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

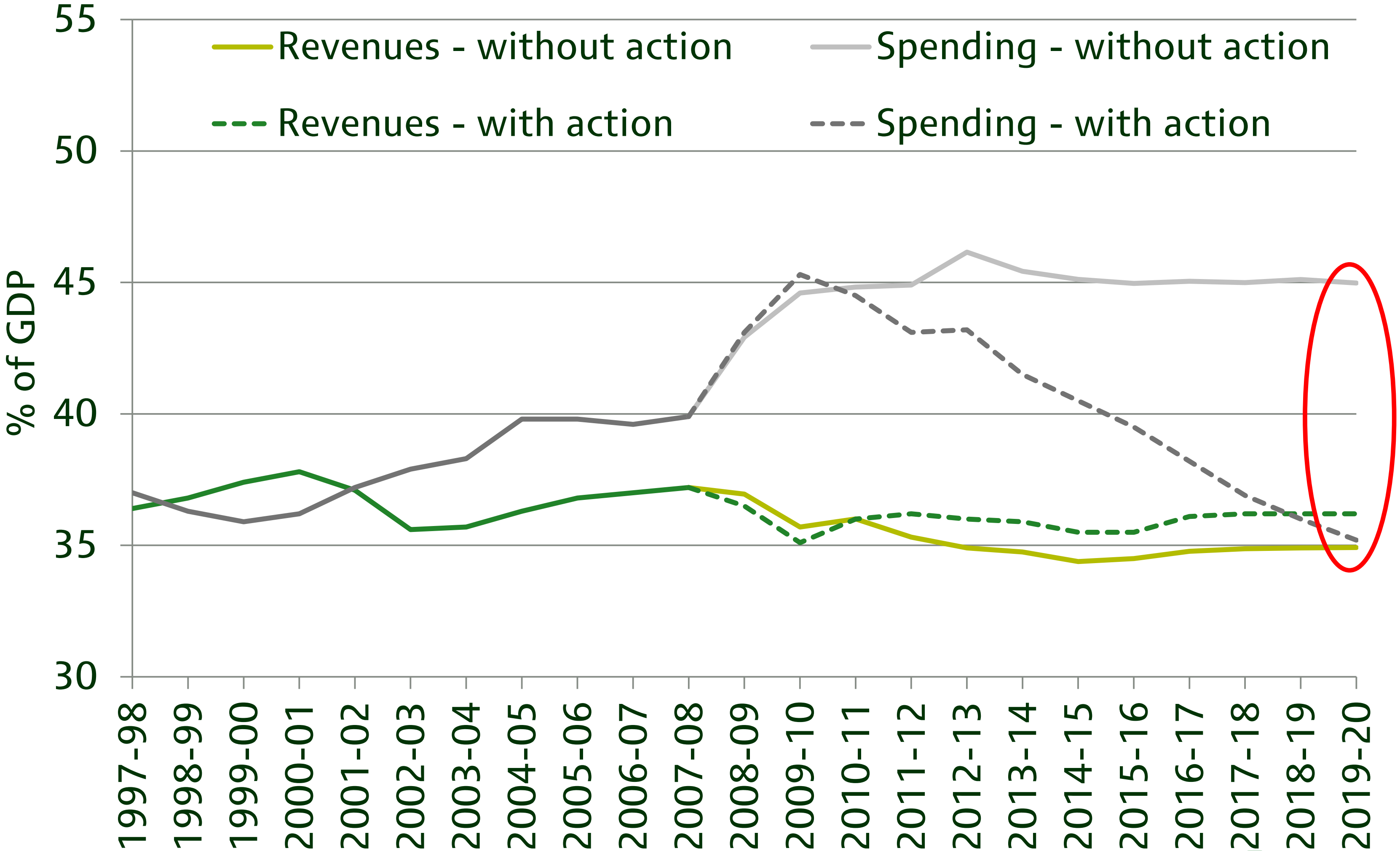
Stuart Adam and James Browne

DG ECFIN workshop on expenditure-based consolidation

Brussels, 20 January 2015

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

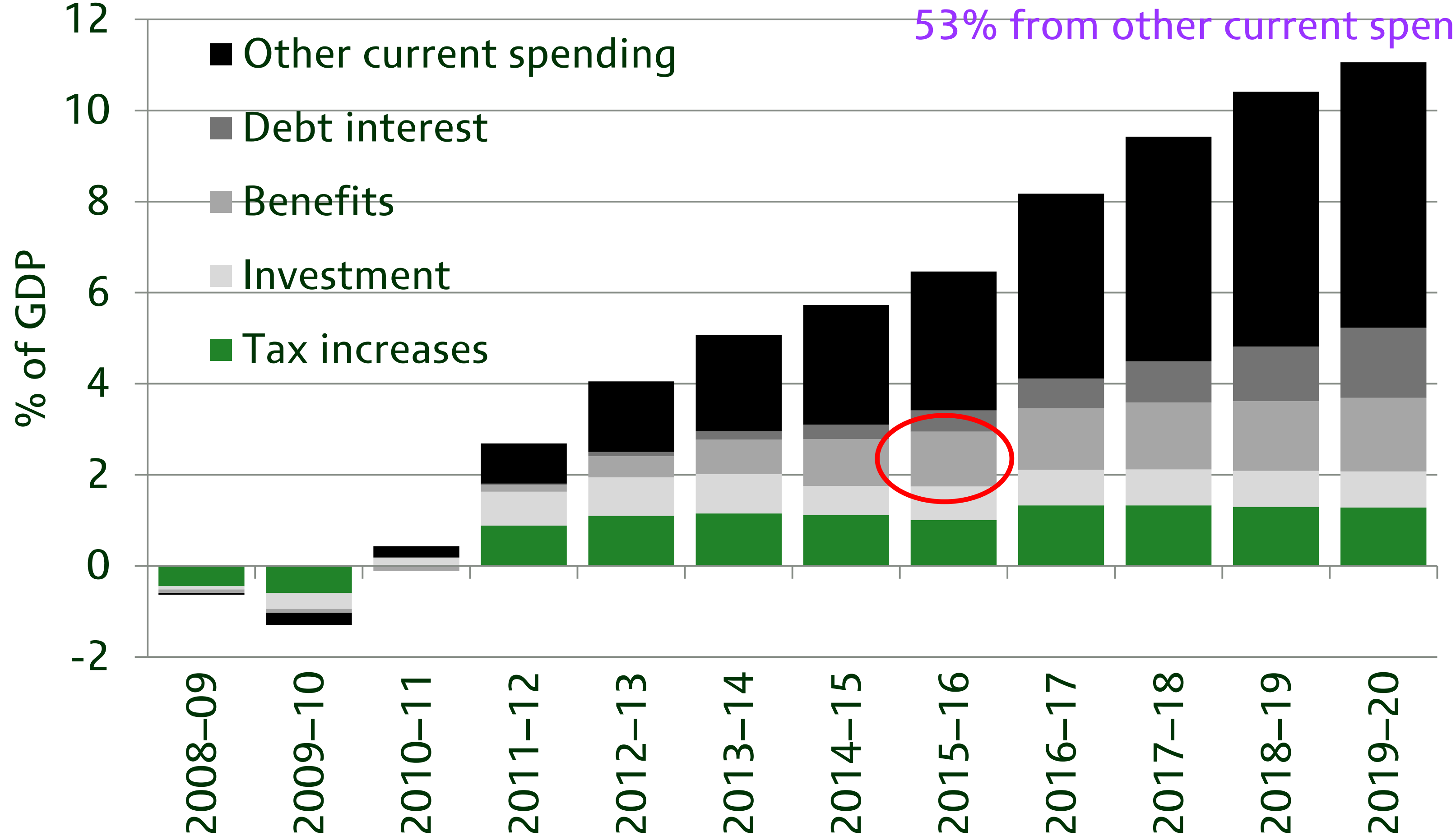
UK government revenue and spending



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

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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  - Participation tax rate (PTR): proportion of total earnings taken in tax and withdrawn benefits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  - Effective marginal tax rate (EMTR): proportion of an extra £1 of earnings taken in tax and withdrawn benefits

