Has Labour made work pay?

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Contents

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Executive summary

The make work pay policy agenda describes a series of reforms introduced by the Labour Government since 1997 with the twin aims of making work pay more than not working and making work pay enough to help families avoid poverty. In common with governments in other countries, Labour's ultimate goals were to reduce the proportion of households where no adult works, increase employment rates and reduce poverty, particularly among children. Although the make work pay agenda applied to adults both with and without children, and both groups have been affected by key make work pay policies such as tax credits for low-income families where at least one adult is working and the minimum wage, the policy changes have been far more substantial for parents. This report therefore focuses on the impact of Labour's policies on individuals in families with dependent children.

Examining outcomes of Labour's ultimate objectives would lead one to conclude that the make work pay policies have been a success.

- More parents are working: employment rates have risen by 10 percentage points for lone parents since 1997 and by a smaller amount for individuals in couples.

- There are 350,000 fewer children under 16 in households where no adult works in 2004 than in 1997.

- Child poverty in 2004 is on track to be at a level last seen in the early 1990s.

Academic studies agree that government policies were partially responsible for these changes, at least among lone parents. They show less agreement about the impact of government policies on individuals in couples, however, but they do suggest that Labour has been successful in reducing worklessness among couples with children, but rather less successful in raising employment rates among parents in couples.

But, while examining the ultimate objectives leads to a positive assessment of Labour's policies, the impact of Labour's changes to personal taxes and benefits for parents on financial work incentives is mixed. Among lone parents, we note the following.

- A majority now have a larger financial reward to work than in 1997.

- Labour's changes have hardly changed the effective marginal tax rate faced, on average, by working lone parents. But low-earning lone parents have stronger financial incentives to progress in the labour market, while medium- and high-earning lone parents face smaller financial incentives to progress.

Among couples with children, we note the following.

- A small number of couples with children have an increased financial reward for having one adult in work, but many more face a smaller financial reward.

- The financial reward to having a second earner is now less, on average, than in 1997. Together with the first effect, this means that a couple with children now face a relatively stronger incentive, on average, to be a single-earner couple, rather than to have two earners or none, than in 1997.

- Financial incentives to progress for over 40 per cent of workers in couples with children have worsened, with the average effective marginal tax rate faced by individuals in couples with children 5 percentage points higher, thanks to Labour's tax and benefit reforms.

Overall, more working parents face reduced incentives to progress in the labour market through Labour's tax and benefit changes than face improved incentives to progress, with the number facing an effective marginal tax rate of over 50 per cent rising by almost 900,000. Although there is some evidence that in-work support (with its high effective marginal tax rates) in the UK does not reduce, and may increase, wage growth among those individuals receiving it, the long-run impact of higher effective marginal tax rates on individuals' prospects is not yet known with certainty.

This mixed impact on work incentives has arisen for two reasons.

- The Government has increased the support available to low-earning parents by increasing the size of the maximum entitlements, and by cutting the rates of withdrawal of in-work benefits and tax credits. This in-work support, though, remains means-tested and, in couples, it still depends on family income. The result of the increased generosity of means-tested, in-work support is that more parents now face some sort of benefit or tax credit withdrawal.

- The Government's desire to substantially reduce child poverty has led it to increase the state support available to non-working families with children and this has reduced the financial reward to work.

There have also been substantial changes in the form of means-tested support: in 1997, Family Credit was administered by the Benefits Agency, and shared many rules with other means-tested benefits, but its replacements are administered by the Inland Revenue and look a little more like part of the income tax system. The impact of these changes on work incentives is, though, unknown and not explored in this report.

Looking forward, there are concerns that the Government's recent policy towards tax credits, of increasing the Child Tax Credit for the poorer half of parents and eroding the value of the Working Tax Credit by freezing the point at which higher incomes reduce tax credit entitlements, may be unsustainable in the medium term because of its negative impact on work incentives. This suggests that the next set of policy reforms for parents may be focused more on improving work incentives than on directly reducing child poverty. The Government may, for example, choose to make more use of finely targeted, time-limited changes to financial work incentives, such as those currently being piloted in the Employment Retention and Advancement demonstration, or the In-work Credit, which have some features in common with current policies designed to ease the transition to work, rather than those designed to support all low-income families with individuals in work. But the unambiguously negative impact of Housing Benefit and Council Tax Benefit on work incentives remains one of biggest challenges to any government wanting to make work pay.

1 Introduction

The goal to make work pay was one of the incoming Labour Government's first policy priorities, first set out in HM Treasury (1997).[1] And, since this articulation, it has been one of the key driving factors behind a significant set of changes to the personal tax, tax credit and benefit system.

This report attempts to evaluate the Government's success in making work pay. This exercise is made somewhat difficult by the fact that the superficially simple political slogan is not defined in terms of unambiguous, easily measurable outcomes. It is also the case that the key make work pay policies – tax credits and the national minimum wage – had other objectives beyond making work pay. But, in this report, we evaluate the success of the Government on what we see as the two main make work pay policy objectives: to make work pay more than not working and to make work pay enough to avoid poverty.

The outline of the report is as follows. Chapter 2 discusses what policies to make work pay might actually be trying to achieve, drawing on a recent JRF-sponsored review (Bennett and Millar, 2004), analyses some of the key government policy documents that outlined the make work pay agenda and discusses how we might evaluate the success of make work pay policies.

Chapter 3 reviews the main policies that the Government has introduced to make work pay. This shows that the Government has been concentrating heavily on making work pay for parents; adults without dependent children have seen financial work incentives change little under Labour, with the biggest changes happening only recently with the extension of in-work support to those without children in the Working Tax Credit in April 2003. For this reason, the rest of the report focuses on how make work pay policies have affected families with children.[2]

The main contribution of this report to the evidence on make work pay policies is in the following two chapters. Chapter 4 reviews the success of the Labour Government in affecting trends in employment of parents and in changing various measures of the financial incentive to work. Chapter 5 reviews a complementary body of work that has analysed whether the Government's reforms have made work pay enough to avoid poverty and hardship. Chapter 6 presents our conclusions and a brief look ahead to future make work pay policies.

This report assumes some knowledge of the structure of the personal tax and benefit system that applies to parents with dependent children in the UK and the key changes since 1997, although references are given to those wishing to learn more in these areas. We also focus exclusively on the UK: Gradus (2001) presents a review of European make work pay policies.

2 The goals of make work pay policies

In this chapter, we discuss the general goals of make work pay policies and examine how the current Government motivated in its first term its key make work pay policy: the Working Families' Tax Credit.[1] By way of an introduction and motivation to later chapters, we then discuss how one should evaluate the success of make work pay policies.

What are governments trying to achieve by making work pay?

As noted by Bennett and Millar (2004):

> … broad statements of policy aims such as 'making work pay' and providing 'support for work' are superficially simple and clear. In practice, however, they cover a complex variety of goals and policy instruments.

But they identify two main goals:

- 'to increase the margin between incomes out of work and in work … [in order] to increase the likelihood of taking up work'
- 'to decrease poverty in work, especially when productivity is not considered high enough for an individual to be able to earn a "living wage", and/or employers are not considered competitive enough to be able to afford to pay it'.[2]

In other words, governments are usually seeking to make work pay more than not working, and to make work pay a decent family wage, although, as Blundell (2001) points out, governments almost always have an additional goal, common to all welfare reform policies, to 'keep government costs low'. Simultaneously achieving the first two of these goals immediately rules out a strategy that relies solely on cutting the benefits available to non-workers (or making them harder to claim): this might sharpen the incentive to work, but would do nothing to make work pay a decent wage.

By the time the Working Families' Tax Credit (WFTC) had been introduced, the Government's stated objectives for its tax credits (its main make work pay policy – see Chapter 3) were a perfect match for these two high-level goals. In 2000, when justifying the extension of in-work support to those without children for the first time, the Government said that:

> It *[the Working Tax Credit for people without children]* would have two objectives: to increase work incentives, together with the minimum wage, for low-paid workers; and to relieve in-work poverty in working households without children, as the Working Families' Tax Credit helps families with children.
> (HM Treasury, 2000, para. 3.6)[3]

A report on how families with children were benefiting from tax and benefit changes said that:

> … measures in [past] Budgets have begun to make work pay, and will help to lift 800,000 children out of relative poverty.
> (HM Treasury, 1999)

The political slogans were backed up with some early evidence-based policy making. A report commissioned by the Treasury from Martin Taylor, then chief executive of Barclays Bank, on the impact of the tax and benefit system on work incentives showed the Government's concern for workless households – a household in which no adult is in work – as much as unemployment among individuals, and argued that financial work incentives were an important contributing factor to the extent of worklessness among households with children.[4]

Taylor's report showed how the interactions between taxes and benefits contributed to poor financial work incentives through both the unemployment and poverty traps, and made specific recommendations to remedy these, while noting that many people 'do not look solely at financial incentives' when considering work opportunities. This argument – linking levels of worklessness to financial work incentives, and showing that the latter were both affected by the tax and benefit system, and could be remedied by tax and benefit changes – provides a guide to Labour's thinking ever since.[5] Both the Taylor report and the earlier analysis made clear that the Government's rationale for increasing the gap between in-work incomes and out-of-work incomes was not solely intended as a supply-side reform to increase employment rates, but was specifically to reduce the proportion of households, especially those with children, where no adult works, for social as much as economic reasons.

When the WFTC was first announced, though, much more weight was given to the first make work pay objective. For example, the Taylor report started with the bold assertion that 'the best way to improve work incentives is to increase the gain from work' (HM Treasury, 1998a, para 3.6). In addition, the main message in the report announcing the introduction of the WFTC was that 'the WFTC will make work pay for families, tackling the main obstacles to work: the unemployment trap, the poverty trap and lack of affordable childcare', and 'the WFTC is designed to make work pay for families, guaranteeing them a minimum income, above and beyond the level of the minimum wage' (HM Treasury, 1998b, para 1.04). There was less mention of how much better off WFTC recipients would be. However, it is arguable that this may reflect the Government's initial reluctance to publicise its efforts to tackle child poverty among families claiming means-tested benefits where no adult was working, rather than being evidence of a shift in objectives.[6]

How should we evaluate the success of make work pay policies?

The fact that make work pay policies usually have multiple objectives has to be reflected when evaluating their success. The ultimate goals of making work pay policies are higher employment rates or lower worklessness rates and lower in-work poverty rates among the target groups.[7] We give evidence on these trends in Chapters 4 and 5, and we attempt to separate out the changes in employment and poverty that were solely due to the Government's make work pay policies.

The direct goal of make work pay policies, though, is to improve financial work incentives.[8] An individual's incentive to work depends, in general, on the shape of the relationship between hours of paid work and after-tax-and-benefit income, given an hourly wage (this is known as a 'budget constraint' and examples are given in Chapter 3).[9] There are two important dimensions of the budget constraint that we attempt to quantify:

- the financial reward to doing any work, measured by some function of incomes in and out of work

- the incentive for those already in work to work harder, or the incentive to progress in the labour market.

Two common measures of the incentive to work at all are the replacement rate and the participation tax rate.[10]

- The replacement rate is measured by: (net income when not working)/(net income in work); it is the inverse of the proportional increase in income that an individual achieves by working.

- The participation tax rate is measured by [1 – {(net income in work – net income out of work)/gross earnings}], or one minus the financial gain to working as a proportion of gross earnings. It measures the extent to which the tax and benefit system erodes gross earnings as someone moves into work.

For both definitions, 'net income' means incomes after taxes and benefits. Calculating either measure for non-workers requires assumptions about the earnings that would be earned in work. Low numbers of both mean stronger financial incentives to work: a participation tax rate of zero would mean that an individual got to keep all of their gross earnings, and lost no benefits or tax credits, when they worked; a replacement rate of zero occurs where someone has no income if they do not work. In the other extreme, a participation tax rate or a replacement rate of one would mean that there is no financial reward to working.

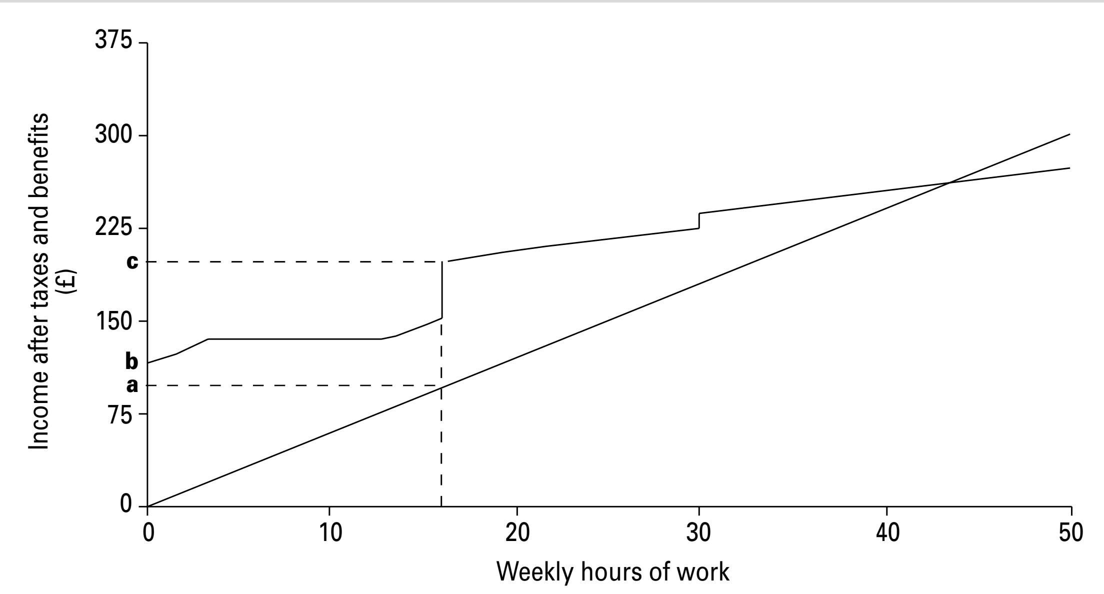
For individuals in couples, we can calculate these two measures of financial work incentives using individual or family income, and this choice will affect our impression of the strength of the financial reward to work. For example, a low-earning person living with a high-earning partner may have no independent income if he or she does not work, and therefore would have a very low replacement rate – or a strong financial incentive to work – when calculated using individual income. However, the same individual would have a very high replacement rate when calculated using family income because whether he or she works makes little difference proportionally to the family's income. By contrast, the participation tax rate for this individual is likely to be very low (if the individual is paying income tax and employee national insurance on only a small portion of their earnings) regardless of whether individual or family income is used for the calculation.[11] In Chapter 4, we analyse only the replacement rate calculated using family incomes; this also allows us to dodge the question as to whether which individual in a couple receives benefit or tax credit payments affects their behaviour in any way.

The incentive for those in work to progress in the labour market can be measured by the effective marginal tax rate, which is the slope of the budget constraint. It measures the incentive for individuals to slightly increase their earnings, whether through working more hours, or through promotion, or qualifying for bonus payments, or getting a better-paid job. We use the term 'incentives to progress' to capture all of these concepts, reflecting that the policy concern for low-income lone parents has shifted slightly from getting them into any work towards how to encourage them to work full time and to get job advancement.[12] Of course, the effective marginal tax rate also measures the incentive that individuals have to reduce their working hours, which may be of interest to parents of young children. Just as individuals facing high effective marginal tax rates face poor incentives to increase their hours of work or their earnings, they would also face a small penalty if they reduced their hours. We do not discuss this point further, but it should be remembered when we analyse incentives to progress in more detail in Chapter 4.

