The effect of UK welfare reforms on the distribution of income and work incentives

Stuart Adam and James Browne

DG ECFIN workshop on expenditure-based consolidation
Brussels, 20 January 2015
UK government revenue and spending

Source: IFS calculations using Office for Budget Responsibility data.
Composition of the discretionary fiscal tightening

12% from tax rises
7% from investment spending cuts
15% from welfare spending cuts
53% from other current spending

Source: IFS calculations based on HM Treasury and Office for Budget Responsibility figures.
Analysing the welfare reforms

• Effects of reforms implemented from May 2010 to May 2015
  – On those below 2010 state pension age
  – Separate out universal credit from other welfare reforms

• Use TAXBEN micro-simulation model of tax and benefit system
  – Run on Family Resources Survey, a representative cross-section of about 25,000 households

• Models entitlement, not receipt (i.e. assumes full take-up)

• Does not model behavioural responses
  – We have separate behavioural models, using TAXBEN as an input – not presenting today
Two kinds of financial work incentives

• Incentive to be in paid work at all
  – Replacement rate (RR): out-of-work income / in-work income
  – Participation tax rate (PTR): proportion of total earnings taken in tax and withdrawn benefits

• Incentive for those in work to increase their earnings
  – Effective marginal tax rate (EMTR): proportion of an extra £1 of earnings taken in tax and withdrawn benefits

❖ In all cases, higher numbers = weaker incentives
Characterising the welfare reforms

1. Changes in the generosity of ‘safety-net’ benefits
   - Some cuts (e.g. housing benefit); some increases (e.g. child tax credit)
     ➢ *cuts strengthen work incentives; increases weaken them*

2. Cuts to in-work support (working tax credit)
   ➢ *weaken incentive to have someone in paid work*
   ➢ *but strengthen incentives to earn more if working, and to have a second earner*

3. Means-testing more aggressively
   - increase in tax credit withdrawal rate; means-testing child benefit
   ➢ *complicated and mixed effect on work incentives*

   • Change to uprating of benefits is the biggest cut
     - Switch to lower inflation measure – effects get bigger each year
     - Uprating limited to 1% in 2013, 2014 and 2015
     - Affects both safety-net and in-work benefits
Distributional impact of welfare reforms

Poorest

All

Income decile group

£ per year (left axis)

% of income (right axis)

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Distributional impact of welfare reforms

- Single, not working
- Single, in work
- Lone parent, not working
- Lone parent, in work
- Zero-earner couple without children
- One-earner couple without children
- Two-earner couple without children
- Zero earner couple with children
- One-earner couple with children
- Two-earner couple with children
- Multi-family household, no children
- Multi-family household with children

All

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### Effect of welfare reforms on work incentives

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Welfare reforms affecting non-financial incentives

• Old welfare-to-work schemes replaced by new Work Programme
  – Further shift towards payment by results
  – Should give providers better incentives and flexibility to innovate
  – Initial evidence not encouraging

• More work search requirements for lone parents with youngest child aged 5-9
  – Recent study found that equivalent policy where child aged 10+ increased affected lone parents’ employment by 8-10ppts after a year

• Tougher medical reassessments for disability benefits
  – Likely to promote employment but hard to quantify
Universal credit

• One benefit to replace 6 existing means-tested working-age benefits
  – Arguably the most radical restructuring since the 1940s
  – Roughly revenue-neutral overall

• Gradually being phased in
  – But implementation problems have caused repeated delays

• Aims: simplify system and rationalise work incentives
Universal credit example: lone parent

Same out of work income

Can earn more before benefits start to be withdrawn

No ‘jump’ at 16 hrs/wk

Avoids withdrawing multiple benefits at the same time, so get to keep more of additional earnings

Assumes: wage £6.50/hr, 2 children, no other income, £80/wk rent. Ignores council tax and rebates
Universal credit: non-financial aspects

• Better admin and smoother transitions into work
  – If can operate successfully with reformed income tax administration: employers must now report wage payments in real time

• Simpler support with more transparent incentives may help
  – Though lose the salience of a working tax credit

• Conditionality may extend to many more people, esp. in couples
  – Currently applies up to 16 hours or £76 (£121 for couples)
  – UC may extend to 35 x min wage = £213 (£416 for couples)

➢ Little empirical evidence on likely impact of these
Distributional impact of welfare reforms

Universal credit
Other welfare reforms

Income decile group

Poorest
2
3
4
5
6
7
8
9
Richest
All

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Distributional impact of welfare reforms

- £4 000
- £3 000
- £2 000
- £1 000
£0
£1 000

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- Universal credit
- Other welfare reforms

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Effect of universal credit on work incentives

Universal credit gets rid of many of the very weakest work incentives:
- reduces number of people with PTRs >75% by nearly half (1.6m)
- reduces number of people with EMTRs >85% by more than 90% (1.0m)

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Averages conceal huge individual-level variation

• For example, welfare reforms (including universal credit):
  – reduce PTRs by >5ppts for 7.7m people and by >20ppts for 1.6m
  – increase PTRs by >5ppts for 3.1m people and by >20ppts for 0.8m
  – reduce EMTRs by >20ppts for 2.0m people
  – increase EMTRs by >20ppts for 0.8m people

➤ Lots of reforms have big effects on small numbers of people
Work incentive trade-offs

- Work incentives vs. redistribution

- Incentives to be in work vs. for those in work to earn more

- Incentives for 1st vs. 2nd earners

- Very weak incentives for a few vs. quite weak incentives for many

- Theoretical optimality vs. practical considerations
Conclusions

- Average cash losses biggest for lower-middle income households
  - Though low-income households lose more as % of income
- Reforms strengthen incentives to be in work, on average
  - More than offsetting effects of falling real earnings
  - Less effect on average incentives for those in work to earn more
- Strengthening is not dramatic given scale of welfare cuts
  - Partly because of nature of tax credit reforms
- UC strengthens incentive for couples to have someone in work
  - But weakens incentive to have a second earner
- UC removes many of the weakest work incentives
- Small average effects conceal big effects at individual level
- And remember financial work incentives are not the whole story!
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