



Institute for
Fiscal Studies

Tax By Design: The Mirrlees Review

Earnings Taxation and Work Incentives

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Our guiding principles

- The personal tax and benefit system should be progressive, coherent and transparent
- It should be designed to reflect the shape of the income distribution and responses to work incentives
- It will need to take much of the strain of distributional adjustments from other parts of the reform package

Where do we start from?

1. A highly complex array of welfare benefits and tax credits
 - which do not fit together well
 - Are difficult and costly for people to deal with
 - impose some very high effective tax rates on low earners
2. An income tax system that is opaque and unnecessarily complex
 - a bizarre marginal rate structure
 - two entirely separate taxes on earnings – income tax and NICs
3. A system that does not take proper account of what we know about how different people respond to tax incentives

Our key proposals

1. Simplify and integrate the benefit system
2. Merge income tax and NICs, and end practice of tapering personal allowances
3. Target work incentives where they are most effective
 - Strengthen incentives for parents with school age children
 - Strengthen incentives for those in their later working life

How did we arrive at our recommendations?

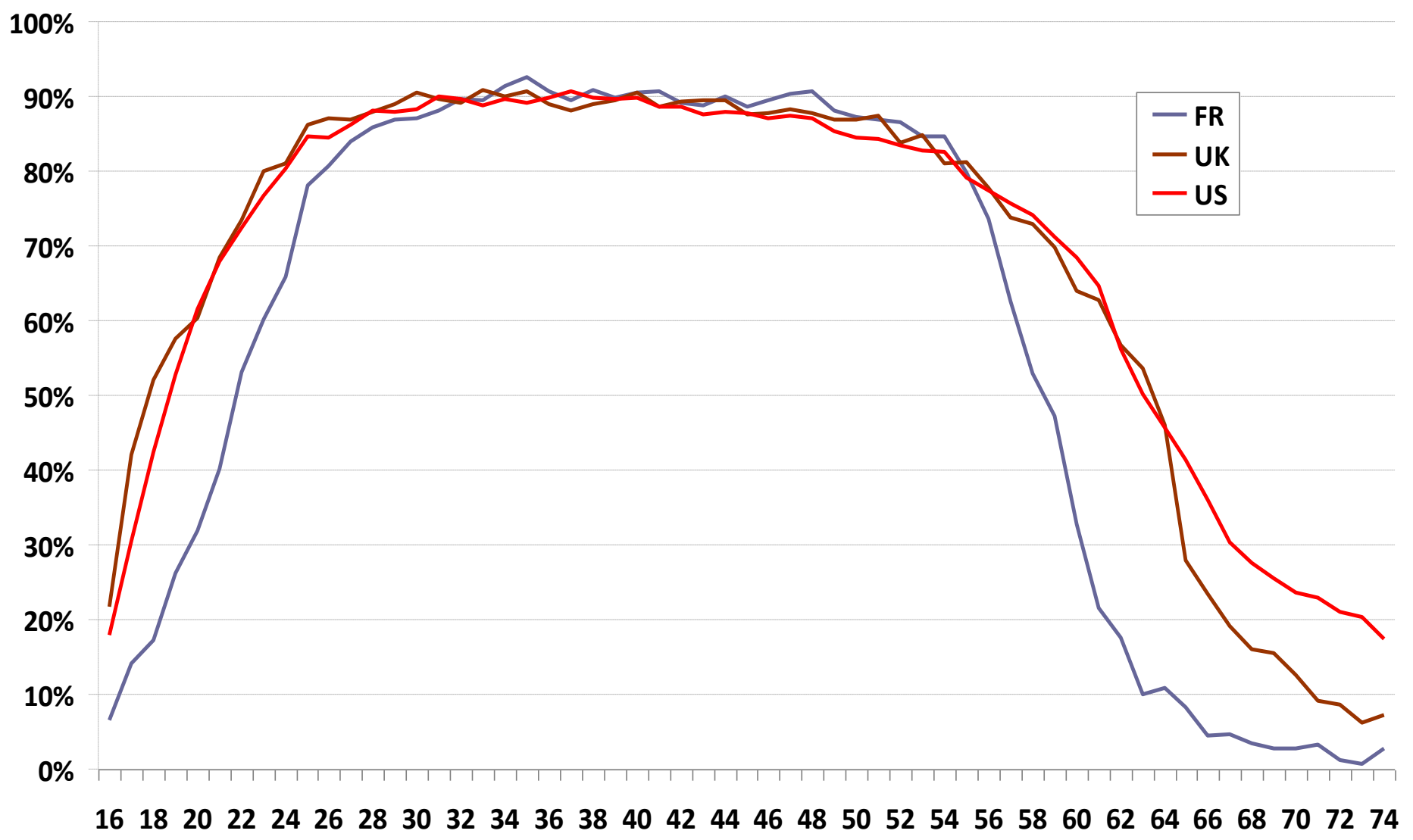
Four steps.....