Box 1 Deriving replacement rates, participation tax rates and effective marginal tax rates from a budget constraint

Figures 1–4 illustrate the relationship between a budget constraint – the relationship between gross earning and net income after taxes and benefits – and three measures of financial work incentives discussed in this chapter. Figure 1 shows a hypothetical budget constraint (assuming a lone parent with one pre-school child earning £6 an hour with no Housing Benefit entitlement, no formal childcare costs, an average Greater London Band D council tax liability, under the April 2004 tax and transfer system).

Figure 1 A budget constraint for a lone parent with one child, April 2004 tax and benefit system



The effective marginal tax rate – which we use as our measure of incentives to progress in the labour market – is the slope of this line and is shown in Figure 2: effective marginal tax rates of 1 occur when an individual is entitled to Income Support and every pound of private earnings above the disregard reduces the Income Support payment by a pound.

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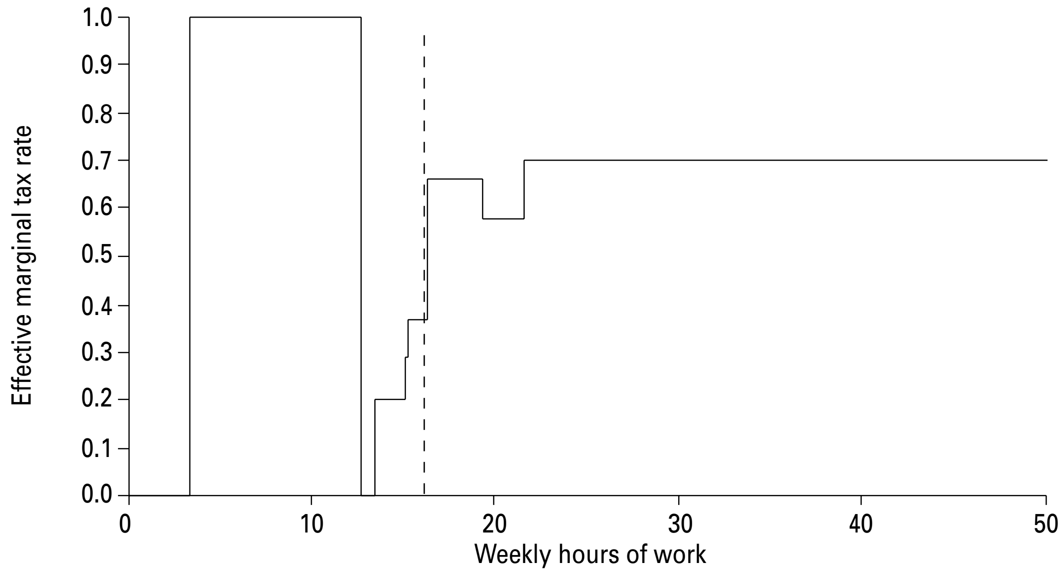
Figure 2 An example of how effective marginal tax rates vary with hours worked



Figures 3 and 4 show the two measures of the financial incentive to work at all: the replacement rate (Figure 3) and the participation tax rate (Figure 4). The dashed lines on Figure 1 show how these are calculated for someone working 16 hours a week. Such a person would have gross earning given by 0a, would receive 0b in benefits if they did not work and would have a net income of 0c if they worked 16 hours. The formula for the replacement rate is 0b/0c and the formula for the participation tax rate is 1 – (0c-0b)/0a.

Figure 3 An example of how replacement rates vary with hours worked

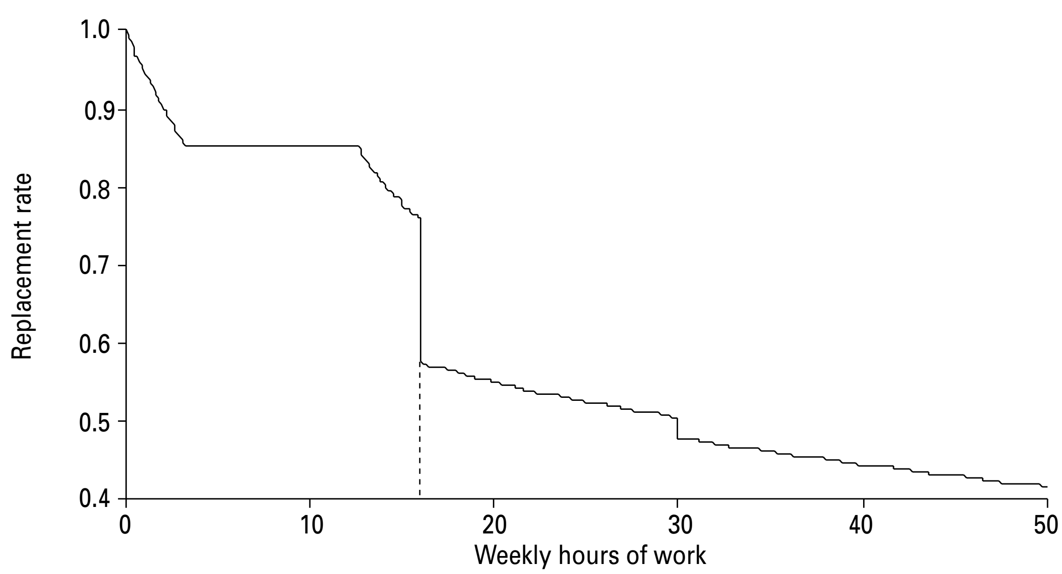


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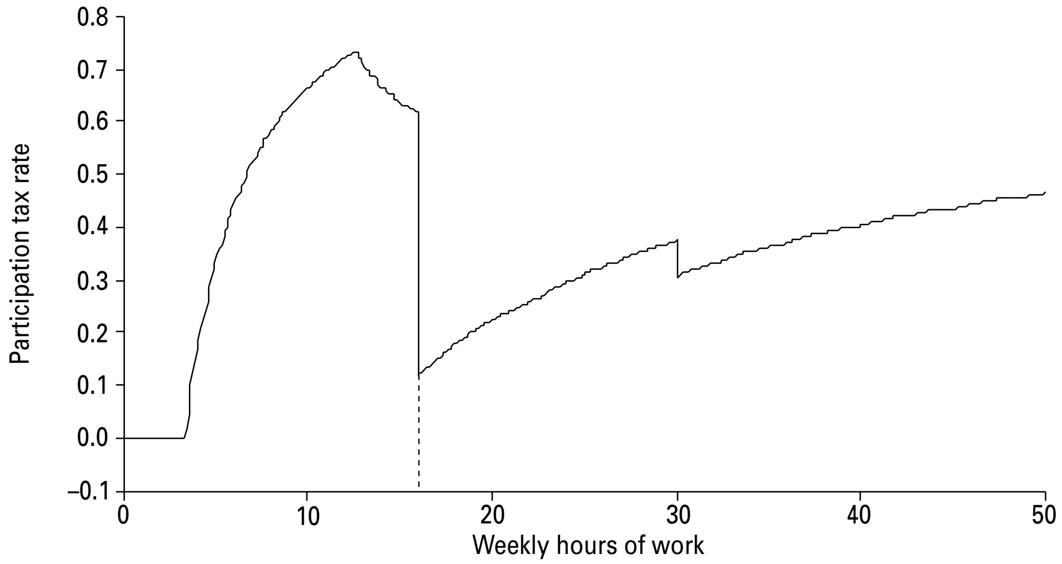
Figure 4 An example of how the participation tax rate varies with hours worked



It is important and interesting to examine these work incentive measures because policies to make work pay – and particularly the sort of in-work benefits that have been used in the UK – usually involve trading off improvements in the incentive to work at all with improvements in the incentive for workers to progress. This is because, if extra support is given to low-wage workers through income-related or means-tested benefits, then the support has to be withdrawn at some point. This point was admitted in the Treasury's first report on the WFTC:

> The low financial returns from work reflected in the unemployment and poverty traps result from providing a benefit safety net for those who have few resources of their own. Once such a safety net is provided, it has to be reduced at higher income levels either directly through withdrawal of benefits or indirectly through the taxes needed to pay for these benefits. The trade-off between incentives and support for those without resources of their own cannot be avoided. The issue is how fast the safety net should be reduced. If withdrawn rapidly, it will mean a relatively small number of people face very high marginal rates; if withdrawn more slowly, a larger number of people will be affected by moderately high rates. (HM Treasury, 1998a, para. 1.13)

When make work pay policies involve support that is assessed on the combined income of the couple, then the trade-off becomes more complicated: many make work pay policies for couples improve the incentive for one person to work, but reduce the incentive for the second person to work and reduce the incentive for either to progress.[13] (All of these points will be illustrated in Chapter 4.)

Box 2 The economic principles behind 'making work pay'

The impact of tax and benefit policies on incentives is one of the most fundamental, and well studied, aspects of public economics, and a vital consideration when designing policy.[14] Economists usually think of tax and benefit programmes as affecting work incentives in two ways: through an income effect and a substitution effect. The income effect refers to the idea that, when taxes and benefits make people better off, they are more likely to be content with their situation, and so less inclined, for example, to seek to increase their earnings. The substitution effect refers to the idea that changes in the effective marginal tax rate alter the price at which higher incomes can be obtained. Means-tested benefits and tax credits mean that higher incomes can be obtained only with a greater increase in hours worked or work effort, because recipients see some of the gain from increasing their private income offset by reductions in tax credit and benefit entitlement.

Although these are extremely helpful concepts for thinking about the impact of make work pay policies, it is hard to use them to help us evaluate particular make work pay policies. This is because the size of the income and substitution effects depend on individuals' preferences and need to be deduced from observing their behaviour. Some models attempt to make inferences about the size of income and substitution effects based on individuals' responses to past tax and benefit changes (an example of these is Brewer *et al.*, 2003b) and it is these sorts of models that tell us that financial incentives do matter to parents' – and especially mothers' – decisions of whether and how much to work. But it is simpler to analyse the impact of make work pay policies on financial incentives to work, and we do this in Chapter 4.

It is, of course, possible to evaluate the impact of make work pay policies on other outcomes. It has been suggested that, through increasing the amount of state support that is contingent on having children, Labour's make work pay policies may have increased fertility among low-income families. It is also the case that the expansion of benefits and tax credits that are assessed against family income with no allowances for the number of adults will reduce the incentive for individuals to cohabit, or to declare cohabitation to the authorities. These topics are beyond the scope of this report (Francesconi and van der Klaauw, 2004 examine the impact of the WFTC on the propensity of lone parents to have more children and to cohabit).

3 What has Labour done to make work pay?

Changes to taxes, benefits and other policy reforms

The Government's make work pay policies have undoubtedly been intellectually dominated by tax credits – first the replacement of Family Credit with WFTC, which was then in turn replaced by the Child and Working Tax Credits. However, other changes have also contributed. In a recent review, Bennett and Millar (2004) give an exhaustive list of policies that have been aimed at encouraging people to move into work or easing the transition to work (see Appendix, Table A.1) and those designed to increase the incomes of low earners or families on a low income with at least one earner (see Appendix, Table A.2).[1]

Alongside changes to personal taxes and benefits, government documents tend to emphasise the national minimum wage as a key make work pay policy. The contribution of the national minimum wage to the make work pay agenda is an important and interesting one, and one that has been under-researched. Theoretically, the introduction of (and rises in) the national minimum wage should contribute positively to the make work pay agenda, by increasing incomes for those who work at the minimum wage, and by increasing the gap between the incomes in work and what is available if individuals do not work. Furthermore, unlike jointly assessed in-work benefits, minimum wages achieve this for both individuals in a couple, regardless of whether we measure income at the individual or family level. It would be hard for a government to make this case if the minimum wage, as predicted by some theories of the labour market, also led firms to offer fewer jobs, reducing employment overall. However, the most recent assessments of the impact of the minimum wage find this not to be the case.[2] However, we do not consider its impact further in this paper.

We also ignore the contribution of the New Deals to the make work pay agenda. We do this partly because we consider their impact to be complementary to make work pay policies: complementary because they share some, but not all, of the goals of make work pay policies, but also complementary in that the parents are relatively unaffected by the most important two New Deals, those for young adults and the long-term unemployed (the New Deal for Young People and the New Deal for the Over 25s). The New Deal for Lone Parents has helped increase employment rates for lone parents, but it has done so by improving job search and job readiness among lone parents, rather than through making work pay.

Changes in personal taxes and benefit for adults with children

The focus of Chapters 4 and 5 will be on the personal tax and benefit changes for parents introduced since 1997, and their contribution to the make work pay agenda. The main outcomes of these changes can be summarised as follows.[3]

- Support for all low-income working families with children has become much more generous. However, because in-work support remains means-tested (rather than universal), the increase in the generosity of support has meant that more – and richer – families have found themselves facing benefit or tax credit withdrawals as their incomes rise, negatively affecting their incentives to progress.

- The rates of withdrawal of benefits and tax credits have tended to be cut. For some very low-waged parents, for example, the effective withdrawal rate of in-work support has fallen from 70 to 37 per cent.[4] This has led to a fall in the number of families facing very high effective marginal tax rates, but has increased the number of families facing some form of benefit or tax credit withdrawal as their incomes rise, worsening their incentives to progress.

- The Government's desire to substantially reduce child poverty led it to increase the support available to families in which no parent is in work. This has reduced the financial reward to work.

- The form and administration of means-tested support has changed: Family Credit used to be administered by the Benefits Agency, and shared many rules with other means-tested benefits, but its replacements are administered by the Inland Revenue and look a little more like part of the income tax system. This change was intended to make in-work support more palatable and to reduce the problem of non-take-up.[5] There was also a period (ongoing, but about to end) towards paying most in-work support through employers, so that most recipients received it in their pay packet: this is discussed more in Box 3.

Box 3 Paying in-work support through the wage packet: a five-year experiment

Until 2000, in-work benefits in the UK had always been paid direct to the recipient and, under Family Credit, the woman in a couple could nominate how she wanted to receive it.[6] But the Labour Government wanted to change this. Martin Taylor argued that:

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… the advantages *[of making in-work support a tax credit]* were clear:

- as a tax credit rather than a welfare benefit, it would reduce the stigma currently associated with claiming in-work support
- it would prove more acceptable than social security benefits to most claimants and taxpayers as a whole
- paid through the wage packet, it would reinforce the distinction between the rewards of work and remaining on welfare
- it could help to lower marginal tax and benefit withdrawal rates. (HM Treasury, 1998a, para 3.19)

However, he gave no evidence to support the first three points and the issue of marginal withdrawal rates has nothing to do with how payments are made. But the Government agreed with Taylor:

[Paying WFTC through the wage packet] is important in order to reinforce the link between receipt of the credit and rewards of work.
(HM Treasury, 1998b, para. 2.15)

However, perhaps because the Government was sensitive to the charge that paying WFTC through the wage packet would leave non-working mothers in couples worse off as individuals, or because of research showing that mothers were more likely to spend resources on children than fathers (see Goode *et al.*, 1998), couples were always able to choose which of them received the WFTC and, if that person was not an employee, then the credit was paid direct. This tension between not making mothers worse off and wanting to link WFTC with work was apparent from the WFTC's inception, with the Treasury's first report on the WFTC saying that: 'The WFTC will be payable through the wage packet', but also:

… *[where]* the main earner is the father, there will be no compulsory transfer of resources from women to men. Couples will have the right to elect to whom the credit is paid, the man or the woman.
(HM Treasury, 1998b, para 2.13)

There was no evidence that the positive work incentives of WFTC would be strengthened by paying it through the wage packet, nor that Family Credit recipients disliked receiving payments direct. In the US, only a tiny minority of recipients of the Earned Income Tax Credit elect to receive it through the wage

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packet, rather than as a one-off lump sum annually in arrears. Employers had always argued that paying WFTC would be an unwelcome addition to their administrative burden and the burden on business was one of the reasons why an earlier Conservative Government gave up a plan to pay Family Credit through employers.[7]

After WFTC was introduced, there was evidence of some illegal behaviour by employers who would fire employees who tried to claim WFTC (Wheatley, 2001). And, around 18 months after the policy started, a quarter of those entitled to WFTC who received it through the pay packet said that this had caused them some difficulty (see McKay, 2003, p. 60).

