

Press Release

Government's welfare reforms mean overall work incentives modestly strengthened despite wage falls

New IFS research, launched at a conference in London today, shows that the coalition government's tax and benefit reforms will strengthen peoples' incentives to work on average. This strengthening more than offsets the weakening in work incentives that would have occurred in the absence of policy change as a result of falling real earnings.

The report considers reforms that have been implemented, or are due to be implemented, from when the coalition government took office in May 2010 until the scheduled end of its term of office in May 2015. The reforms examined involve significant changes to existing personal taxes (raising £11 billion a year) and benefits (saving £22 billion a year) and the integration of six existing benefits into universal credit (broadly revenue-neutral).

Incentives to be in work at all

Taken together, these reforms strengthen the incentive for people to be in work, on average. They reduce the average replacement rate (RR, the income someone would receive if they were not working as a percentage of the income they would receive if they were in work) by 3.4 percentage points (ppts), and reduce the average participation tax rate (PTR, the proportion of earnings that are lost to higher taxes or lower benefits) by 2.5ppts. In the absence of these reforms work incentives would have weakened as a result of falling real earnings. Average RRs would have *increased* by 1.7ppts.

These changes to averages conceal far bigger changes at the individual level. For example, the benefit reforms (including universal credit):

- reduce PTRs by 5ppts or more for 7.5 million people and by 20ppts or more for 1.6 million people;
- increase PTRs by at least 5ppts for 3.5 million people and by at least 20ppts for 1.1 million people.

Benefit changes other than universal credit are responsible for the bulk of the strengthening of incentives to be in work. But their effect is perhaps less dramatic than might be expected given the scale of the cuts. Incentives are strengthened much less for those with children than those without children.

Once fully in place, **universal credit** will:

- strengthen the incentive for couples to have one person in work rather than none;
- weaken the incentive for both members of a couple to work rather than just one;

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Embargo

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- strengthen incentives for those who have the weakest incentives under the current system. Universal credit will halve the number of people with participation tax rates of 75% or more – a reduction of 1.5 million people.

Incentives for those in work to increase their earnings

Effective marginal tax rates (EMTR, the proportion of a small increase in earnings that is lost to higher taxes or lower benefits), are little affected by the tax and benefit reforms on average, but this again disguises dramatic effects at the individual level:

- Two million workers see their EMTR fall by at least 20ppts, while a million see their EMTR rise by at least 20ppts as a result of benefit reforms (including universal credit);
- Universal credit reduces EMTRs for those who face the very highest rates at the moment, significantly reducing the average EMTR for lone parents in particular, but weakens the incentive for others to increase their earnings;
- Reductions in the generosity of means-tested benefits mean that fewer workers face steep benefit withdrawal rates;
- The tax changes, in particular increases in rates of National Insurance contributions and VAT, tend to increase EMTRs. But at very low levels of earnings increases in the personal allowance have taken many people out of income tax altogether, thereby significantly reducing the EMTRs they face.

At the event, Stuart Adam will say: “The government’s welfare reforms strengthen financial incentives to be in work, on average, more than offsetting the weakening caused by falling real wages. But there is huge amount of variation in these effects, with large numbers of people seeing big rises or falls in effective tax rates.

Changes in non-financial work incentives and in the perception of how the tax and benefit system works are also likely to be important – and are much harder to quantify. The overall effects of these changes on behaviour remains to be seen.”

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Notes to Editors:

1. The report, ‘Do the UK government’s welfare reforms make work pay?’ by Stuart Adam and James Browne will be launched at an event in Westminster at 9:30am on 11 September 2013 (<http://www.ifs.org.uk/events/942>). Other speakers at the event will include Stephen Brien (DWP), Fran Bennett (Women’s Budget Group and University of Oxford) and David Phillips (IFS). Please contact Bonnie Brimstone (020 7291 4800, 07730 667013 or bonnie_b@ifs.org.uk) for embargoed copies of the report and details of the event if you would like to register to attend.
2. The research was funded by the ESRC Centre for the Microeconomic Analysis of Public Policy at the Institute for Fiscal Studies (RES-544-28-5001).

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3. The report examines two kinds of work incentive: the incentive to be in paid work at all and the incentive for those in work to increase their earnings. The financial incentive to be in work at all can be measured using the replacement rate (RR), which gives the income an individual would receive if they were not working as a percentage of the income they would receive if they were working, and the participation tax rate (PTR), the proportion of total gross earnings lost in the form of tax and withdrawn benefits. The incentive for those in work to increase their earnings can be measured by the effective marginal tax rate (EMTR), the proportion of a small increase in earnings lost in tax and withdrawn benefits. In all cases, higher numbers mean weaker work incentives.



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