1. Evidence on the size of responses
2. The distribution of effective tax rates
3. The importance of complexity and salience
4. Implications from evidence and theory for tax design

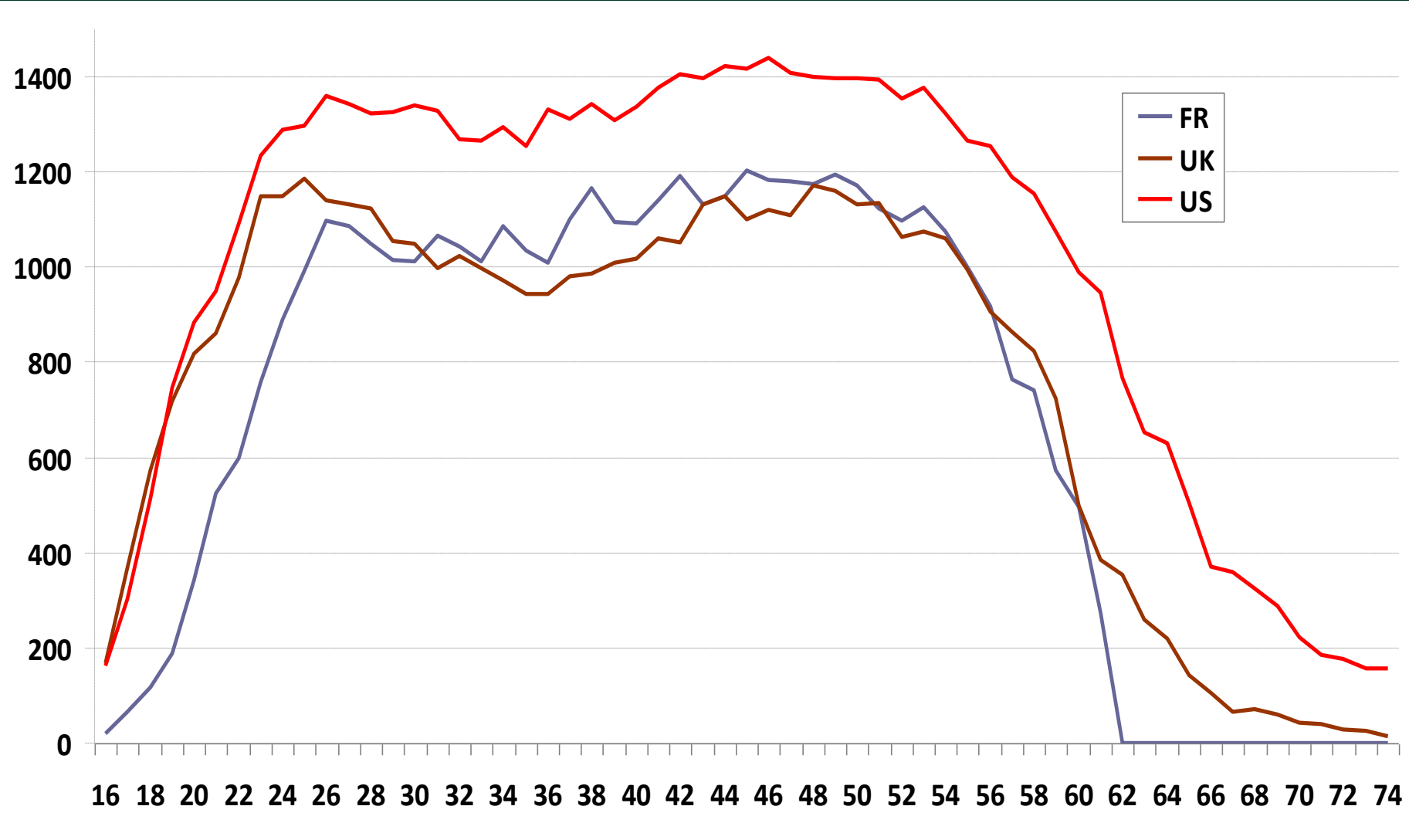
What do we know about how people respond to taxes and benefits?