The Government was no doubt mindful of these findings and the new tax credits eased the burden on employers, according to the Inland Revenue (see Inland Revenue, 2002). It seems that the experiment of paying in-work support through employers will be abolished altogether from 2005, five years after it began (see HM Treasury, 2004).

Changes in personal taxes and benefit for adults without children

There have been far fewer, and less significant, changes to personal taxes and benefits for non-parents. The thrust of the changes, though, and their contribution to the make work pay agenda, is as follows.

- Support for low-income families without children with at least one full-time earner was introduced in 2003, in the form of the Working Tax Credit. It has increased the incentive for such families to have one adult in work rather than none, reduced the incentive to have two adults in work rather than one and reduced incentives to progress. The first two effects are the same as that of the WFTC on parents, but the low level of the Working Tax Credit for those without children means that far fewer adults are affected by this change than were affected by the introduction of the WFTC (235,000 benefit units without children were receiving the Working Tax Credit as of April 2004, but 37,000 of these would have been eligible for the Disabled Person's Tax Credit, which existed before the Working Tax Credit).

- Income tax and employee national insurance liabilities have been reduced for those on very low incomes, because the starting rate of income tax has fallen from 20 to 10 per cent, and the entry fee from the national insurance system has been removed, and the point at which employee national insurance contributions are payable has been raised. This has lowered effective marginal tax rates for low earners.

- Effective marginal tax rates for high earners have gone up, because the upper earnings limit (UEL) – the point at which, before April 2003, employee national insurance contributions stopped being payable – has risen faster than inflation and there is a new employee national insurance rate of 1 per cent on earnings above the UEL.

The difference in approach may be explained by two factors. First, the Labour Government seems to be content for non-working adults without children to experience low levels of income and high rates of relative poverty; certainly, there have been few policies that directly alleviate poverty among this group. Second, there may be less need to use make work pay policies to increase employment for adults without children, because this group faces a relatively tough active labour market regime if they claim benefits and do not work (tough, at least, compared to the regime that faces lone parents who claim benefits and do not work).

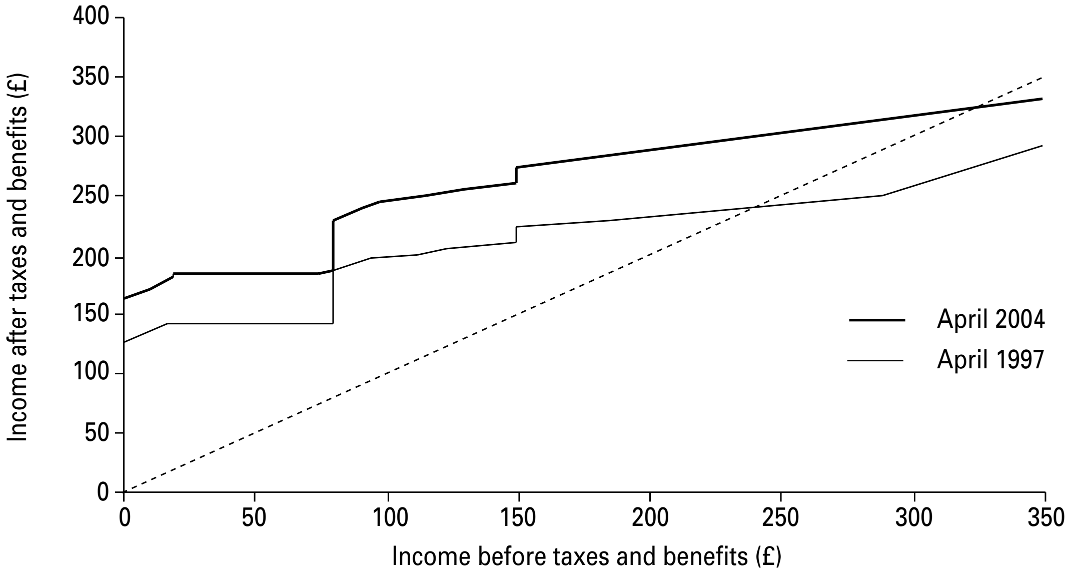
Changes in the relationship between net and gross income for six different families

In Chapters 4 and 5, we show what the changes to personal taxes and benefits between 1997 and 2004 mean for financial work incentives and for incomes and poverty rates. But, to help illustrate what the personal taxes and benefits mean for particular families, Figures 5–10 show the budget constraint – or the relationship between income before and after taxes and transfers – for six different family types under two different tax and benefit systems: that of April 2004 and that of April 1997, having stripped out the effect of inflation. The pictures therefore show the effect of Labour's changes to the tax and benefit system compared to a world where Labour made only the usual or default changes each year to reflect price inflation.

The particular families shown are by no means 'representative': indeed, the family types have been chosen by the authors to show that a range of changes is possible. Our main conclusions from Figures 5–10 are as follows.

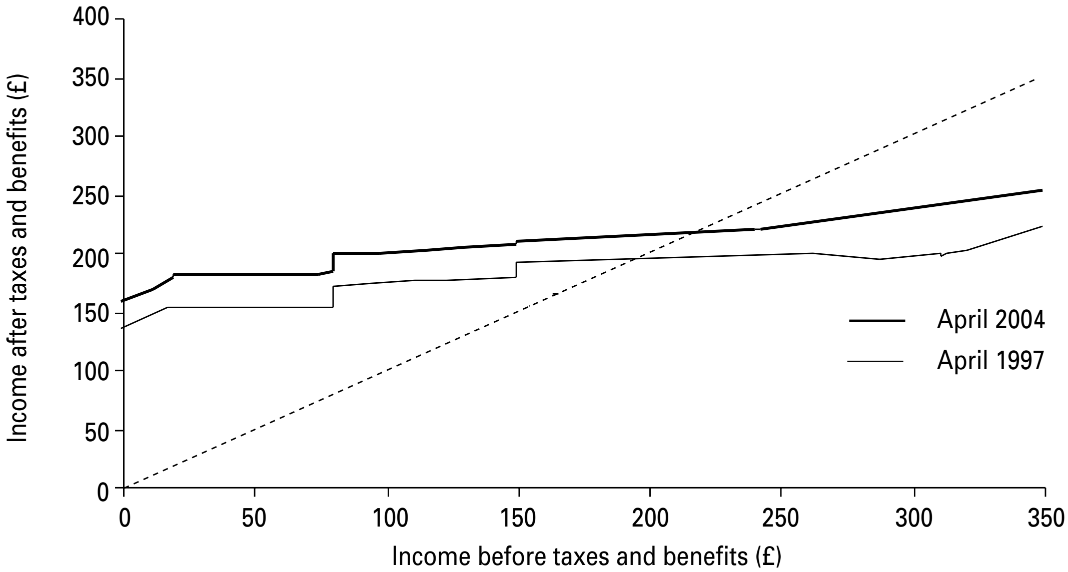
- Labour's changes have led to a large gain in income for a low-waged lone parent not receiving Housing or Council Tax Benefit (Figure 5). The size of the gain is not strongly linked to the number of hours worked, although a low-waged lone parent working full time would have seen the largest gains in income. The cuts in the rate of withdrawal of in-work support have reduced the effective marginal tax rate on weekly earnings between £150 and £300.

Figure 5 Change in the budget constraint for a lone parent, two children under 11



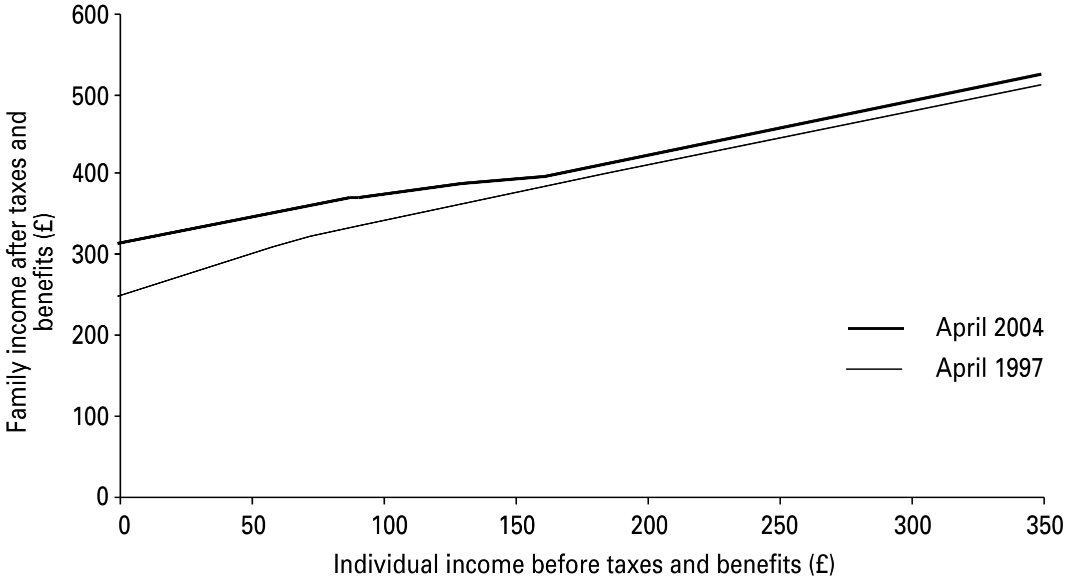
Note: all in 2004 prices. Assumes hourly wage of £5, no housing costs, average Greater London Band D council tax liability, no entitlement to child support and no childcare costs. The dashed diagonal line: this represents a hypothetical budget constraint where there are no taxes or benefits. If the actual budget constraint lies above this line, the individual is a net beneficiary from taxes, benefits and tax credits.

Figure 6 Change in the budget constraint for a lone parent in rented accommodation, two children under 11



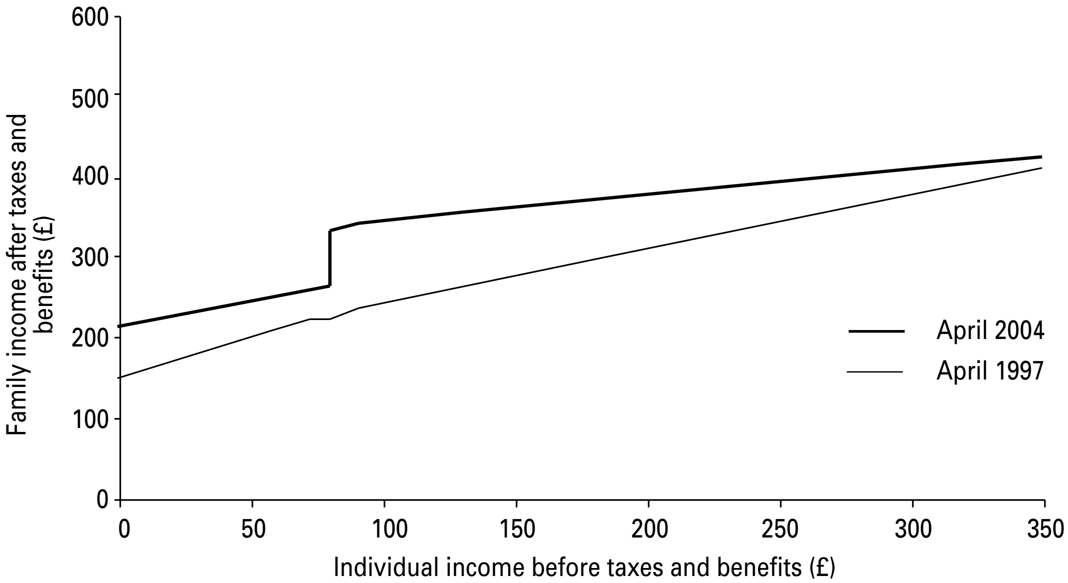
Note: all in 2004 prices. Assumes hourly wage of £5, housing costs of £80 per week, average Greater London Band D council tax liability, no entitlement to child support and no childcare costs. The dashed diagonal line: this represents a hypothetical budget constraint where there are no taxes or benefits. If the actual budget constraint lies above this line, the individual is a net beneficiary from taxes, benefits and tax credits.

Figure 7 Change in the budget constraint for a mother in a couple with a working partner, two children under 11



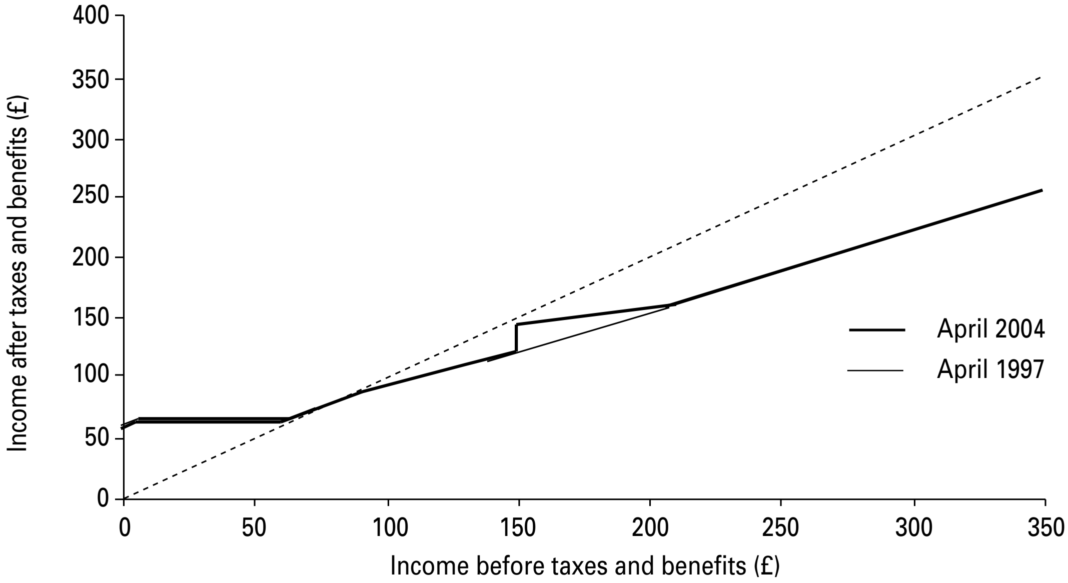
Note: all in 2004 prices. Assumes hourly wage of £5, no housing costs, average Greater London Band D council tax liability, no entitlement to child support and no childcare costs. The woman's partner earns £300 per week.

