A.11 These problems reflect a range of factors. Changes on the demand side of the labour market have been important as well as the incentives that people face in deciding whether to work. Although the tax and benefit systems are not the only factors influencing incentives, they play a role in a number of ways.

The unemployment trap

A.12 The unemployment trap occurs where net income after taxes and in-work benefits is little or no better than income out of work.

A.13 Low returns from working reflect partly the low level of wages that some people are able to obtain. But for some, particularly those with large families, the financial gains from working can be small even at moderate earnings.

A.14 The tax and benefit system plays a key role here. Those out of work can claim Jobseeker's Allowance (JSA) or Income Support (IS), subject to satisfying certain eligibility conditions.

A.15 Contributory JSA is paid at a flat rate for up to six months to those with sufficient contributions. Income-related JSA can be paid indefinitely depending on the other sources of income of the claimant and his family (ie partner/spouse and dependant children). Claimants must be available for, and actively seeking work. Benefit can be abated if these conditions are not met. For those who leave work voluntarily, benefit can also be reduced for a period.

A.16 Income Support is income-related and can be claimed by certain categories of people who are not required to be available for work, including lone parents, carers, the sick and disabled, and some people over 50.

A.17 The amount of JSA and IS paid is the difference between the sum required to meet the needs of the claimant's family ("applicable amounts") and their net income (including Child Benefit and income from savings). These rates are the same for JSA and IS and vary with family circumstances: a couple with two children can receive up to about £120 a week.

A.18 Recipients of JSA/IS can also automatically claim:

- full payment of their major housing costs, subject to limits: Housing Benefit (HB) to cover rent or additional IS to cover mortgage interest payments, plus Council Tax Benefit (CTB) to meet council tax;

- other "passported" benefits, such as free school meals and welfare milk and exemption from prescription and other health charges.

A.19 When claimants start working, a small amount of earnings is disregarded when calculating entitlement to JSA/IS – £5 a week for a single person, £10 a week for a couple and £15 a week for a lone parent. Beyond that, benefit is reduced £ for £ as earnings of the claimant (or his spouse/partner) increase, ie they face a 100 per cent withdrawal rate.

A.20 Once the claimant works for 16 hours a week (or his partner works for 24 hours) all remaining entitlement to JSA/IS is lost irrespective of the family's income. They also lose entitlement to benefit for mortgage interest. Amounts of HB and CTB will also start to be reduced as soon as the family's net income exceeds a threshold.

A.21 For those without children there is no replacement benefit for JSA/IS, and they also lose entitlement to most passported benefits. Those with children can switch to claiming Family Credit (FC) if they work for 16 hours a week. The amounts of FC vary with the number and ages of children – the maximum for a two child family is over £70 a week. The rates are set so that generally families will receive more in FC plus earnings from working than they would have received from working less than 16 hours. But the difference can be small, and may not compensate for travel or other costs associated with working, or in the case of owner-occupiers for the loss of benefit to cover mortgage interest.

The severity of the unemployment trap

A.22 The severity of the unemployment trap depends primarily on the generosity of out-of-work benefits, which reduce the return from working, and the wages that can be obtained from working plus the generosity of in-work benefits, which increase the return from working.

A.23 The return from working tends to be lower for those with:

- low (actual or potential) earnings (as out-of-work benefits do not vary with earnings);
- high costs associated with working, such as travel-to-work costs or costs of unregistered childcare (neither of which is directly allowed for in benefits or taxes);
- a mortgage (because there is no in-work mortgage benefit):
- several children (because the extra amount of FC in respect of more children is less than that on JSA/IS).

A.24 Variations in these factors make a substantial difference to the earnings levels that need to be achieved to be markedly better-off in work. For example, a two-child couple would need to earn over £300 a week to be £30 a week better-off in work if it had work-related costs of £40 a week. On the other hand, a single person with no work-related costs would only need to earn £150 a week to be £30 better-off.

A.25 The traditional measure of the unemployment trap is the replacement ratio, which is defined as income out of work as a percentage of income in work. Around 600,000 families have replacement ratios of over 70 per cent. But this statistic almost certainly under-estimates the extent of the unemployment trap as:

- estimates of the ratios ignore in-work costs, such as the costs of travelling to work and childcare costs, which can vary considerably;
- the estimates only cover people in full-time work (over 30 hours), which means that they ignore low part-time incomes and, as a result, are a poor proxy for estimating the replacement ratios for those out of work;
- they also assume full take-up of income-related benefits. Take-up of Family Credit has improved recently, but is still only 70 per cent. There is still some stigma associated with claiming in-work benefits, and it is possible that some claimants do not associate them fully with the rewards of work, since they are paid neither through the pay packet nor always to the main wage earner.

A.26 A more useful measure would be the number of unemployed families with high replacement ratios. This is much more difficult to measure as it depends on the earnings these could obtain if they were to take a job. But as many of those out-of-work have a fairly low earnings potential, the proportion is likely to be much higher.

The poverty trap

A.27 The poverty trap arises when people in work cannot improve their net income significantly by increasing their pay, because this is largely offset by income tax and, particularly, withdrawal of in-work benefit.