- Taxes and means testing reduce labour supply
 - substitution effects are generally larger than income effects
- And, especially for low earners,
 - responses are larger at the extensive margin—employment
 - than at the intensive margin—hours of work.
- These responses are largest for
 - women where the youngest child is school-age
 - those aged over 55
- Other responses affecting taxable income matter
 - certainly for the rich

Male employment by age – US, FR and UK 2007



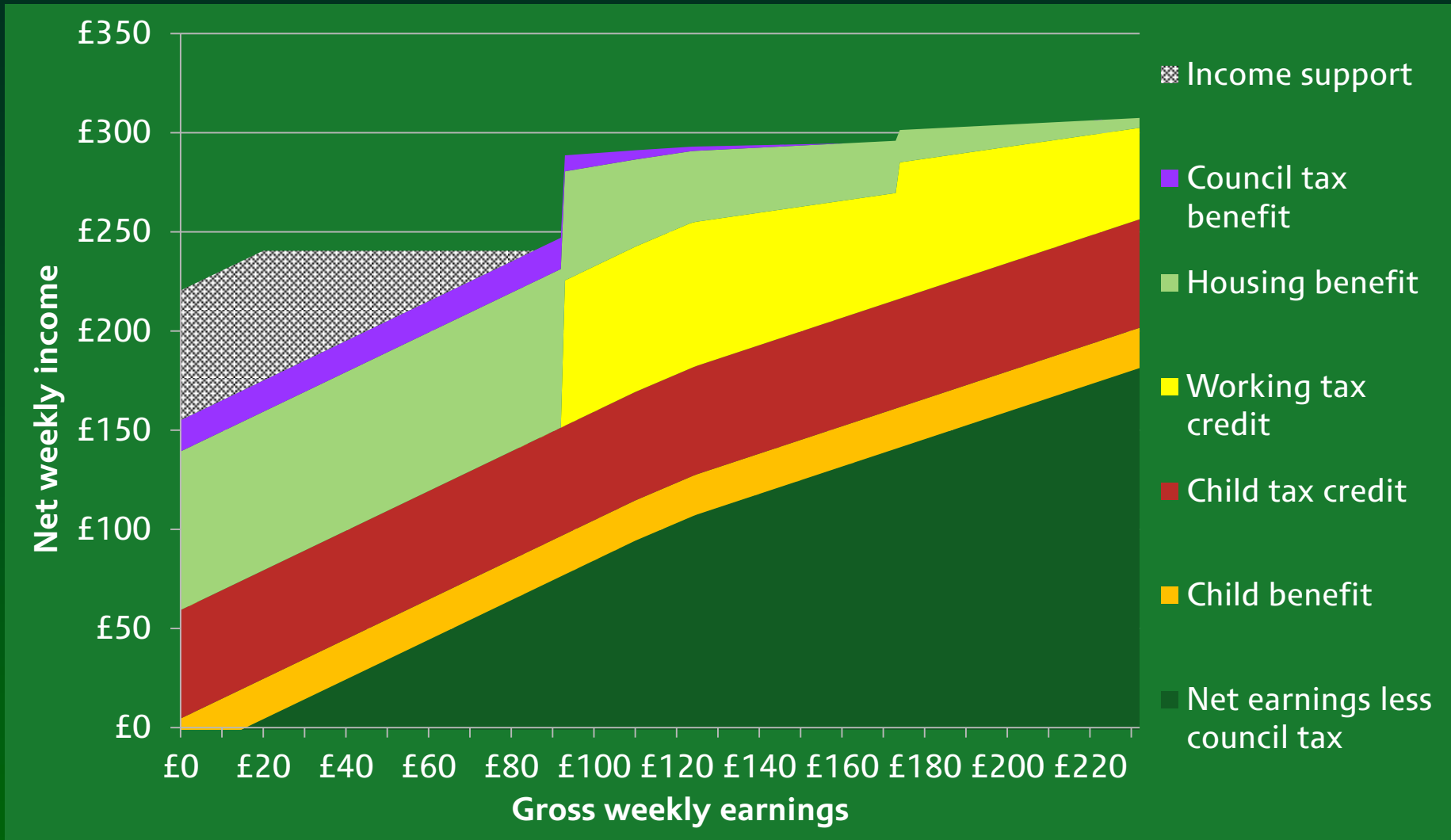
Female hours by age – US, FR and UK 2007