Figure 8 Change in the budget constraint for a mother in a couple with a working partner and formal childcare costs, two children under 11



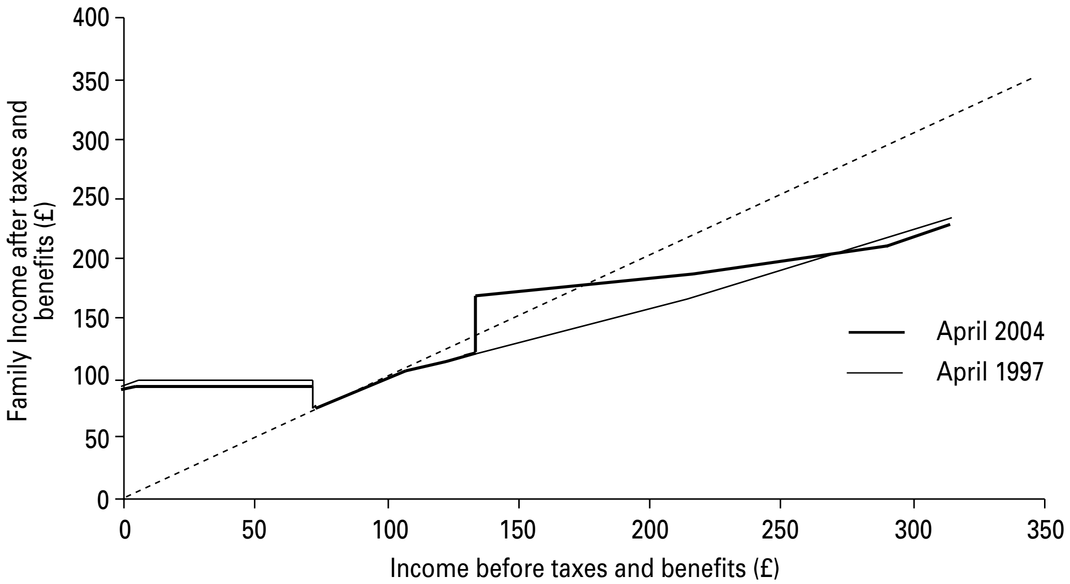
Note: all in 2004 prices. Assumes hourly wage of £5, no housing costs, average Greater London Band D council tax liability, no entitlement to child support. The woman's partner earns £300 per week. The family spend £100 per week on formal childcare irrespective of the woman's employment behaviour.

Figure 9 Change in the budget constraint for a single person aged 25 or over, no dependent children



Note: all in 2004 prices. Assumes hourly wage of £5, no housing costs, average Greater London Band D council tax liability. The dashed diagonal line: this represents a hypothetical budget constraint where there are no taxes or benefits. If the actual budget constraint lies above this line, the individual is a net beneficiary from taxes, benefits and tax credits.

Figure 10 Change in the budget constraint for an individual aged over 25 whose partner is not working, in a couple, no dependent children



Note: all in 2004 prices. Assumes hourly wage of £4.50, no housing costs, average Greater London Band D council tax liability. The dashed diagonal line: this represents a hypothetical budget constraint where there are no taxes or benefits. If the actual budget constraint lies above this line, the family is a net beneficiary from taxes, benefits and tax credits.

- An otherwise-equivalent lone parent receiving Housing Benefit would have seen a smaller gain in incomes from Labour's changes. He or she would also have seen a smaller improvement in financial work incentives, which remain poor, as shown by the relatively flat lines in Figure 6. However, such a lone parent would no longer face effective marginal rates of over 100 per cent, as was the case in 1997.[8]

- The change in the budget constraint for a couple with children where only one adult works would be very similar to those shown in Figures 5 and 6, and is therefore not shown here (the only difference would be that the couple would receive more income than the lone parent if both adults worked no more than 15 hours and the couple received income-related Jobseeker's Allowance or Income Support). However, the change in the budget constraint for a second earner in a couple with children is different and is shown in Figure 7. Labour's changes have led to increases in incomes regardless of the earnings of the second earner, but the gains are smaller, the higher the earnings. This is because the gains in income have largely come from increased in-work support and this support is withdrawn as earnings rise. This also means that financial work incentives have either got worse or have not changed, as shown by the line for 2004 being less steep than in 1997. For this individual, the incentive to work at all has been reduced and the incentive to progress is either unaffected (at high earnings) or is reduced.

- A relatively low-earning two-earner couple with formal childcare costs would have gained substantially from Labour's changes if the second earner worked 16 or more hours (Figure 8). This extra support, however, is provided through tax credits and is withdrawn as income rises, and so the slope of the budget constraint, once the second earner reaches 16 hours, has become much steeper, indicating worsened incentives to progress. The change in the incentive for the second earner to work at all depends on how childcare costs vary with their employment status. The figure assumes that the couple would pay for formal childcare if the second earner did not work: in this case, the incentive to work 16 or more hours is much greater in 2004.[9]

- By way of comparison, Figures 9 and 10 show how budget constraints have changed for some low-waged benefit units without children. Both figures show that Labour's tax and benefit reforms have had a smaller impact on budget constraints than shown in Figures 5–8. Any gain in income has come where these benefit units are entitled to some Working Tax Credit under the 2004 tax and benefit system. The Working Tax Credit will have increased the incentive to work 30 or more hours, compared to not working, but the fact that it is withdrawn as earnings rise mean that incentives to progress are at best unchanged and have worsened for some.

4 Make work pay and employment: the record so far

In this chapter, we review the evidence to date on the impact of make work pay policies on employment, their most obvious goal.

In the first section, we show the changes in the key labour market outcomes – employment and worklessness rates – and review studies that have estimated the contribution of policy reforms to these changes. In the second section, we examine the contribution of Labour's personal tax and benefit policies to changes in an intermediate outcome: financial work incentives. We do not limit ourselves to the impact of make work pay policies alone, but instead look at all of Labour's personal tax and benefit changes because all of them may affect financial incentives to work. The following chapter complements this one by examining how Labour's personal tax and benefit policies have affected income levels and poverty rates.

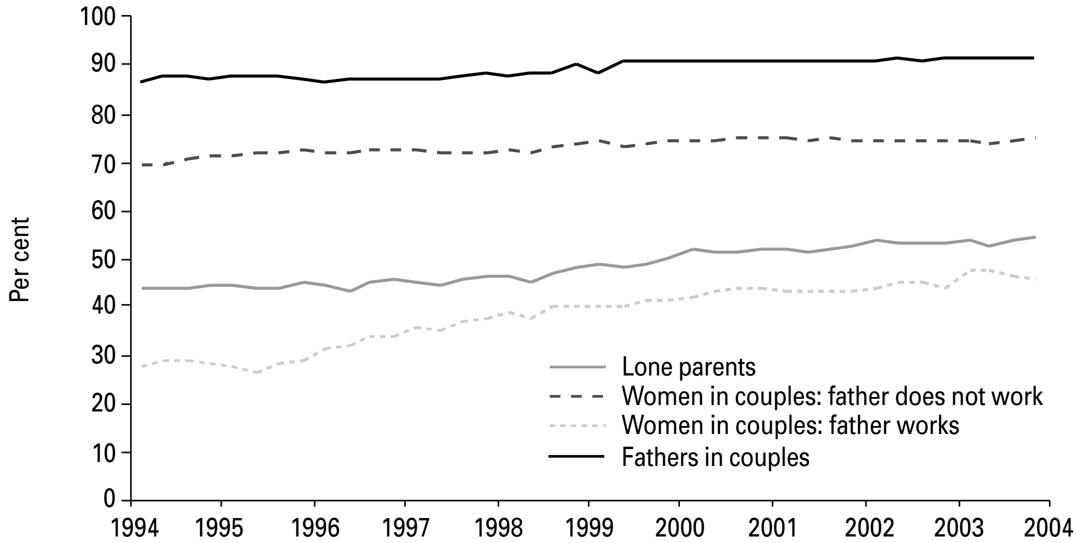
As explained in Chapter 1, this and the next chapter have more detail on families with children than those without. This is primarily because the changes in policies have been much more substantial for families with children: as described in Chapter 3, only a very small proportion of adults without children are affected by the Working Tax Credit, the key make work pay tax reform for those without children. Also, there are, to date, no estimates of the impact of Labour's changes on employment trends among adults without children.

Changes in employment and worklessness among parents

What happened?

Figure 11 shows employment rates for lone parents and individuals in couples with children. More parents of dependent children are in paid employment now than in 1994 and than in 1997: 71.5 per cent of parents were in employment in 1994, 73.1 per cent in 1997 and 76.7 per cent in 2004.[1] As is well known, there has been an increase of a quarter in the proportion of lone parents working, from 43 to 54 per cent over the period shown. There has been a smaller rise – both in absolute and proportional terms – in the proportion of mothers in couples who work and this has been concentrated among mothers whose partner is not working. Employment rate for fathers in couples also showed a small rise during the period.

Figure 11 Employment rates of parents, 1994–2004



Source: authors' calculations based on quarterly Labour Force Survey (LFS) data.

The rise in the employment rates for lone parents, and for mothers whose partner is not working, began before 1997, although the rate of increase in the employment rate of lone parents appears to have begun to rise in 1998.[2]

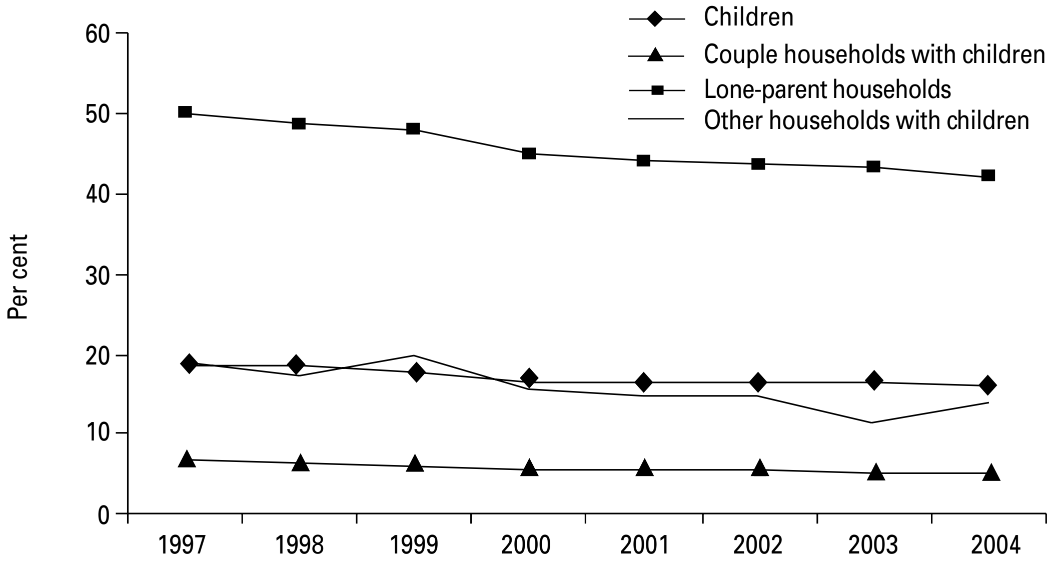
The rise in employment of parents, and particularly of lone parents, has led to a steady decline in the proportion of children who live in a workless household. Figure 12 shows the worklessness rates among various types of households with children and the proportion of all children under 16 who live in workless households since 1997: all show a decline, with the number of children under 16 in workless households falling by 350,000 since 1997.

Disentangling the impact of 'make work pay' policies

Figures 11 and 12 show that the employment rate of parents has risen, and the proportion of children living in a workless household has fallen, since 1997. But it does not tell us whether this was because of Labour's policies, or whether it would have happened anyway.

Several studies have attempted to address this by estimating the impact of Labour's make work pay policies on the employment rates and labour market behaviour of parents. The results from these studies are summarised in Table 1.[3] The papers each use one of two methodologies.

Figure 12 Worklessness rates among households with dependent children and the proportion of children living in workless households, 1997–2004



Source: from Tables 1(ii) and 3(ii) of ONS (2004), based on LFS data. The series are not consistent: base for 'lone parents', 'couples with children' and 'other households with children' is all households of that type with dependent children; the base for 'children' series is children under 16 only. A workless household is a working-age household where no one aged 16 or over is in employment.

- The more common method is the 'difference-in-differences' approach. This relies on the assumption that, in the absence of the Labour Government's policies, the labour market behaviour of parents would have followed the same trend as otherwise-identical individuals of the same gender without children (more details can be found in any of the studies referred to).[4] By their design, these studies cannot focus just on Labour's make work pay policies, or even the impact of all personal tax and benefit changes: strictly speaking, they estimate the impact of all of Labour's policies that have influenced parents' propensity to work differently from adults who are not parents, which might include the New Deals and policies affecting childcare.

- The two studies that do not use the difference-in-differences approach (Brewer *et al.*, 2003b; Blundell *et al.*, 2004b) use an economic model of parents' labour supply behaviour to predict how parents would respond to particular tax and benefit changes. The economic model is estimated by relating the behaviour of parents in the labour market – how many of them choose to work and how many hours they work – to the underlying financial incentives to work and progress. By contrast to the studies using difference-in-differences, these two studies can focus solely on Labour's make work pay policies.

Table 1 Estimates of the impact of Labour's make work pay policies on the labour market outcomes of parents

Study	Data	Reforms analysed	Estimated impact on lone parents	Estimated impact on couples	Other notes
Difference-in-differences approach					
Gregg and Harkness (2003)	LFS and GHS, 1979–2002	Changes affecting lone parents between 1998 and 2002.	Increased employment by 5 ppts.	N/a	Estimated that reforms also increased hours worked and weekly earnings.
Francesconi and van der Klaauw (2004)	BHPS, 1991–2001	Policies affecting lone mothers between 1998 and 2001.	Increased employment by 4 ppts in 1998 and 7 ppts by 2001 (lone mothers only).	N/a	Uses longitudinal (panel) data. Estimated that lone mothers' fertility and propensity to cohabit/marry declined after 1998.
Leigh (2004)	LFS, 1999–2000	All changes affecting parents between September and November 1999.	Increased employment by around 1 ppt.	Increased employment by around 1 ppt.	Estimated that reforms also increased hours worked and earnings by parents.
Blundell *et al.* (2004a)	LFS, 1996–2002	All changes affecting parents between 1999 and 2002.	Increased employment by 3.6 ppts (lone mothers) and 4.6 ppts (lone fathers).	No statistically significant impact for mothers. Reduced employment by around 0.5 ppts for fathers.	
Structural model approach					
Brewer *et al.* (2003b)	FRS, 1995–2002	All changes to taxes and benefits made in October 1999 and April 2000.	Increased employment by 3.4 ppts (lone mothers only).	Reduced employment by 0.4 ppts (men and women).	Estimated that reforms also increased hours worked by lone mothers.
Blundell *et al.* (2004b)	FRS, 1995–2002	All changes to taxes and benefits made in April 2000 and April 2003.	Increased employment by 3.4 ppts (lone mothers only).	Reduced employment by 0.3 ppts (women); increased employment by 0.9 ppts (men).	Uses same model of behaviour as Brewer *et al.* (2003b).

Note: LFS is Labour Force Survey, FRS is Family Resources Survey, BHPS is British Household Panel Study, GHS is General Household Survey. For more details, see individual papers. Ppts = percentage points.

