

Labour's tax and benefit reforms weaken average work incentives

Despite the Labour government's stated aim to 'make work pay', the extension of means testing has weakened incentives for many people to stay in work and increase their earnings, according to a new report by researchers at the Institute for Fiscal Studies.

The report, funded by the Joseph Rowntree Foundation, provides new evidence on the trade-off between redistributing income and improving work incentives. It finds that:

- Across the whole population, Labour's reforms to date have acted to weaken both incentives to be in work at all and incentives for those in work to increase their earnings. On average, tax and benefit changes since 1997 mean that someone choosing to work harder gets to keep 2½p less of each extra £1 they earn.
- These trends have not been universal, however: on average, Labour's reforms have strengthened incentives for lone parents to work at all, and have strengthened incentives to earn more for some groups previously facing the weakest incentives.
- The weakest work incentives are faced by people on low incomes who face having their means-tested benefits or tax credits withdrawn if they increase their income. Such disincentives are much greater than those imposed on high-income people through higher 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.
- The Government has explicit and tough targets for cutting child poverty further. Its current strategy of increasing means-tested 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.
- An alternative would be to target the sort of families that are likely to be poor, rather than directly to those that are poor. For example, an extra credit for families with three or more children would be well targeted on the poorest children, and would hardly affect work incentives. But this approach is not without drawbacks: it might be considered unfair on those who are poor but in small families, and it might affect families' child-bearing decisions.

The report considers a number of other possible reforms that might reduce poverty or strengthen work incentives. Housing benefit recipients face some of the weakest work incentives, and a reform in keeping with changes since 1997 would be to reduce the rate at which it is withdrawn with income. This would help some families on low income, and strengthen incentives for those currently facing housing benefit withdrawal to earn more. But such a reform would involve a considerable extension of means testing, weakening incentives to earn more for those families who became newly entitled to housing benefit.

Stuart Adam, one of the authors of the report, said: "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.

There is no easy solution to this trade-off. Ultimately, governments need to decide how much they want to redistribute income to low-income families, and how much they mind if people work less as a result.”

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Notes to editors:

1. *The poverty trade-off: work incentives and income redistribution in Britain*, by Stuart Adam, Mike Brewer and Andrew Shephard, is published by The Policy Press and available from www.policypress.org.uk or Marston Book Services, PO Box 269, Abingdon, Oxon OX14 4YN (tel:01235 465500), price £12.95 plus £2.75 p&p. The full report and a summary of findings can be downloaded free of charge from www.jrf.org.uk.
2. 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*, will be available from www.ifs.org.uk/projects_research.php?project_id=60
3. Findings from these reports will be presented at a briefing at the IFS offices in Ridgmount Street, London on Wednesday 4 October 2006, 11am–12:30pm. Please contact Bonnie Brimstone (bonnie_b@ifs.org.uk) if you would like to reserve a place.
4. The Joseph Rowntree Foundation is one of the largest social policy research and development charities in the UK. It supports a research and development programme that seeks to understand the causes of social difficulties and explore ways of overcoming them.
5. Please note that the Institute for Fiscal Studies is not related in any way to the *ifs School of Finance* (also known as *ifs*). For information about the *ifs School of Finance*, see <http://www.ifslearning.com>