What about effective tax rates in the current system?

- Let's take a quick tour....

The interaction between taxes, tax credits and benefits

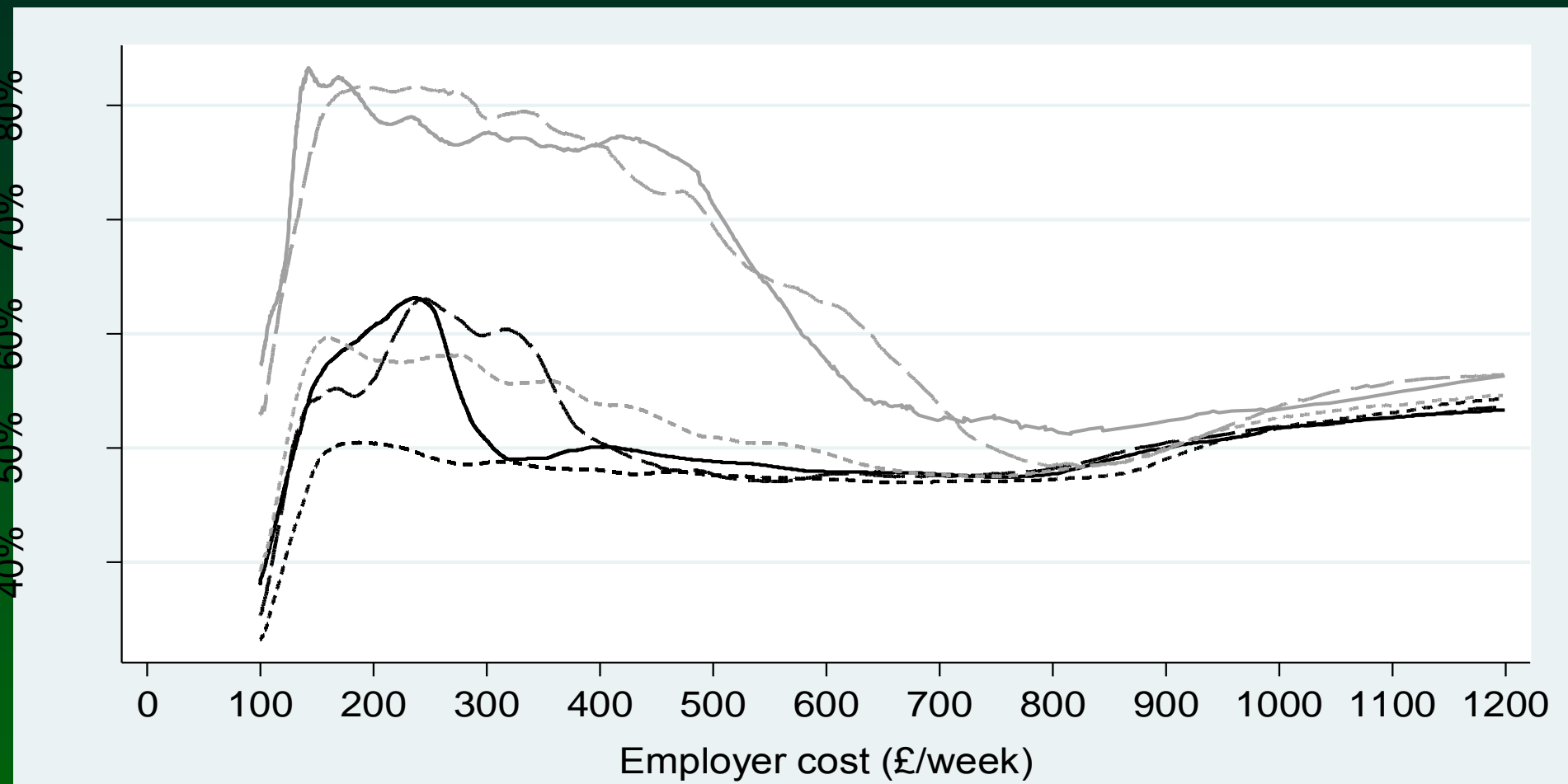


Notes: Lone parent, with one child aged between one and four, earning the minimum wage (£5.80 per hour), with no other private income and no childcare costs, paying £80 per week in rent to live in a council tax Band B property in a local authority setting council tax rates at the national average