All of the studies in Table 1 use data from before and after Labour's reforms. Three studies, not summarised here, predicted the impact of the key make work pay policy – the WFTC – on labour market outcomes using only data from before its introduction: the results from these are summarised in Blundell and Reed (2000).

There is general agreement on the qualitative impact of the policies, regardless of the methodology used.

- Labour's policies increased the proportion of lone parents in employment and increased the hours worked, on average, of those who do work. Estimates of the size of the employment impact vary considerably, though, from +1 percentage point (ppt) to +7 ppts. Some of this variation is explained by the time period investigated by the different studies: the paper with the smallest estimate examined the employment rates just before and just after the introduction of the WFTC. Interestingly, almost all studies find that the impacts were greater on lone parents who have pre-school children than those with older children: this could be either because this group gained more from the WFTC than lone parents with older children, or because lone parents with pre-school children are a group who are particularly sensitive to financial incentives to work.

- Not all of the studies estimate the impact of Labour's policies on individuals in couples, but those that do suggest that the effect is small, overall. Two studies find the effect on mothers in couples to be negative, and one finds it to be positive.

It should also be noted that all of the studies that use difference-in-differences use data from 2002 or earlier: we do not yet have a good idea of how the new tax credits, introduced in April 2003, actually affected employment among parents, although Blundell *et al.* (2004b) predict the impact of all tax and benefit changes between April 2000 and April 2003.

Changes in financial incentives

The aim of this section is to examine the contribution of make work pay policies to changes in financial work incentives for parents.

We look first at how Labour's changes have affected the incentive to work at all, as measured by the replacement rate. We then examine changes in the incentive to progress, as measured by the effective marginal tax rate, and we do this not just because some of Labour's changes aimed to improve incentives to progress, but also because policies to make work pay – and particularly the sort of in-work benefits that have been used in the UK – usually involve trading off improvements in the incentive to work at all with improvements in the incentive for workers to progress.

We then conclude with an overall assessment of the impact of Labour's personal tax and benefit changes on financial work incentives for parents. As we say in that conclusion, economists do not yet have an unambiguous view on the importance of the sort of changes in financial incentives that we show below. It is, though, widely accepted that financial incentives do affect parents' – and particularly mothers' – decisions of whether and how much to work: the debate is over by how much.

Changes in the incentives to work at all

This section quantifies the impact of Labour's policies on the incentive to work at all using the replacement rate, calculated using family income.

It is possible, having made suitable assumptions, to calculate the incentive to work at all for those individuals who are currently working, or for those who are not. The latter is perhaps more interesting, for this is presumably the group at whom the policies are targeted. But it is easier and more transparent to calculate how incentives to work have changed for those who are working.[5] Table 2 therefore shows the impact of Labour's tax and benefit changes on the incentive to work at all for working parents. It shows how the personal tax and benefit changes between 1997 and 2004 have affected the average (mean and median) and the inter-quartile range of replacement rates, and the proportion of each family type who have seen rises or falls in their replacement rate (as Chapter 2 explained, a higher replacement rate indicates a lower incentive to work at all).

Table 2 shows the following.

- The group for whom the financial reward to working at all, measured by the replacement rate, has improved the most is lone parents. Replacement rates have fallen for over half of working lone parents and risen for around fifty.

- Individuals in couples whose partner does not work have, on average, seen the financial reward to work at all fall through Labour's changes. However, the average change for individuals in couples masks considerable variation: personal tax and benefit changes since 1997 have improved the financial reward to work for around a quarter of individuals in couples with children whose partner does not work, and these are people who, in 1997, faced very poor rewards to working at all (we infer this from the fall in the 75th centile replacement rate for individuals in couples with children whose partner does not work). The changes have worsened the incentive to work at all, though, for over half this group.

Table 2 The impact of tax and benefit changes from 1997–2004 on the replacement rates of working parents

	Replacement rates (%)		
	April 1997	**April 2004**	**Change**
Lone parents			
Mean	67.9	65.0	–2.9
Median	71.9	65.9	–6.0
25th centile	55.8	52.3	–3.5
75th centile	81.9	80.4	–1.5
Proportion whose rate rises		21.3	
Proportion whose rate falls		56.7	
Individuals in couples with children whose partner does not work			
Mean	59.3	61.1	+1.8
Median	62.6	65.5	+2.9
25th centile	41.3	45.3	+4.0
75th centile	80.6	79.5	–1.1
Proportion whose rate rises		52.7	
Proportion whose rate falls		26.6	
Individuals in couples with children whose partner does work			
Mean	59.2	62.5	+3.3
Median	58.5	62.7	+4.2
25th centile	45.6	50.4	+4.8
75th centile	74.3	76.0	+1.7
Proportion whose rate rises		53.8	
Proportion whose rate falls		6.6	

Source*: authors' calculations from FRS 2002–03 and TAXBEN. Excludes parents aged over 55 and the self-employed. The row marked '25th centile' reports the replacement rate that is higher than 25 per cent of all replacement rates faced by that family type.*

- Individuals in couples whose partner also works have, on average, also seen the financial reward to work at all fall through Labour's changes. The impact of the changes on the incentive to work at all has been worse for this group: only a very few (6.6 ppts) experience a fall in their replacement rate (or an improved incentive to work at all) and over half experience a rise.

Changes in the incentives to progress

Tables 3 and 4 show how the effective marginal tax rate faced by working parents has changed as a result of Labour's changes to the personal tax and benefit system (see Box 4 for our definition of effective marginal tax rate).

Box 4 Calculating effective marginal tax rates

As explained in Chapter 2, we are using the phrase ‘effective marginal tax rate’ to measure what fraction of an increase in earnings is lost to income tax and employee national insurance contributions, and to foregone benefits and tax credits. In practice, the rates were calculated by increasing weekly hours worked by 5 per cent, implying an extra two hours a week for someone working 40 hours a week.

For the purpose of these calculations, we assume full take-up of all benefits and tax credits. This may mean that we overstate the extent of high marginal tax rates, because claiming a benefit or tax credit never reduces and usually increases an individual’s effective marginal tax rate. It will also mean that we estimate the change in marginal tax rates incorrectly, because more individuals were entitled to means-tested benefits or tax credits under the April 2004 system compared to the April 1997 system (if estimated on an unchanging population). On the other hand, take-up rates of in-work benefits rose between 1997/98 and 2001/02, and, if this trend continued to 2004/05, this would mean that we would underestimate the extent to which tax and benefit changes have increased effective marginal tax rates.

When calculating effective marginal tax rates in the April 2004 tax and benefit system, we ignored the £2,500 disregard in the new tax credits. This disregard means that individuals whose income rises by up to £2,500 in a year do not lose any tax credit eligibility until the following financial year (and those whose income rises by more than £2,500 are treated as if the rise was £2,500 lower than it was). Effectively, the marginal tax credit withdrawal rate on the first £2,500 of income rises is zero in the short run. We do not yet know how people are reacting to this short-run disregard of gains in income (or, indeed, whether they understand how it works). Our approach means that we will have slightly overestimated the effective marginal tax rates in the 2004 system, but the alternative approach – to ignore entirely the withdrawal of tax credits – would certainly be a large underestimate of effective marginal tax rates.

We calculated effective marginal tax rates only for individuals in work; we could also have calculated them for individuals not working, but it is more likely that the replacement rate is the more important measure of financial work incentives for this group. However, this means that Tables 3 and 4 give an underestimate of the number of parents who face effective marginal tax rates of certain levels.

Continued overleaf

Estimates of the number of people facing particular levels of effective marginal tax rates are sometimes published by the Treasury: see HC Deb (2002–3), for example.

Table 3 Changes in effective marginal tax rates among working parents from personal tax and benefit reforms between April 1997 and April 2004

Marginal effective tax rate	Number of working parents facing marginal tax rates under tax and benefit systems (thousands) April 1997	April 2004	Difference
0%	153	174	21
0.1–10%	229	227	–1
10.1–20%	131	106	–26
20.1–30%	1,177	639	–538
30.1–40%	4,077	3,476	–60
40.1–50%	927	1,197	271
50.1–60%	34	234	201
60.1–70%	48	617	568
70.1–80%	305	635	330
80.1–90%	181	148	–33
90.1–100%	273	107	–165
Over 100%	34	8	–26
All	7,569	7,569	

Source: authors' calculations from FRS 2002–03 and TAXBEN. Excludes parents aged over 55 and the self-employed. Marginal rates were calculated by increasing hours worked by 5 per cent. Numbers may not add because of rounding.

Table 4 Marginal effective tax rates (METRs) among working parents, cumulative

Marginal effective tax rate	Number of working parents facing marginal tax rates under tax and benefit systems (thousands) April 1997	April 2004	Difference
All	7,569	7,569	
More than 0%	7,415	7,395	–21
More than 10%	7,187	7,167	–19
More than 20%	7,056	7,062	6
More than 30%	5,878	6,423	545
More than 40%	1,802	2,947	1,146
More than 50%	875	1,749	875
More than 60%	841	1,515	674
More than 70%	793	899	106
More than 80%	488	264	–224
More than 90%	307	116	–191
More than 100%	34	8	–26

Source: authors' calculations from FRS 2002–03 and TAXBEN. Figures grossed up using FRS weights. Negative 'differences' in the third column are a good thing if lower effective marginal tax rates are a good thing. Excludes parents aged over 55 and the self-employed. Marginal tax rates were calculated by increasing hours worked by 5 per cent. Numbers may not add because of rounding.

To focus attention on the changes due to policy changes, we have calculated incentives to progress on an unchanging population of working parents.[6] In reality, the characteristics of the parents who are working in 2004 are different from those working in 1997; these changes may also have affected the incentives to progress, but are excluded from Tables 3 and 4. We have excluded self-employed parents because of concerns that their incomes are recorded incorrectly by household surveys.

Table 3 shows that the majority of working parents faced effective marginal tax rates of between 30 and 50 per cent, with small numbers on very low and very high rates (Box 5 explains how particular marginal tax rates arise). But it also shows that the changes to the tax and benefit system between 1997 and 2004 have considerably altered the pattern of effective marginal tax rates faced by working parents. There are three main effects.

- About 600,000 fewer working parents face marginal tax rates of between 30 and 40 per cent.
- About 900,000 more working parents face marginal tax rates of over 50 per cent.
- Around 220,000 fewer working parents face marginal tax rates of over 80 per cent.

Box 5 Understanding different levels of effective marginal tax rates

The most common effective marginal tax rate faced by working parents under both the 1997 and 2004 tax and benefit system was 33 per cent. This would apply to parents whose own earnings were high enough to pay basic-rate income tax, but lower than the upper earnings limit in national insurance, and with a family income sufficiently high that in-work support had all been withdrawn. In 1997, the rate of 33 per cent came from an income tax rate of 23 per cent and the employee national insurance rate of 10 per cent; in 2004, it came from an income tax rate of 22 per cent and the employee national insurance rate of 11 per cent.

Effective marginal tax rates of 20 per cent or below apply to approximately half a million parents who themselves earn too little to pay basic-rate income tax and who live in families who are not subject to a withdrawal of in-work support: these could be either very low-income or relative high-income families. Marginal rates between 40 and 50 per cent tend to apply to the million or so well-off parents who earn enough to pay the higher rate of income tax.

Continued overleaf

Effective marginal tax rates of over 50 per cent almost always arise when parents have a family income that means they face a withdrawal of a means-tested benefit or a tax credit. In 1997, this would have meant that they were on a relatively low income, but, in 2004, this could apply to most of the poorer half of parents.

The highest effective marginal tax rates arise when individuals are eligible for more than one means-tested benefit or tax credit, usually Housing Benefit and/or Council Tax Benefit in conjunction with in-work support of some kind. Even in April 2004, an individual facing simultaneous withdrawal of tax credits and Housing Benefit faces an effective marginal tax rate of 91 per cent, although, as Table 4 shows, this applies to only around 110,000 working parents.

Three factors have led to these changes in effective marginal tax rates (discussed more in Chapter 3).

- Withdrawal rates of in-work benefits and tax credits have fallen. This directly reduces the number facing very high rates (over 80 per cent), but increases the number facing high rates (over 50 per cent) because more working parents are now entitled to some in-work support.

- In-work support has become more generous. This has increased the number of parents facing a high withdrawal rate when in-work support is tapered away.

- Marginal tax rates faced by some parents have increased because national insurance rates have increased by 1 percentage point and because the Child Tax Credit is now phased out from high income families. The combined effect is to increase the number facing a rate between 40 and 50 per cent by 270,000, although, in some cases, the change in the rate is only 1 percentage point.

The trade-off inherent in the first point has always been recognised by the Government, which has always made clear that it sought to remove some of the highest marginal tax rates that arise when means-tested benefits and tax credits overlap:

> The WFTC's withdrawal rate will be much lower than that of FC, improving work incentives and resulting in lower marginal tax and benefit withdrawal rates for 500,000 families currently in receipt of Family Credit. Under FC, $^3/_4$ million families face marginal rates of over 70 per cent. Under the WFTC this number will fall by two thirds to around $^1/_4$ million.
> (HM Treasury, 1998b, para. 1.04)

The same document spent considerable effort defending the reduction in the withdrawal rate, which directly led to more working parents facing high marginal effective tax rates, because more families were now entitled to some in-work support:

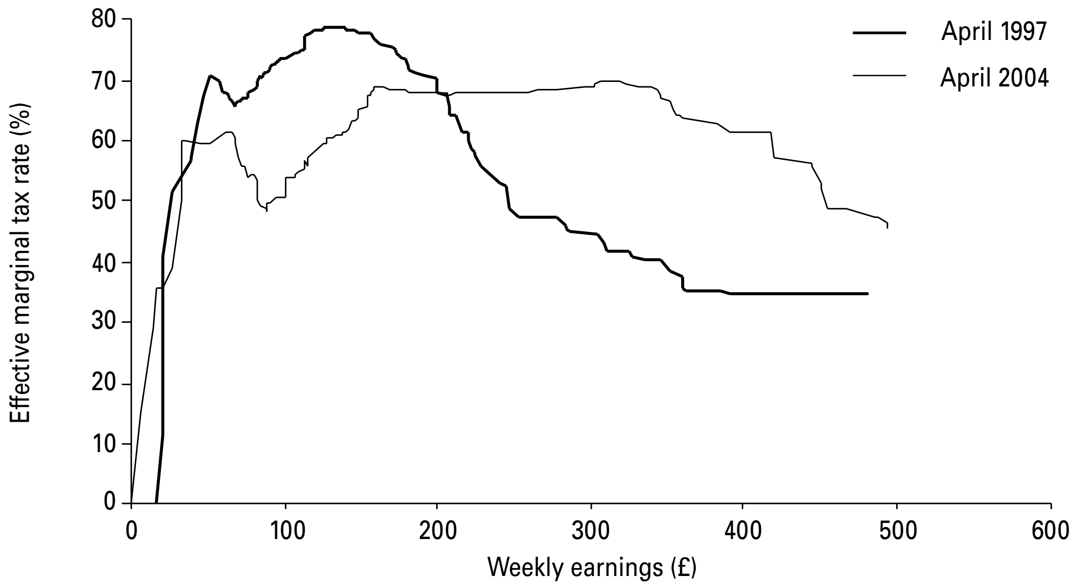
> Reducing marginal rates for the lowest paid inevitably means that marginal rates will have to rise higher up the income distribution. Those brought into entitlement and on the WFTC taper will face higher marginal rates than at present. This is, of course, inevitable if the worst excesses of the poverty trap are to be removed.
> (HM Treasury, 1998b, para. 4.10)

We can learn more about the changes in the incentives to progress by seeing how the effect of tax and benefit changes between 1997 and 2004 vary between three family types – working lone parents, individuals in couples whose partners do not work and individuals in couples whose partners do work – and how effective marginal tax rates have changed within those three groups.