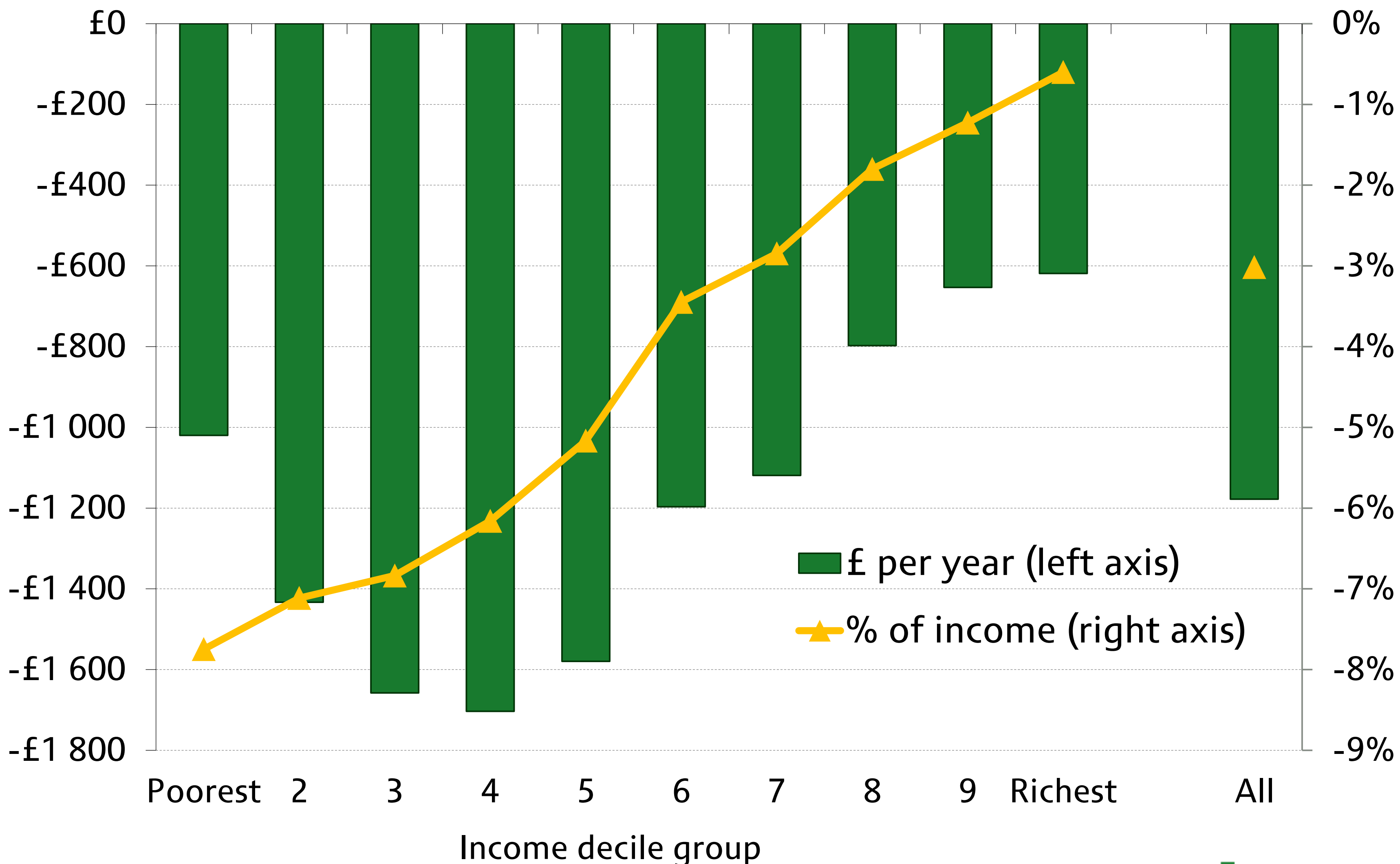
- In all cases, higher numbers = weaker incentives