But this is just an example....

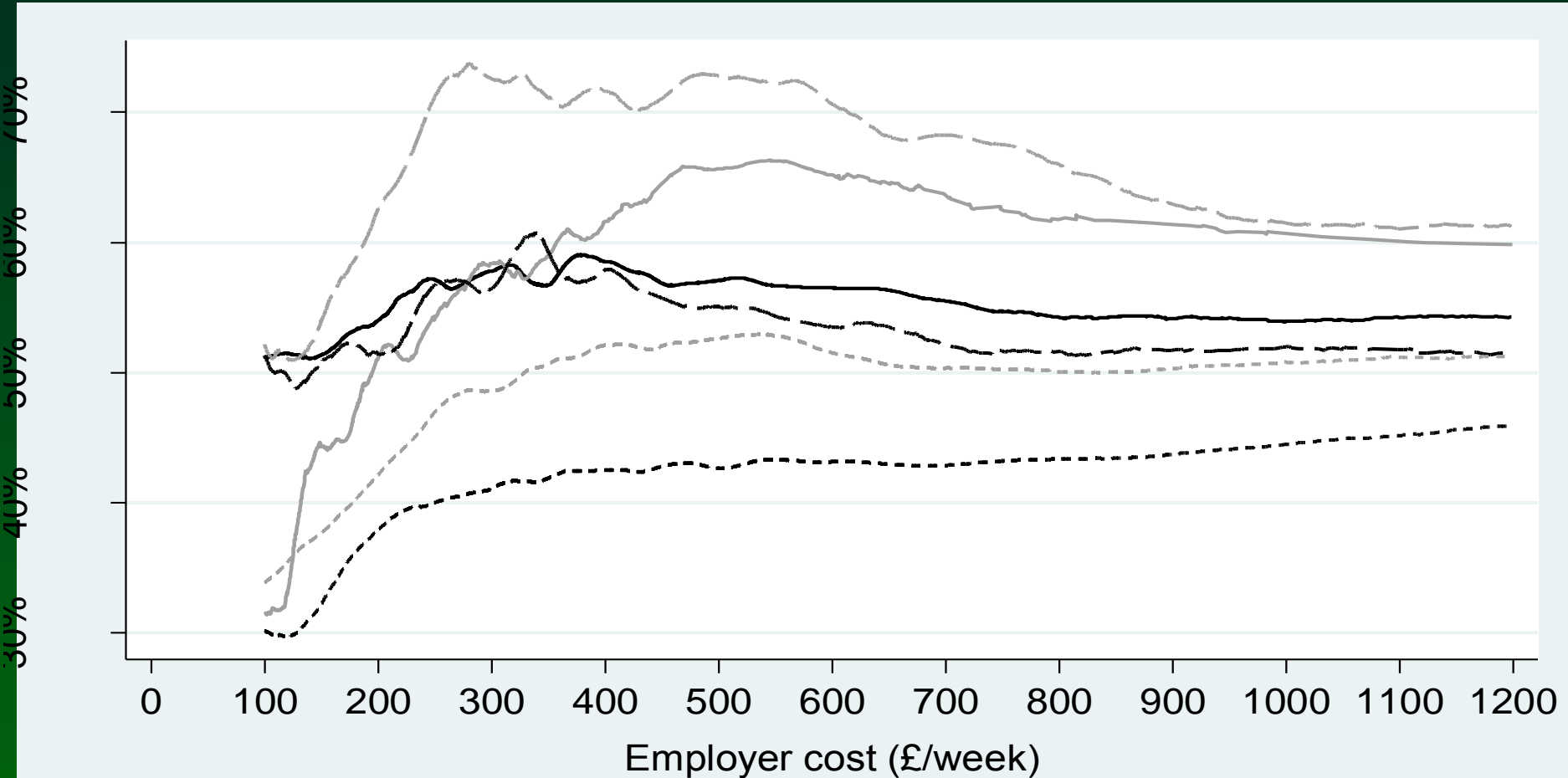
- What does the tax and benefit system imply across the distribution of earnings and different family types?
 - What do **effective marginal tax rates** look like? – the proportion of a small increase in earnings taken in tax and withdrawn benefits
 - What do **participation tax rates** look like? – the incentive to be in paid work at all – defined by the proportion of total earnings taken in tax and withdrawn benefits.