Figures 13, 14 and 15 explore the changes for these three groups by showing the effective marginal tax rate averaged across individuals with similar weekly earnings, and how these rates have changed through personal tax and benefit reforms between 1997 and 2004. It is important to remember that the figures do not necessarily show how incentives to progress change as earnings change, but how they vary in reality between individuals with different levels of earnings and other characteristics. The figures themselves do not show how many individuals have been affected by the changes, but Table 5 reports the proportion of working parents who are affected by rises or falls in their effective marginal tax rate, and the change in the average (mean and median) effective marginal tax rate.

Figure 13 and the first part of Table 5 show the changes in effective marginal tax rates for working lone parents. There are considerable changes within the population of working lone parents. For example, Figure 13 directly shows the trade-off inherent in reducing the withdrawal rate of in-work support: lone parents earning below £200 now face, on average, better incentives to progress than in 1997, but the reverse is true for those earning over £200, with the latter group containing lone parents who are eligible for support through tax credits in 2004 but who were too rich for Family Credit in 1997.

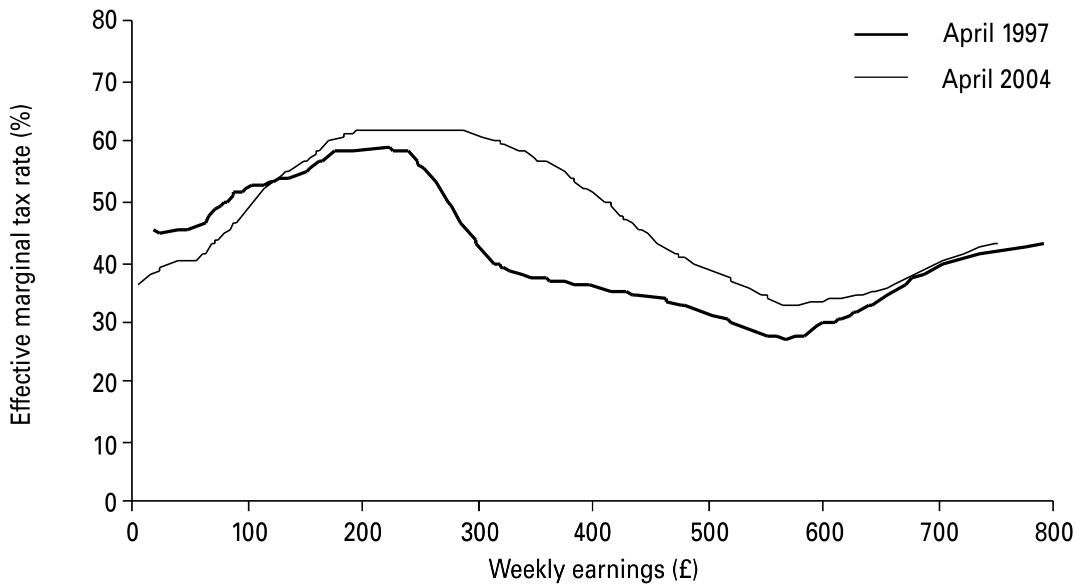
Figure 13 Changes in incentives to progress from tax and benefit changes for working lone parents, April 1997–April 2004



Notes: all in 2004 prices. Excludes parents aged over 55 and the self-employed and the few lone parents who earn more than £500 per week. Marginal rates were calculated by increasing hours worked by 5 per cent.

Source: authors' calculations from FRS 2002–03 and TAXBEN.

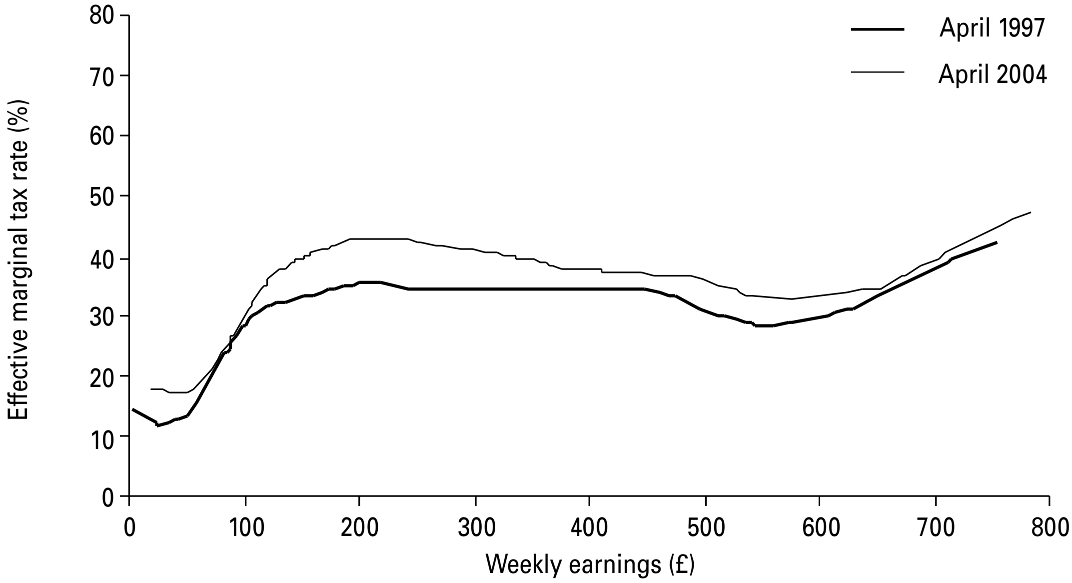
Figure 14 Changes in incentives to progress from tax and benefit changes for individuals in couples with children whose partner does not work, April 1997–April 2004



Notes: all in 2004 prices. Excludes parents aged over 55 and the self-employed and the small number who earn more than £800 per week. Marginal rates were calculated by increasing hours worked by 5 per cent.

Source: authors' calculations from FRS 2002–03 and TAXBEN.

Figure 15 Changes in incentives to progress from tax and benefit changes for individuals in couples with children whose partner does work, April 1997–April 2004



Notes: all in 2004 prices. Excludes parents aged over 55 and the self-employed and the small number who earn more than £800 per week. Marginal rates were calculated by increasing hours worked by 5 per cent.

Source: authors' calculations from FRS 2002–03 and TAXBEN.

Table 5 The impact of tax and benefit changes from 1997–2004 on the mean effective marginal rate faced by working parents

	Effective marginal tax rates (%)		
	April 1997	**April 2004**	**Difference**
Lone parents			
Mean	58.0	58.3	+0.3
Median	72.5	69.0	–3.5
Proportion whose rate rises		31.2	
Proportion whose rate falls		46.9	
Individuals in couples with children whose partner does not work			
Mean	43.0	48.2	+5.2
Median	35.7	42.1	+4.4
Proportion whose rate rises		45.4	
Proportion whose rate falls		21.0	
Individuals in couples with children whose partner does work			
Mean	32.5	36.8	+6.1
Median	33.0	34.9	+1.9
Proportion whose rate rises		39.4	
Proportion whose rate falls		10.0	

Source: authors' calculations from FRS 2002–03 and TAXBEN. Excludes parents aged over 55 and the self-employed. Proportion whose rate rises or falls ignores those whose rate has changed by less than 1 ppt.

The impact of Labour's make work pay policies for lone parents, then, has been to improve the very poor incentives to progress among low-earning lone parents, but at a cost of reducing incentives to progress among higher earners. Table 5 suggests that there are more lone parents in the former group than the latter, because nearly half of working lone parents face a lower effective marginal tax rate thanks to Labour's tax and benefit changes, but around a third face a higher rate. The median effective marginal tax rate faced by working lone parents has fallen by 3.5 ppts, but the average rate has hardly changed (telling us that the average rise for those experiencing rises is greater than the average fall for those experiencing falls).

Figures 14 and 15, and the bottom two sections of Table 5, show the same picture for working parents in couples according to their partner's employment status. Among individuals who are the only worker in a couple (who tend to be men), Labour's policies have reduced effective marginal tax rates for those with very low earnings (below £100 a week), but have increased effective marginal tax rates, and reduced incentives to progress, for those with weekly earnings above £250 (see Figure 14). The changes have led to more rises in effective marginal rates (45 per cent of this group) than they have to reductions (20 per cent), and the average effective marginal tax rate faced by individuals who are the only worker in a couple has risen by over 5 ppts.

Figures 13 and 14 together also show us the following.

- Lone parents face worse incentives to progress than single earners in couples on the same earnings, perhaps because they are more likely to be entitled to means-tested benefits, such as Housing Benefit.

- The individuals facing the highest effective marginal tax rates among single-earner benefit units with children are those with weekly earnings between £200 and £300, and not those paying higher-rate income tax (roughly, those earning over £700 a week).

Figure 15 shows that working parents in couples whose partners also work (who are equally likely to be men or women, by definition) face lower effective marginal tax rates, on average, than both working parents in couples whose partners do not work and lone parents on the same earnings. But the impact of Labour's reforms on incentives to progress for this group has been unambiguously negative: they have worsened, on average, right across the earnings distribution. Table 5 confirms that the tax and benefit changes have led to more rises in effective marginal rates (39 per cent of this group) than they have to reductions (10 per cent), and the average effective marginal tax rate faced by individuals who are the only worker in a couple has risen by over 6 ppts.

Most of these changes in the incentives to progress shown in Figures 13–15 – just like those shown in Tables 3 and 4 – can be attributed to three main aspects of Labour's changes. But Figures 13–15 give us a little more information because they show us the level of earnings at which marginal rates have changed, on average. In particular:

- Withdrawal rates of in-work benefits and tax credits for parents have fallen since 1997. This has simultaneously reduced the number of low-earning families facing very high marginal tax rates, but has increased the range of earnings over which parents face some sort of withdrawal of in-work support, raising marginal tax rates.

- In-work support has become more generous. This has increased the range of earnings over which parents face some sort of withdrawal of in-work support, extending higher marginal rates up the earnings distribution.

- Marginal tax rates faced by some high-earning parents have increased because national insurance rates have increased by 1 percentage point and because the Child Tax Credit is now phased out from high-income families.

The link between the changes in policy (particularly changes to in-work benefits and tax credits) and the changes in incentives is less obvious for individuals in couples than for lone parents. This is because in-work support is assessed on the joint income of a couple, and there is a difference in two-earner couples between family income and individual earnings; for lone parents, the two concepts are identical, of course. Figure 15 shows that the impact of this worsening of incentives to progress is not limited to individuals in couples with a particular level of earnings, as it is for working lone parents; on the other hand, it shows us that the average deterioration of incentives to progress for individuals in couples with a particular level of earnings is not that large. Box 6 discusses the changing work incentives among couples in more detail.

Box 6 The overall impact of make work pay policies on couples' work incentives

Table 2 together with Figures 14 and 15 illustrate clearly how the changes in work incentives generally for parents in couples depend on the employment status of their partners. The pattern of changes that we observed – an increased financial reward for one person to work, but a reduced reward for the second earner in a couple, and reduced incentives to progress for almost all workers in couples with children – is inevitable given that the Government has chosen to

Continued overleaf

withdraw in-work support against the joint income of couples, with no extra allowances for the number of earners, and given that changes to in-work support have dominated Labour's make work pay policy agenda.

This pattern of changes in incentives is matched to an extent by the evidence on the impact of Labour's changes on the employment rates of individuals in couples, some of which finds that the changes increased the number of couples in which one adult works and reduced the number in which two adults work.[7]

This critical trade-off between the incentives faced by first and second earners was acknowledged by the Government in its first document on the WFTC:

- [Some] have … questioned the extent to which the WFTC will improve work incentives. In particular, it has been argued that some second earners will choose to reduce their hours in order to increase entitlement. However, this fails to take into account that:
- at a time when one in five households are not working, the highest priority must be to get one member of workless families into work. It is the 'work poor' rather than the 'work rich', which need the greatest help in the modern labour market …
- in any case, the childcare credit will benefit second earners, as well as lone parents, making it easier to return to employment, and once there reducing the cost of working longer hours. Two earner households will only be eligible for the credit if they both work more than sixteen hours a week. For many second earners working only a few hours, this will provide a strong incentive to work more
- … those facing higher marginal rates – as a result of being brought into WFTC entitlement – will be better off than they are now: in some cases, significantly so. It is difficult to argue that those earning around £300 a week are entrapped in poverty.
  (HM Treasury, 1998b, para. 4.10)

This defence makes clear, then, that the Government thought that the worsening of incentives to progress for second earners was a price worth paying for changes in incentives that should reduce the proportion of workless households.

Make work pay policies and financial work incentives: conclusion

How one assesses the overall effect of all these changes depends on how much importance one gives to the different levels of marginal effective tax rates, and to whom they apply. For example, is it more important that some rates have increased from below 40 per cent to above 40 per cent, or that some have fallen from above 80 per cent to below 80 per cent? Is it more important that most people's rates have risen, or that fewer people face rates above 80 per cent? Does it matter that second earners in couples face worse incentives if first earners face improved incentives? These are important questions about economic efficiency to which, unfortunately, economists don't yet have unambiguous answers. But, if we assume that this Government is content with the outcome of seven years of its reforms, then it is clear how it would respond to those questions.

Whatever the Government's views, it is clear that Labour has paid a high price for reducing the number of parents who faced very poor incentives to progress in 1997: Labour's changes mean that around 900,000 more working parents face effective marginal tax rates of over 50 per cent, while 220,000 fewer face effective marginal tax rates of over 80 per cent. Some couples face a larger financial reward to having one person in work, but the reward to the second adult working has declined, on average, and over 40 per cent of individuals in couples with children face weaker incentives to progress in the labour market. Although there is some evidence that the Working Families' Tax Credit did not reduce, and may have increased, wage growth, the long-run impact of higher effective marginal tax rates on individuals' prospects is unknown.[8]

The Treasury's first document on the WFTC concluded that 'academic research supports the conclusion that the WFTC will improve work incentives' (para. 4.11). It is hard to reach such an unambiguous conclusion when examining seven years of Labour's make work pay policies.

Make work pay policies and employment trends: conclusion

Can we reconcile the findings from the first two sections of this chapter?

Taking lone parents first, the second section of the chapter argued that, on average, personal tax and benefit changes since 1997 mean that lone parents now have a stronger financial reward to work, that low-earning lone parents will see stronger financial incentives from progressing in the labour market, but that lone parents on medium to high earnings now face smaller financial incentives to progress. However, the first section of the chapter argued that academic studies agree that the Labour Government's policies have been partly responsible for the rise in the employment rate of lone parents since 1997 and for a rise in the average number of hours worked by lone parents.

It should be remembered that some of the studies referred to in the first section of the chapter examine the combined impact of all of the policies that affected parents' propensity to work differently from non-parents, whether they be tax and benefit changes, the New Deals, or policies expanding formal childcare places, for example. This means that they are not entirely comparable with the analysis in the second section of the chapter, which is just about the impact of tax and benefit changes, and is likely to be more positive about the Government's policies. But two of the studies in the first section examine the impact of tax and benefit changes alone (Brewer *et al.*, 2003b; Blundell *et al.*, 2004a), and these two studies conclude that the combined effect of tax and benefit changes (between 1999 and 2003) was to increase lone parents' labour supply. This suggests that, overall, the response of those lone parents whose work incentives improved was larger than that of those whose work incentives worsened.