Characterising the welfare reforms

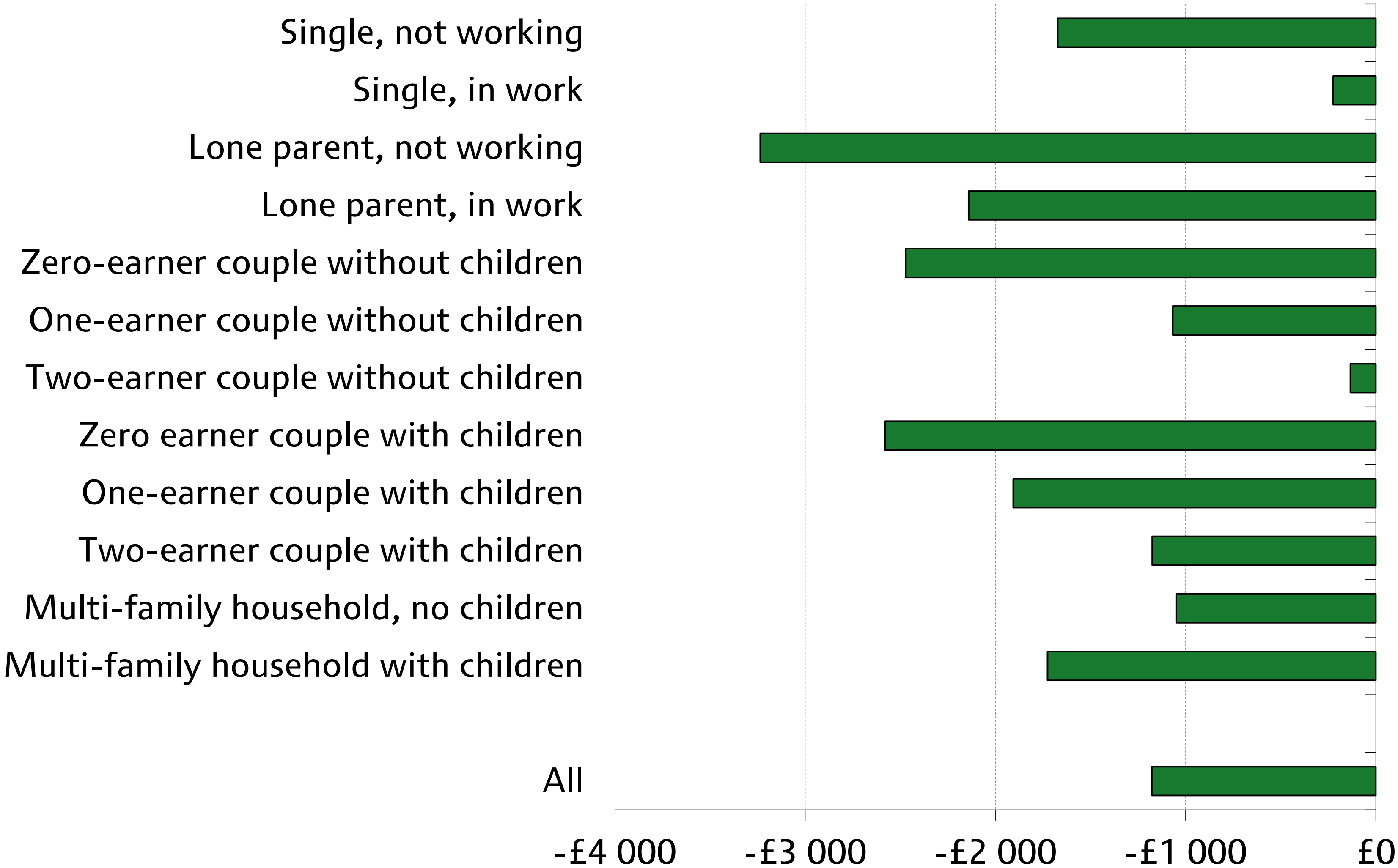
1. Changes in the generosity of 'safety-net' benefits
   - Some cuts (e.g. housing benefit); some increases (e.g. child tax credit)
   - ➢ *cuts strengthen work incentives; increases weaken them*
2. Cuts to in-work support (working tax credit)
   - ➢ *weaken incentive to have someone in paid work*
   - ➢ *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