Average EMTRs for different family types



- Single, no children
- - - Partner not working, no children
- Partner working, no children
- Lone parent
- - - Partner not working, children
- Partner working, children

Average PTRs for different family types



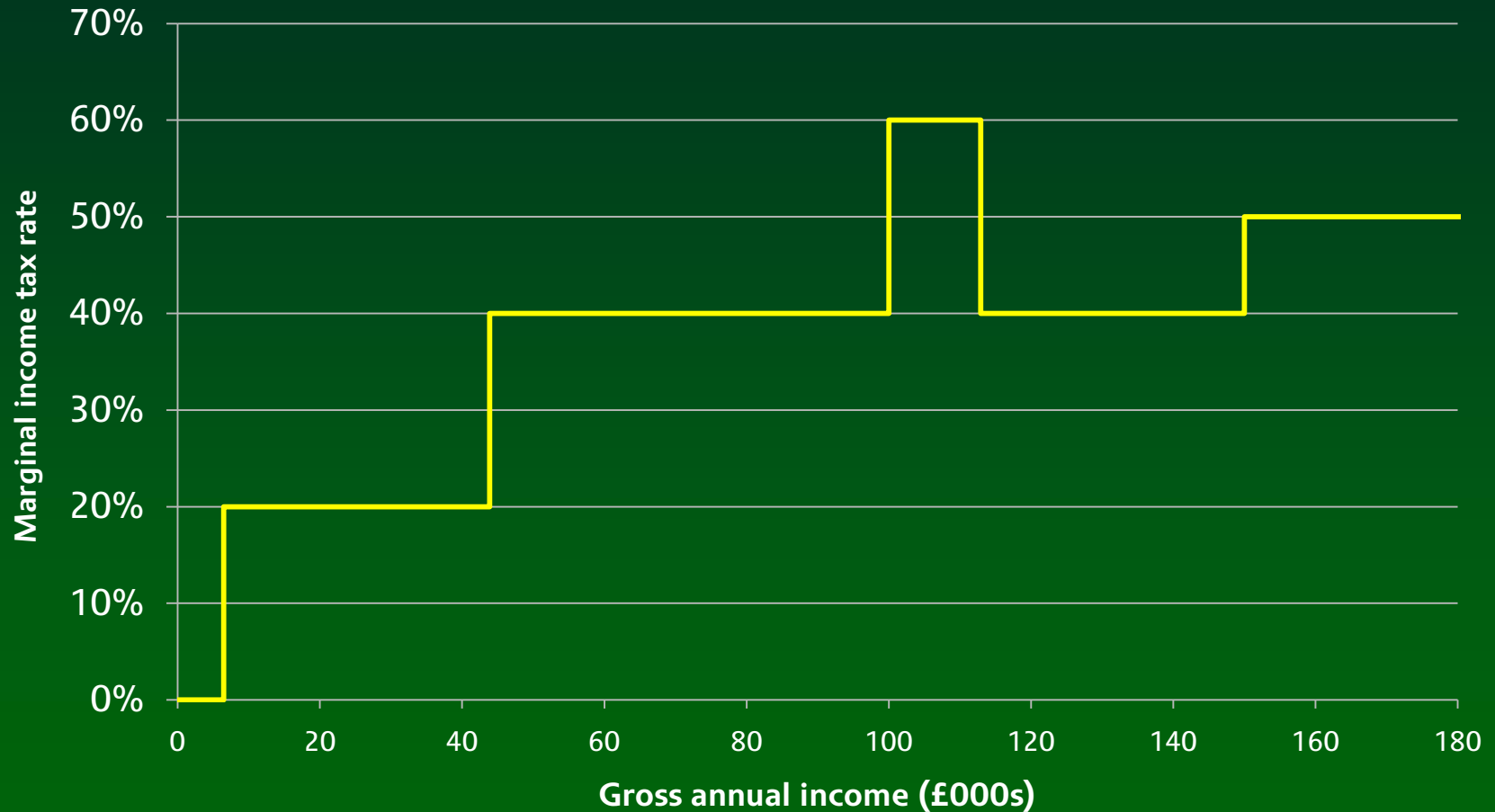
- Single, no children
- Partner not working, no children
- Partner working, no children
- Lone parent
- Partner not working, children
- Partner working, children