For individuals in couples, the second section of the chapter showed how Labour's changes to personal taxes and benefits have improved the financial reward to having one adult in work for a minority of couples with children, but worsened it for the majority. In addition, the changes have lowered the financial reward to having a second earner for a majority of couples and increased the effective marginal tax rate of over 40 per cent of individuals in couples with children. This rather pessimistic analysis is partly – but not perfectly – matched by the results of studies in the first section of the chapter. In detail:

- Brewer *et al.* (2003b) and Blundell *et al.* (2004b) find that the combined effect of tax and benefit changes between 1999 and 2003 was to reduce employment among women in couples and slightly increase employment among men in couples.

- Blundell *et al.* (2004a), on the other hand, found that Labour's changes between 1999 and 2002 had no statistically significant impact on the employment rate of women in couples and slightly reduced the employment rate of men.

- Leigh (2004) found that the WFTC alone slightly increased the employment rate of women in couples with children (the study did not look at men).

However, there is more agreement between the studies in the first section of the chapter that Labour's reforms have increased the proportion of couples with children with one adult in work by reducing the proportion of couples with both two and no adults in work, and this finding is entirely consistent with the results in the second section of the chapter, which show that both the incentive to work at all and the incentive to progress have worsened, on average, among individuals in couples whose partner works.

5 Make work pay and poverty: the record so far

In this chapter, we review the latest evidence on the impact of make work policies on income levels and poverty rates.

In the first section, we show the changes in poverty rates for families with children in recent years. It is hard to disentangle observed changes in child poverty into those due to government policies and those that would have happened anyway.[1] In the second section, therefore, we use microsimulation techniques to examine the impact of Labour's tax and benefit changes on household incomes assuming that nothing else is changing.

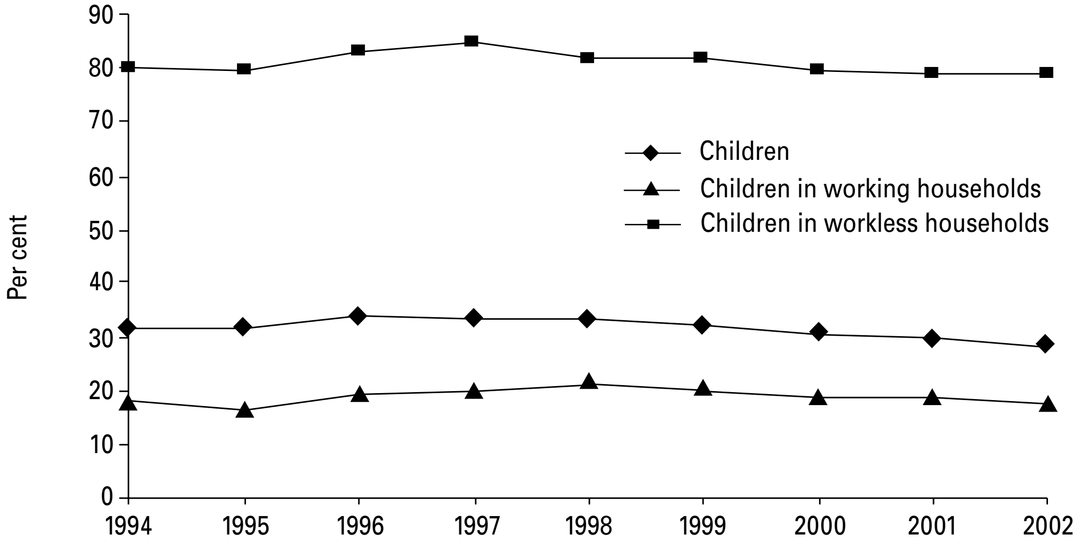
This section focuses entirely on families with children. Poverty rates for those without children have increased slightly under Labour, but the latest data predate the Working Tax Credit (see Brewer *et al.*, 2004), so we omit further analysis of this from the first section of the chapter. And, although it is possible to analyse the impact of Labour's personal tax and benefit reforms on the incomes of families without children (as we do for families with children in the second section of the chapter), the impact will be dominated by the effect of policies whose primary purpose is unconnected with the make work pay agenda.

Changes in poverty rates

The substantial increases in support for families with children, and the increase in employment among parents, have both led to large falls in child poverty rates under Labour.[2] It is now widely accepted that Labour has probably managed to reduce child poverty by a quarter since 1998/99 – see HC 85-I (2003-4), for example – although we won't know for certain whether it has met its target until early 2006. And, if it does, then child poverty will be at rates last seen in the early 1990s.

Figure 16 shows the rate of child poverty for all children and then separately for children according to whether there is a working adult in the household. The figure uses the standard Households Below Average Income (HBAI) definition of relative poverty, which counts a child as being in poverty if he or she lives in a household whose income is below 60 per cent of the median after housing costs (AHC), with incomes adjusted using the McClements scale. This is one of the definitions used for the Government's target for 2004, but it is not among the definitions that the Government is targeting in 2010.

Figure 16 Trends in child poverty, 1994/95–2002/03



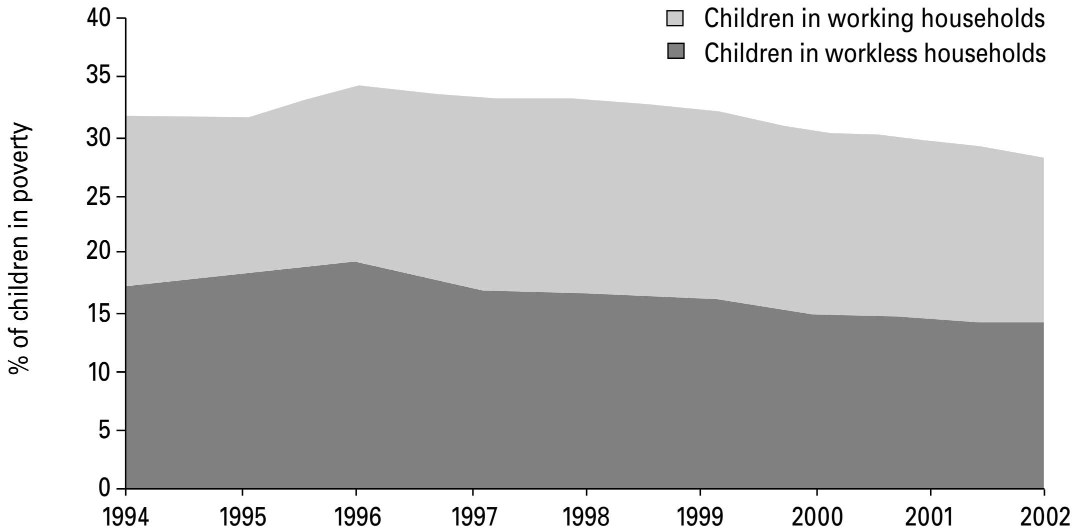
Source: authors' calculations from HBAI/FRS datasets. Child poverty is defined as being in a household with less than 60 per cent median AHC income using the McClements equivalence scale. A working household is a household where at least one adult has positive hours of work or (before 1997/98) is self-employed. Labels on horizontal axis correspond to financial years.

Poverty rates have declined since 1998 for both children in working households and those in workless households. As we saw in Figure 12, though, there are now fewer children in workless households than in 1997 (or, using HBAI data, than in 1996/97) and this will also have contributed to the overall fall in child poverty. This point is illustrated in Figure 17, which shows the contribution of children in workless and working households to the total proportion of children in poverty. Even though the poverty rate for children in workless households has changed little under Labour (see Figure 16), the proportion of children who are both in a workless household and in poverty has fallen quite substantially under Labour. This means that children in a working household now make up a slightly higher proportion of children in poverty than they did in 1997, even though the poverty rate for such children is now lower than it was then; indeed, since 2001/02, the majority of children in poverty on this measure have been in a working household.[3]

Impact of personal tax and benefit changes on the incomes of families with children

Although we know that child poverty has fallen considerably under Labour, we do not know for certain to what extent Labour's policies caused the decline shown in Figure 16. We can attempt an intermediate step, though, and this section therefore examines what Labour's personal tax and benefit reforms have done to the incomes of families with children.

Figure 17 The changing composition of children in poverty, 1994/95–2002/03



Source: authors' calculations from HBAI/FRS datasets. Child poverty is defined as being in a household with less than 60 per cent median AHC income using the McClements equivalence scale. A working household is a household where at least one adult has positive hours of work or (before 1997/98) is self-employed. Labels on horizontal axis correspond to financial years.

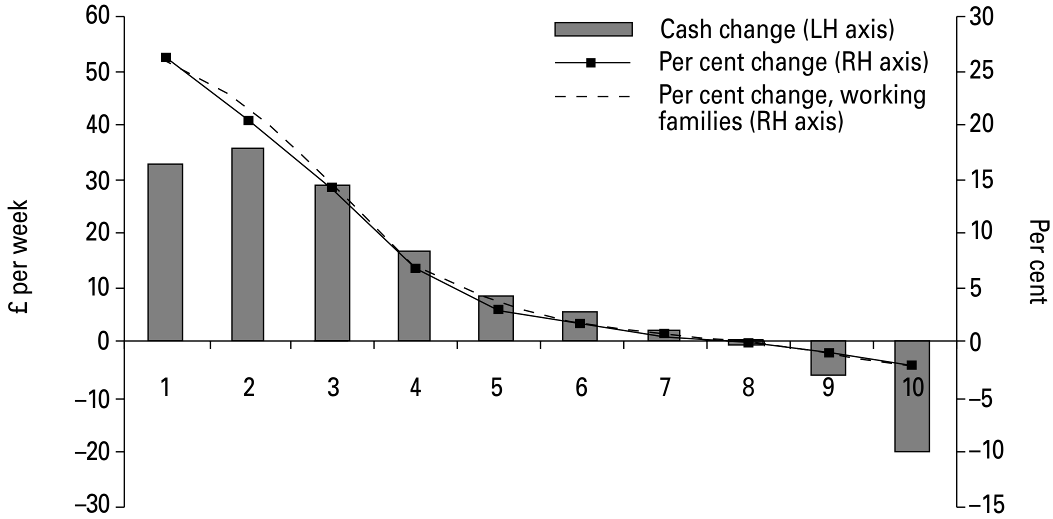
It is well known that the Labour Government has substantially increased the amount of state financial support that is contingent on having children. Adam and Brewer (2004) estimate that child-contingent support rose by 52 per cent in real terms between 1999 and 2003; HM Treasury (2003) estimates that it increased by 64 per cent, or over £9 billion, between 1997 and 2003 (see para. 5.13), although the studies use slightly different definitions of, and ways of estimating spending on, child-contingent support.

Changes in household incomes will, of course, depend on changes in other taxes and benefits that affect non-parents as well as parents. Figure 18 therefore estimates the impact of changes in personal taxes and benefits between April 1997 and April 2004 on the incomes of families with children.[4] The figure has split the seven million families with children in Britain into ten equal-sized groups (or deciles) according to their income (adjusted using the McClements scale), with decile 1 containing the poorest 10 per cent of families and decile 10 the richest 10 per cent of families. It shows the average proportional gain in income in each decile separately for all families and then just families with at least one worker.

The figure shows the following.

- As well as redistributing to families with children, Labour's tax and benefit changes have been extremely redistributive within families with children, with the average gain in proportional terms inversely related to family income.

Figure 18 Average gains in incomes from personal tax and benefit reforms of families with children, 1997–2004



Source: authors' calculations using TAXBEN and FRS 2002–03. Base is all families with children in Great Britain; deciles are among families with children only. Family income has been adjusted using the McClements equivalence scale.

- The gains for the poorest families have been substantial, with tax and benefit changes under Labour increasing the incomes of the poorest fifth of families with children by over 20 per cent.

- The proportion gains among low-income families with someone in work are very similar to the gains among low-income families with no one in work (we conclude this because the two lines showing proportional gains are almost coincident).

The last point has come about because Labour's desire to substantially reduce child poverty required it to increase benefits for families with children who do not work and it did so by almost as much as it did for low-income working families (this point was illustrated for certain lone-parent families in Figures 5 and 6). But these increases in out-of-work benefits act to reduce the incentive to work, leading to little change, or a worsening, of the incentive to work at all, and this is why replacement rates for some lone parents and for some individuals in couples whose partner does not work (i.e. among benefit units with one worker) have risen, despite large increases in in-work support (see Table 2). In addition, Brewer *et al.* (2003b) found that the non-WFTC changes in taxes and benefit between April 1999 and April 2000 – principally, increases in child allowances in Income Support and income-related Jobseeker's Allowance – acted to dull the positive labour-supply effects of the WFTC and, on their own, would have reduced employment rates among parents.

6 Conclusions and future challenges

The aims of Labour's make work pay policy agenda were to make work pay more than not working and to make work pay a decent wage, especially for parents. Ultimately, though, the policies were intended to reduce the number of workless households with children, increase the proportion of parents in work and reduce child poverty. Examining these outcomes would lead one to conclude that the policies have been a success: employment rates for lone parents have risen by 10 percentage points since 1997; there are 350,000 fewer children under 16 in households where no adult works; and child poverty in 2004 is on track to be at a level last seen in the early 1990s. Academic studies agree that the Government's policies were partially responsible for these changes.

But Labour's changes to personal taxes and benefits have had a mixed impact on financial work incentives for parents. For lone parents, the story is relatively positive: on average, lone parents now face a larger financial reward to work than in 1997 and more lone parents will see stronger financial incentives to progress in the labour market than will see weaker incentives, with the former group likely to be those with low earnings.

Among couples with children, the impression is much less positive. Labour's reforms have increased the financial reward to having one adult in work for a few, but reduced it for many, and they have also reduced the financial reward to having a second earner for the majoirty of couples. Incentives to progress in the labour market have been dulled: over 40 per cent of individuals in couples with children face a higher effective marginal tax rate, with the mean change in tax rates being a rise of over 5 percentage points. Overall, the impact of Labour's changes on couples means that a couple with children now faces, on average, an increased incentive to be a single-earner couple, rather than have two earners or none, than in 1997. Academic studies suggest Labour has been successful in reducing the proportion of couples with children where no adult works, but employment rates among parents in couples have changed by very little.

If we look at the changes across all working parents, the obvious weak point of Labour's policies has been that, overall, more working parents face reduced incentives to progress in the labour market through Labour's tax and benefit changes than face improved incentives to progress, with, for example, the number facing an effective marginal tax rate of over 50 per cent rising by almost 900,000. Although there is some evidence that in-work support (with its high effective marginal tax rates) in the UK does not reduce, and may increase, wage growth among those individuals receiving it, the long-run impact of higher effective marginal tax rates on individuals' prospects is not yet known with certainty.

This mixed impact on work incentives has arisen for two reasons. First, Labour has increased the support available to low-earning parents. This support, though, has been means-tested and, in couples, it has depended on family income and means that more parents now face some sort of benefit or tax credit withdrawal. Second, Labour's drive to reduce child poverty has led it to increase the state support available to non-working families with children and this has reduced the financial reward to work. We presume, though, that the Government views these drawbacks as a price worth paying.