Distributional impact of welfare reforms



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Effect of welfare reforms on work incentives

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children			
Lone parent			
Partner not working, no children			
Partner not working, children			
Partner working, no children			
Partner working, children			
All	–2.5	–1.5	–1.1

Effect of welfare reforms on work incentives

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	–3.8		
Lone parent	–2.2		
Partner not working, no children	–4.5		
Partner not working, children	–0.8		
Partner working, no children	–1.5		
Partner working, children	–1.9		
All	–2.5	–1.5	–1.1

Effect of welfare reforms on work incentives

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	–3.8	–2.2	
Lone parent	–2.2	+0.7	
Partner not working, no children	–4.5	–2.8	
Partner not working, children	–0.8	+2.2	
Partner working, no children	–1.5	–1.7	
Partner working, children	–1.9	–1.6	
All	–2.5	–1.5	–1.1

Effect of welfare reforms on work incentives

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	–3.8	–2.2	–1.4
Lone parent	–2.2	+0.7	–1.0
Partner not working, no children	–4.5	–2.8	–1.2
Partner not working, children	–0.8	+2.2	–1.7
Partner working, no children	–1.5	–1.7	–0.7
Partner working, children	–1.9	–1.6	–1.0
All	–2.5	–1.5	–1.1

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

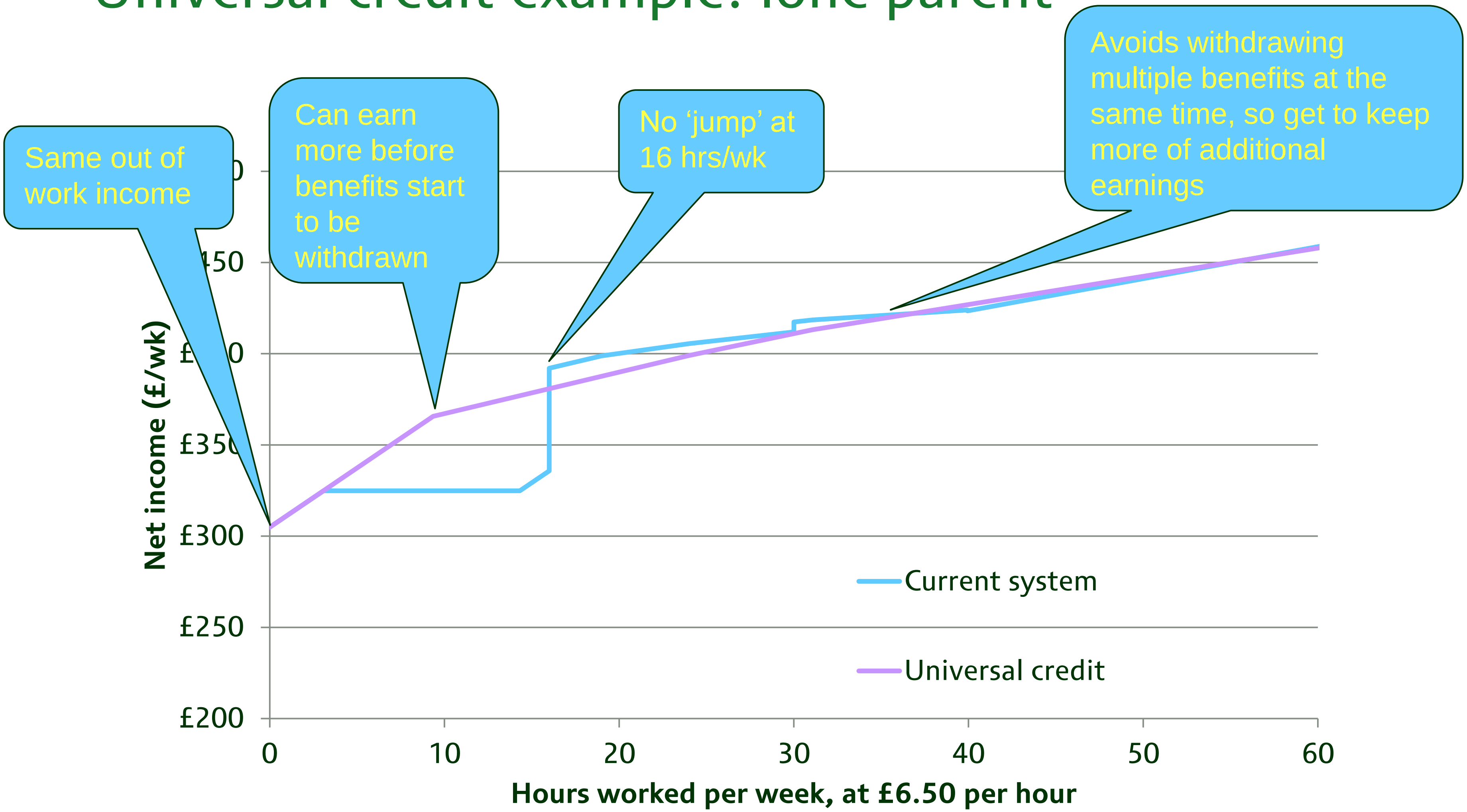
- More work search requirements for lone parents with youngest child aged 5-9
  - Recent study found that equivalent policy where child aged 10+ increased affected lone parents' employment by 8-10ppts after a year

- 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



Assumes: wage £6.50/hr, 2 children, no other income, £80/wk rent. Ignores council tax and rebates