...and these EMTRs and PTRs are just averages.

- The current structure of multiple benefits with an array of overlapping means-tests leaves some people facing effective marginal tax rates of over 90%.
- **Implications for reform:**
- For the tax and benefit system to be effective requires simplification and integration of the benefit and tax credit system

At the top too... the income tax system lacks coherence

Income tax schedule for those aged under 65, 2010–11



Implications

- Coherence and transparency requires that the income tax system itself be sensibly structured
 - we need to move away from complexities such as that which sees the marginal rate rise from 40% to 60% at £100,000 of income before falling back to 40% at £112,950
- But what about National Insurance?

Reforming National Insurance

- NI has become very much like an income tax but one that just penalises employment
 - either make it a proper social insurance
 - or merge with income tax
- Move away from having separate systems of income tax and NICs, with different sets of rules and exemptions
 - enhance transparency
 - reduce compliance and admin costs
 - broaden the NICs base to cover capital income

What about redesigning the tax rate schedule?

- Use what we know about behavioural responses so people face strengthened work incentives:
 - parents with school age children,
 - people aged 55-70.
- People face stronger incentives at the times they are most responsive to them
- Reforms can be designed which redistribute mainly across the life-cycle
- The specific reforms we have simulated would generate large increases in employment rates

Strengthen work incentives where they are most effective

I. for families whose youngest child is of school age

- reflecting the finding that the mothers of older children are more responsive to the incentives in the tax and benefit system.

- One way of achieving this:

- make CTC more generous (and so means-testing more extensive) for families a child aged under five,
- and less generous (with less means-testing) for families whose youngest child is aged five or older.

- Simulations point to a net addition to employment of over 50,000 and to earnings of nearly £1bn.

Strengthen work incentives where they are most effective

II. for those in their later working life, aged 55-70

– a group which is highly responsive to incentives.

- This could be achieved in the current system by
 - raising the age of eligibility for pension credit to 70,
 - reducing to 55 the age at which employees no longer have to pay NI and the age at which the higher tax free personal allowance becomes available.
- Our simulations point to an increase in net employment of more than 150,000 and in earnings of just under £2bn.
- As with our child tax credit proposals, much of the distributional impact would consist of offsetting effects over the life-cycle.

Summary

- We are still bound by the trade-off between incentives and redistribution
- But the current system is unnecessarily complicated and induces too many people not to work or to work too little
 - The rate structure of income tax should be simplified, and income tax and NICs should be merged.
 - A single integrated benefit should be introduced rationalising the way in which total support varies with income and other characteristics.
 - Work incentives should be targeted where they are most effective
- Placing us in a good position to address the distributional implications of other aspects of our reform package