Where will the make work pay agenda go next, if Labour continues in government? Our view is that the trend in changes to tax credits that has been set in very recent years may not be sustainable in the long run. In particular, one year after introducing the new tax credits, the Government eroded the value of the Working Tax Credit in April 2004 by freezing the point at which extra earnings reduce entitlement and simultaneously increased the per child element of the Child Tax Credit for the poorer half of families. Both of these changes have small but negative impacts on financial work incentives: the former reduces the incentive to work at all among some families and the latter leads to more families with children facing a withdrawal of tax credits as their incomes rise. Current spending plans assume these two policies will continue indefinitely, increasing the negative impact on work incentives over time. It seems possible, then, that the next assault on child poverty will involve policies that are at least neutral, or will even improve work incentives.

One clue to future policy reforms might come from some of the pilots that are currently being run by the Department for Work and Pensions. In particular, the Employment, Retention and Advancement demonstration, and the In-work Credit, each provide extra support to people who move from welfare to work, but provide this for only a limited period of time.[1] In design, they fall somewhere between policies focused exclusively on the transition to work and policies aimed at families on a low-income with someone in work (see Tables A.1 and A.2 in the Appendix), because they are intended to act as temporary support, which hopefully leads to permanent changes in behaviour. The two policies have other common features too: they are very generous, substantially improving the financial reward to work; they are not related to income, so they have no impact on incentives to progress; and they are targeted closely on specific groups. These two pilots may indicate an increased willingness to make use of time limits, and much more precise targeting, in designing make work pay policies, something that has been done a lot more in the US and Canada, for example.

Another obvious next step for a government keen to continue the make work pay agenda would be to reform Housing Benefit. The highest effective marginal tax rates still arise when individuals are receiving both tax credits and Housing Benefit (or Council Tax Benefit). In 1998, when assessing how taxes and benefits could be reformed to improve work incentives, Martin Taylor concluded that he ‘did not need to consider Housing Benefit in detail’ because ‘the Comprehensive Spending Review (CSR) is considering the relationship between benefits and rents and whether help with rents can be given in ways that improve incentives more effectively’ (HM Treasury, 1998a, para. 1.35). Six years later, the structure of Housing Benefit and Council Tax Benefit – with their unambiguously negative impact on the reward to work and incentives to progress – remains unchanged. The Government has made clear its intention to break the link between actual rent and Housing Benefit entitlements, by having a local housing allowance. But it has so far said nothing about whether it intends to alter the earnings disregard, or change the current withdrawal rates in the two benefits. If any government is keen to make a sizeable impact on financial work incentives, then it should turn to Housing Benefit and address the issue that, almost without exception, Housing Benefit recipients still face extremely weak work incentives.

Notes

Chapter 1

1 'Work' throughout means paid work.

2 Throughout, a family is used as a synonym for a benefit unit, which comprises one or two cohabiting or married adults and their dependent children. For the sake of brevity, we refer to the adults in a benefit unit with children as 'parents'.

Chapter 2

1 See Dilnot and McCrae (1999) or Brewer and Gregg (2003) for a description of the WFTC and the means-tested benefit that it replaced (Family Credit).

2 Quoting Bennett and Millar (2004), who identify the various goals of in-work support. Pearson and Scarpetta (2000) make a similar argument having reviewed international experience with make work pay policies.

3 In fact, this claim by the Government was disputed by some commentators, who argued that the Government had put forward no evidence that financial work incentives were a problem for benefit units without children (see, for example, Bennett and Hirsch, 2001; Brewer *et al.*, 2001).

4 See HM Treasury (1998a). Much of the same arguments had been made the previous year in HM Treasury (1997), which has quantified the extent of the unemployment and poverty traps by examining replacement rates and effective marginal tax rates (see paras 4.19–4.22).

5 For example, HM Treasury (1998b) said that 'Five million adults and 2.7 million children live in workless households, which account for a growing proportion of those in poverty. The proportion of children living in families without a full-time employee has risen from 16 per cent in 1970 to 33 per cent in 1995. The Government believes that the best way to tackle poverty is to get people into jobs. It is therefore important to improve skills and employability. But it is also necessary to address many of the features of the tax and benefit system that fail to reward work and allow people to climb the earnings ladder:

- the unemployment trap which can result in in-work incomes being little higher than those available out of work
- the failure of in-work support to recognise in-work costs associated with childcare

- the poverty trap which arises when people in work cannot improve their income by working longer hours or for higher pay. At present $^3/_4$ million working families face marginal tax and benefit withdrawal rates of over 70 per cent.'

6 Brewer and Gregg (2003) and Sutherland *et al.* (2003) analyse the Government's anti-child poverty agenda in more detail, but it is worth noting that the WFTC was announced at the same time as increases in the child allowances in Income Support, a policy that reduced the ability of the WFTC in making work pay more than not working and that was not mentioned in HM Treasury (1998b). This suggests that the Government always had the twin aims of improving work incentives and reducing child poverty, but initially chose to give more weight in public to the former.

7 It is relatively straightforward to estimate how particular make work pay policies have affected the incomes, and therefore the poverty rates, of the families that benefited. But it is also of interest to examine how make work pay policies have altered the incomes of non-workers: a policy of reducing out-of-work benefit entitlements, for example, would make work pay (defined as increasing the financial incentives to work), with no adverse effects on the incomes of working families, but would obviously push non-working families further into poverty.

8 This section draws on ongoing work at the IFS on work incentives and poverty changes over time, funded by the Joseph Rowntree Foundation: see http://www.jrf.org.uk/knowledge/wip/record.asp?ID=802995.

9 For individuals in couples, it is possible to construct a budget constraint for one adult given the other adult's labour market state and weekly earnings, or to extend the concept of the budget constraint into three dimensions by showing how variations in the gross earnings of both individuals relate to the net income of the family; we do the former.

10 The latter is sometimes called the average tax rate, although different authors can have different definitions of the average tax rate.

11 This is discussed more in Gregg *et al.* (1999). It is also the case that a given reform can change the two measures in different ways: for example, an equal cash gain in in-work and out-of-work incomes will not change the participation tax rate, but will increase the replacement rate.

12 The Employment, Retention and Advancement demonstration project aims to achieve precisely that (see Morris *et al.*, 2003). The impact of in-work support on incentives to progress is highlighted as an important research issue in Blundell and Walker (2001).

13 For more details on this for the WFTC, see section 2.2 of Brewer *et al.* (2003b) or Blundell *et al.* (2000). The general point is made in, for example, Blank *et al.* (2000).

14 Some of this section draws on Brewer and Clark (2002).

Chapter 3

1 The original source did not give the cost to the Government of the changes. This is partly because constructing consistent and comparable estimates of the cost of reforms is hard: Table A1 in Brewer *et al.* (2002), though, gives the latest estimate of the full-year cost of the main changes to social security and tax credits announced between 1997 and Budget 2002. Among families with children, the tax credit changes have been by far the most expensive, but the income tax and national insurance changes were relatively expensive reforms because they also affect those without children, as well as affecting individuals on low pay, rather than just families with a low income.

2 See Stewart (2004), who concludes that ‘No significant adverse employment effects are found for any of these events [the introduction of the minimum wage and its uprating in 2000 and 2001] for any of the estimators for any demographic group’. Metcalf (2004) agrees with this assessment, while Machin and Wilson (2004) find ‘some evidence of employment reductions’ in the care home sector.

3 This report will not attempt to describe what the changes have involved: for that, see, for example, Brewer (2003) on the new tax credits; Dilnot and McCrae (1999) on the WFTC.

4 Family Credit was withdrawn at the rate of 70p for every pound of net income; tax credits are withdrawn at the rate of 37p for every pound of gross income, but, for an individual who earns too little to pay tax or national insurance, then net and gross income are the same, so the effective tax rate will have fallen from 70 to 37 per cent. For someone paying basic rate income tax and national insurance and receiving in-work support, though, the effective marginal tax rate will have fallen from 79.9 per cent in 1997 to 70 per cent in 2004.

5 See, for example, Brewer *et al.* (2003b) or Inland Revenue (2003) for evidence on take-up of Family Credit and how it changed under WFTC.

6 In other words, some payments were made to fathers, but only if the mother elected for this.

7 As remembered by David Willetts in an article in *New Statesman*, cited in Duncan *et al.* (2003).

8 As Table 4 shows, the number of individuals in work who face effective marginal tax rates of over 100 per cent is far fewer under the 2004 tax and benefit system than the 1997 tax and benefit system.

9 It is unrealistic that a family with one worker earning £300 a week would spend £100 a week on formal childcare, but it is not unrealistic that a family with two earners would need to spend £100 a week on formal childcare. The precise relationship between the hours worked by the second earner and spending on formal childcare does not affect the conclusion that the incentive for the second adult to work at all has improved dramatically if the family spends money on formal childcare when the second adult works.

Chapter 4

1 Authors' calculation from Labour Force Survey. 'Children' means dependent children.

2 Employment trends among lone parents over a three-decade period are analysed in some detail in Gregg and Harkness (2003).

3 It should be noted that none of these studies has yet been published in a peer-reviewed journal: all are working or discussion papers.

4 This was the approach used to evaluate the impact of the Earned Income Tax Credit (EITC) on lone parents' labour market behaviour in the US (see Eissa and Liebman, 1996).

5 Calculating incentives to work at all for those who do not work requires one to make assumptions about how much these people would earn and how many hours they would work if they were to work. In ongoing research, we have found that the incentive to work at all for those not in work is usually slightly worse than

for those in work, partly because those not working have lower earnings potential, on average, and partly because those not working have greater entitlements to benefits than those working would do if they stopped working, on average. But recent changes in policies have had very similar impacts on the incentives to work at all for both workers and non-workers (see the research referred to in Chapter 2, note 8).

6 We perform this analysis by expressing the April 1997 and April 2004 tax and benefit system in April 2002 prices, and then calculate entitlement to benefits and net liability to taxes for each family in the 2002–03 FRS. Earnings are expressed in current (April 2004) prices in the figures. Quantifying the changes in work incentives due to changes in the characteristics of workers, including their real wages, is one of the aims of the research referred to in Chapter 2, note 8.

7 See Brewer *et al.* (2003b); Blundell *et al.* (2004a, 2004b). Leigh (2004), the only other study to look at couples, does not investigate the impact of tax credits on the number of earners in a family.

8 See Lydon and Walker (2003). The issue of whether high marginal tax rates had a long-term damaging impact was raised as a key research question for the UK's make work pay agenda in Blundell and Walker (2001).

Chapter 5

1 This was part of the reason for the controversy that arose when poverty figures for 2001/02 showed that child poverty had fallen by only 500,000, rather than the 1.2 million that some people were expecting given what the Government had said (see Brewer *et al.*, 2003a).

2 See, for example, Sutherland *et al.* (2003); Brewer *et al.* (2004); Department for Work and Pensions (2004).

3 Some of these findings are sensitive to the choice of poverty measure. Examining the broader point in more detail with earlier data, Sutherland *et al.* (2003) found that, out of the 3.46 percentage point (ppt) decline in child poverty between 1996/97 and 2000/01, only 0.58 ppts was due to a reduced risk of poverty within a particular family and employment state, with the rest being due to changes in the make-up of households with children, the most important change being the decline in children in households classified as 'Head or spouse unemployed'. This research, though, pre-dates the latest data on poverty rates, which cover

two years in which there were substantial increases in benefits and tax credits for low-income families.

4 The figure compares the changes to taxes and benefits that actually happened to the changes that usually happen each year because of inflation. Like the analysis in Chapter 4, this assumes full take-up of benefits and tax credits. This will overstate the gains to low-income families, some of whom do not claim all the state support to which they are entitled. Unlike Chapter 4, this analysis includes self-employed families with children and parents aged over 55.

Chapter 6

1 This trend is discussed in Bennett and Millar (2004).

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Appendix: Supplementary tables

Table A.1 Making work pay: the transition to work

Year	Measure
Dec. 1997	Budgeting loans from Social Fund for work-related items.
Oct. 1998	Linking rule for Incapacity Benefit (to same benefit rate if job fails) extended to one year.
1999 Budget	Fast track proposed to Disabled Person's Tax Credit for newly disabled.
April 1999	Income support run-on for lone parents entering work (two weeks).
2000 Budget	£100 job grant for job-related expenses on entering work.
April 2000	Employment Tax Credit for over-50s long-term unemployed getting low-paying job.
July 2000	New Deals made 'permanent'.
April 2001	'Choices' for lone parents include option of 'mini-job' with childcare help for a year (and other options).
April 2001	Income Support mortgage interest: four-week run-on and linking rule.
April 2001	Housing Benefit and Council Tax Benefit run-ons will be more automatic.
April 2001	£15 per week earnings disregard in Income Support increased to £20.
Oct. 2001	Rapid reclaim of benefits announced, so that people who took a job that did not work could go back to benefits more easily.
2003 Budget	Eligibility for job grant extended, with £250 rate for those with children. Run-on of Housing and Council Tax Benefit also extended.
2004	Child Tax Credit extended to Jobseeker's Allowance and Income Support claimants.

Source: Bennett and Millar (2004).

Table A.2 Making work pay: measures targeted primarily on individual low-paid workers or families on low incomes with an earner/someone in work

Year	Measure	Target
1998–2000	Earnings Top-up (means-tested in-work benefit) piloted.	Household
1998	Maximum childcare costs disregard in Family Credit increased.	Household
April 1998	Subsidised jobs for young under New Deal for Young People.	Individual
June 1998	Subsidised jobs for adult long-term unemployed under New Deal 25+.	Individual
April 1999	National minimum wage becomes law: £3 per hour for 18–21s, £3.60 per hour for adults.	Individual
April 1999	Introduction of 10 per cent lower income tax rate, replacing 20 per cent lower band.	Individual
April 1999	Abolition of NI ‘entry fee’ for employees.	Individual
Oct. 1999	Working Families’ Tax Credit (with child support disregarded) and including Childcare Tax Credit.	Household
Oct. 1999	Disabled Person’s Tax Credit.	Household
April 2000	Increases in Child Benefit.	Household
June 2000	Increases in Working Families’ Tax Credit rates for under-16s.	Household
June 2000	National minimum wage raised from £3 per hour to £3.20 per hour (18–21s).	Individual
Oct. 2000	National minimum wage increased from £3.60 per hour to £3.70 per hour (adults).	Individual
Oct. 2000	Campaign to encourage take up of WFTC.	Household
April 2001	Introduction of ‘primary threshold’ (at tax threshold level) for employee NICs above lower earnings limit.	Individual
Budget 2001	Increase in 10 per cent income tax band.	Individual
June 2001	Higher Working Families’ Tax Credit and Childcare Tax Credit.	Household
Oct. 2001	Adult minimum wage increased 10.8 per cent to £4.10 from £3.70 per hour; and youth rate rises from £3.20 to £3.50.	Individual
April 2002	Independent Living Funds payment rules allow severely disabled people with job to keep more of their pay.	Individual
Oct. 2002	Adult minimum wage increased 10p per hour to £4.20 and youth rate to £3.60.	Individual
June 2002	Increases in basic credits in tax credits.	Household
April 2003	Working Tax Credit: based on 2001/02 income levels initially, but current working circumstances.	Household
April 2003	Childcare element of Working Tax Credit.	Household
Oct. 2003	Adult minimum wage increased to £4.50 and youth rate to £3.80.	Individual

Source: Bennett and Millar (2004).