A.28 For those with sufficient income or hours to take them off JSA/IS, the return from further increases in earnings can be reduced by national insurance contributions (NICs), income tax and the withdrawal of FC, HB, and CTB:

- NICs become payable as soon as each individual's earnings reach £64 a week, after which employees pay a flat rate "entry fee" of £1.28 a week plus 10 per cent of their earnings in excess of £64 (8.4 per cent if they are contracted out of SERPs);

- income tax becomes payable at about £80 a week for a single person (or spouse) and about £100 a week for a lone parent or married person, after which a rate of 20 per cent is paid up to almost £160 a week and 23 per cent beyond that;

- the "maximum" amount of FC is payable to families working 16 hours a week whose income does not exceed the threshold; though there is an additional premium of £10.80 a week for those working 30 hours a week or more. Credit starts being withdrawn once the family's income exceeds £79 a week, beyond which it is reduced at a rate of 70 per cent of the increase in income after income tax and NICs. Payments of up to £60 (£100 for a family with two or more children) a week for registered childcare can be offset against income in calculating the size of entitlement. Family credit is also assessed for a 26-week period, so any increase in earnings within that period does not lead to an immediate loss of benefit ;

- rent and council tax can be claimed in full, subject to limits, under HB and CTB by those with incomes up to the JSA/IS rates. Beyond this, payments are reduced at a rate of 65 per cent of the increase in the family's income after income tax, NICs and FC in the case of HB, and at a rate of 20 per cent in the case of CTB. Small amounts of earnings and the additional FC premium for those working over 30 hours a week can be disregarded when calculating entitlement. Payments are in principle reassessed as soon as income or other circumstances change.

A.29 The overall size of the marginal "tax" rate facing a low earner (ie the proportion of a small increase in gross pay that is taken away in NICs, tax or loss of benefits) depends on which benefits are being received. It can range from about 30 per cent for those just paying tax and NICs to 97 per cent for those also on FC, HB and CTB. Because withdrawal of benefits is calculated on the basis of income after tax and other benefits, the overall rate cannot normally exceed 100 per cent, but at certain points, such as around the "step" at the NIC threshold, it can go higher over a small range of income.

The severity of the poverty trap

A.30 The severity of the poverty trap depends on marginal tax and NICs rates but particularly on the generosity of in-work benefits and the rates at which they are withdrawn. Whereas higher in-work benefits improve the unemployment trap, they tend to make the poverty trap worse because they mean more families will be receiving these benefits and hence face high withdrawal rates.

A.31 Marginal rates for low earners tend to be higher for those with:

- children (because they may then be affected by the withdrawal of FC). Those with several children are particularly likely to be affected as entitlement then extends to higher earnings;

- those with high rents and/or council tax (because they may then be affected by the withdrawal of HB/CTB).

A.32 How far up the income scale high marginal rates extend depends on the characteristics of the family. But for those with children they can extend to quite a high earnings level. For example, for a family with three children, it is almost £300 a week, close to average male manual earnings.

A.33 About 3/4 million working families (about 5 per cent of the total) have marginal tax rates of 70 per cent or more. This is approximately twice the number in the mid 1980s.

Non Financial Incentives

A.34 Many people, however, do not look solely at financial incentives. Their decisions on whether or not to work, or as to what type of job to take, are not driven simply by calculations of the sort illustrated by the unemployment and poverty traps. Many unemployed people say they would like to work even if it meant taking jobs that left them little, if any, better off. As can be seen from Table 1[2], people stay in the benefits system for a range of reasons. Some are put off working by family responsibilities or lack of knowledge of what jobs might be available. Others may not want to take on the extra burden of a more demanding and better paid job. And a large number of people are concerned about problems in the transition into work, such as the possible disruption to their incomes or uncertainty as to how much they will actually receive in work.

A.35 A range of considerations lie behind such attitudes and concerns but the tax and benefits systems play a significant part. The conditions on which out-of-work benefits are given (for example, how the requirement to be "available for and actively seeking work" is applied) and the help that is given to those seeking work is clearly important. Ignorance and stigma about in-work benefits such as Family Credit and Housing Benefit can also affect decisions as to whether to take a job. Many people are concerned that if they take a job there will be delays in receiving these benefits or in reverting to their existing benefit payments if the job does not work out.

TABLE 1: What prevents people leaving benefits?

	% mentioning:
Work Incentives	
Worries about wages being too low	35
Amount of council tax benefit	32
Losing housing benefit/mortgage help	31
Losing passported benefits	27
Paying extra costs (eg work clothing/travel)	21
Cost of childcare	18
Problems making the Transition	
Worries about jobs being temporary	26
Managing until pay day	23
Worries about re-claiming benefit after a short period in work	23
Finding someone to mind the children	14
Hassle of sorting out benefits	11
Waiting for Family Credit	5
Waiting for other benefits	4
Personal Issues	
Not fit enough	19
Job not right	17
Not wanting someone else to look after the children	12
Employer discrimination	11
Nervous about working	9
Having enough time to care for an elderly or disabled person	6
Something else (including no jobs available)	5
None of these	19

[2] *See Shaw A, Walker R, Ashworthy K, Jenkins S and Middleton S. (1996) Moving off income support: barriers and bridges, DSS Research Report.*

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