Universal credit: non-financial aspects

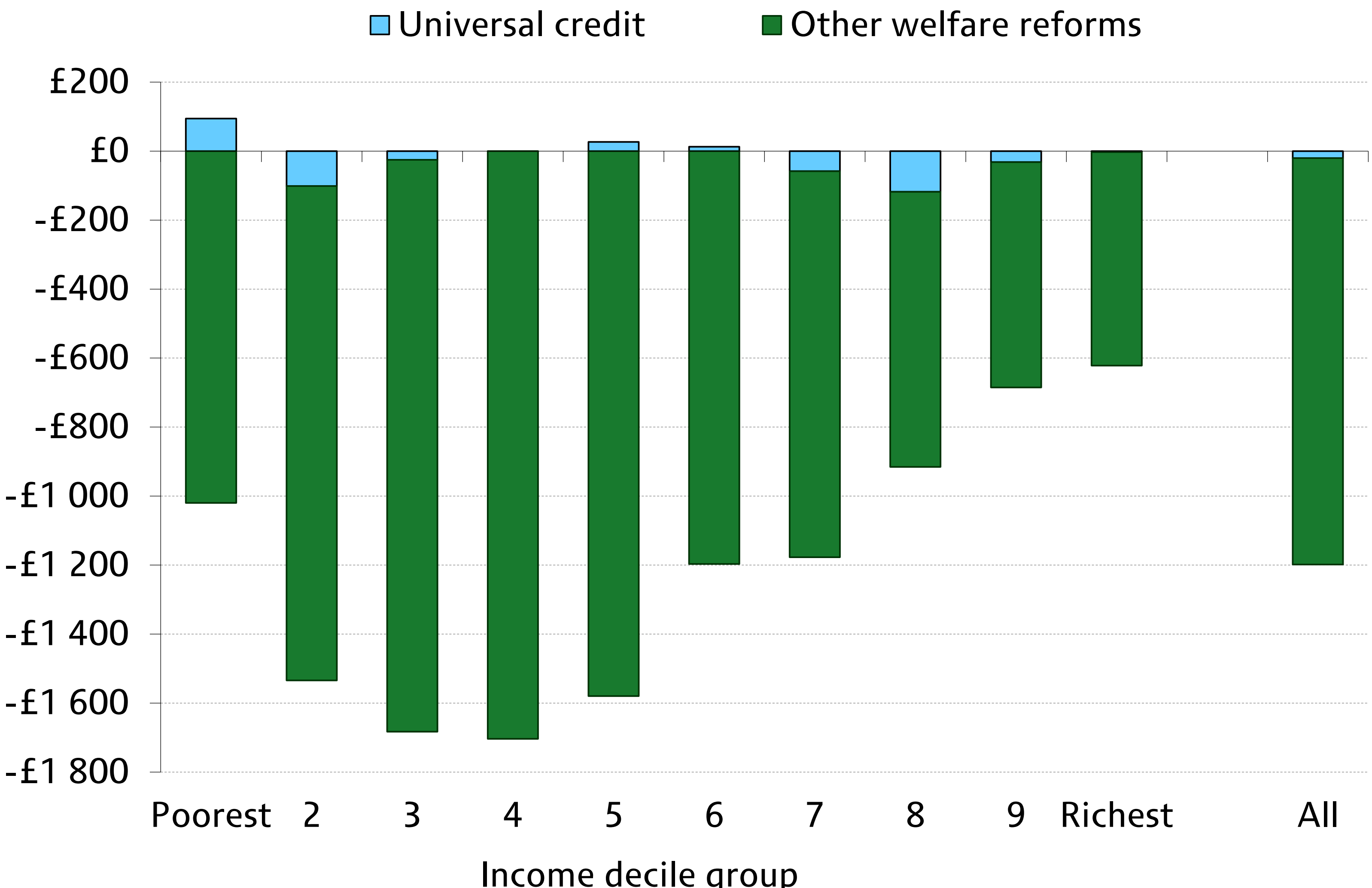
- Better admin and smoother transitions into work
  - If can operate successfully with reformed income tax administration: employers must now report wage payments in real time

- 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



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Distributional impact of 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)

Effect on average work incentives:

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children			
Lone parent			
Partner not working, no children			
Partner not working, children			
Partner working, no children			
Partner working, children			
All	–0.8	–0.7	–0.4

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Effect on average work incentives:

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	–0.8		
Lone parent	–0.2		
Partner not working, no children	–3.4		
Partner not working, children	–5.4		
Partner working, no children	–0.0		
Partner working, children	+0.4		
All	–0.8	–0.7	–0.4

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Effect on average work incentives:

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	–0.8	–1.3	
Lone parent	–0.2	+2.6	
Partner not working, no children	–3.4	–3.7	
Partner not working, children	–5.4	–8.0	
Partner working, no children	–0.0	+0.0	
Partner working, children	+0.4	+1.4	
All	–0.8	–0.7	–0.4

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Effect of universal credit on work incentives

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Effect on average work incentives:

	Percentage point change in average:		
	RR	PTR	EMTR
Single, no children	–0.8	–1.3	+0.4
Lone parent	–0.2	+2.6	–6.4
Partner not working, no children	–3.4	–3.7	–0.4
Partner not working, children	–5.4	–8.0	+0.1
Partner working, no children	–0.0	+0.0	–0.2
Partner working, children	+0.4	+1.4	–0.4
All	–0.8	–0.7	–0.4

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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