Welfare reform in tough fiscal times

Creating a better and cheaper benefits system

Corin Taylor, Mike Denham, Richard Baron and Andrew Allum

tpa
The TaxPayers' Alliance

Contents

About the authors

Corin Taylor is a Senior Policy Adviser at the Institute of Directors. He also sits on the Social Return on Investment Steering Group at the Centre for Social Justice and is a Senior Fellow at the Economic Policy Centre. He was previously a member of the Economic Dependency Working Group at the Centre for Social Justice, Research Director at the TaxPayers' Alliance, Political Secretary at the Tax Reform Commission and Economics Research Officer at the think tank Reform. He has also written for the Centre for Policy Studies, Civitas and Policy Exchange think tanks on a freelance basis.

Mike Denham is a Research Fellow at the TaxPayers' Alliance. As a former Treasury economist he worked extensively on public spending and fiscal analysis during the 1970s and early 1980s. His work included cost benefit appraisal of public expenditure, value for money studies, and public sector budgeting. He then spent twenty years in the City as an investment manager, still closely following fiscal and monetary policy developments. Now semi-retired, he scrutinises public spending on the TaxPayers' Alliance Burning Our Money blog, and has written a number of TPA research papers. Mike studied PPE at Oxford University, and has a Masters in Economics from the LSE.

Richard Baron is Head of Taxation at the Institute of Directors. He has worked as a tax professional in a variety of roles for over 25 years. He was Head of Taxation at the IoD from 1996 to 2002, and then spent three years working on corporation tax policy for HM Revenue & Customs. He returned to the IoD in 2005.

Andrew Allum is the non-executive and unpaid Chairman and co-founder of the TaxPayers' Alliance. From 1998 to 2002 he served as a Conservative member of Westminster City Council before leaving the Conservatives in 2003. He is a Partner at LEK, a leading strategy consulting firm.

The views expressed in this paper by authors working at the Institute of Directors are personal to the authors and do not necessarily reflect the views of the Institute of Directors.

Acknowledgements

The authors are grateful to the UK Data Archive, the distributor of the full datasets from the Expenditure and Food Survey and the Living Costs and Food Survey, which are carried out by the Office for National Statistics. The full datasets from the 2007 Expenditure and Food Survey and the 2008 Living Costs and Food Survey were used to calculate the costs of the proposed reformed benefits system. It goes without saying that the original data creators, depositors, copyright holders, and the UK Data Archive bear no responsibility for the further analysis and interpretation in this report.

The authors are also grateful to David Martin, author of *Benefit simplification: How, and why, it must be done,* Centre for Policy Studies, July 2009, for his very helpful and insightful comments on earlier drafts. All errors, of course, remain our own.

Executive Summary

This report sets out how a better and cheaper benefits system could be designed, that would reduce damaging marginal tax and benefit withdrawal rates on the poorest in society, simplify administration, and, in tough fiscal times, save taxpayers' money.

It proposes a simple negative income tax that would replace most of the benefits that are currently paid to working-age households, shows how it could be administered, and provides a model for policymakers to see the cost of a number of combinations of negative income tax levels and taper rates.

A considerable amount of excellent and very detailed work on benefit system reform has been carried out by the current Work and Pensions Secretary through the Centre for Social Justice, and this report extends analysis of the welfare system to provide a costed plan for how a better benefits system can save money in the short-term as well as the longer-term. Reform is possible, desirable and should not be delayed because of short-term fiscal constraints.

The problems with the current welfare system

The current system of benefits is the result of "sticking plaster" decisions over many decades, taking its scope far beyond that envisaged by Beveridge, and has led to an inexorable growth in welfare dependency. It has a number of key failings:

- It is almost impossible to understand, with over 50 different benefits, all with different rules and taper rates and a total of 8,690 pages of guidance for DWP benefits alone.
- It is administratively chaotic, with take-up rates for key tax credits and benefits as low as 57 per cent in some instances, an annual benefit fraud and error bill of £4.5 billion, and over 1 million households affected by tax credit overpayments every year.
- Couples are unfairly treated, with an estimated 1.8 million low-earning couples losing an average of £1,336 per year because they live together.
- People who want to work and progress in work are financially penalised. A claimant who loses Housing Benefit, Council Tax Benefit and tax credits, at the same time as paying income tax and NICs, faces a marginal tax and benefit withdrawal rate of 95.5 per cent. Over 2.5 million non-disabled working-age households face a marginal tax and benefit withdrawal rate of over 60 per cent.
- Perhaps most damning, while the number of children living in households with less than 60 per cent of median income has fallen over the past decade, studies suggest

that the number of people in severe poverty, living in households with less than 40 per cent of median income, has actually increased from around 5 per cent of households a decade ago to around 6 per cent today. The welfare system has failed to solve the most acute poverty.

Unavoidable trade-offs

The welfare system may be failing, but implementing a single benefit / negative income tax to replace the complex system we have today is not an easy task. If it was it would surely have been done by now, as the Freud Review pointed out.

The "iron triangle" of benefit reform means that it is generally only possible to fulfil two of the following three objectives at any one time: directly raise the incomes of the poor, increase the employment of the poor and reduce welfare spending. This report argues that the latter two sides of this "iron triangle" are most important, since employment is the most sustainable way out of poverty in the longer-term.

The two key political constraints on reform, however, are the existing definition of poverty as 60 per cent of median income and the need to prevent any group being made worse off. But this makes it impossible to reduce benefit withdrawal rates and reduce spending at the same time.

Revisiting the 60 per cent poverty threshold would create losers in the short-term and it will be important for the DWP to establish who they are before any final reform is instituted, but it would have three beneficial and vital effects:

- It would allow benefit withdrawal rates to be reduced, reducing disincentives to work, without increasing the cost of the benefits system.
- If a reformed system was introduced as a single negative income tax, it would greatly increase take-up and reduce the incidence of severe poverty. It would surely be better to have a lower poverty threshold with nobody below it than a higher threshold with thousands of families slipping through the net.
- It would greatly improve work incentives, encouraging the most sustainable route out of poverty – employment. Decades of increasing welfare dependency have not solved the problem of poverty; reducing dependency could help to give low-income households a better chance.

Reform objectives and design considerations

The following five objectives would, if achieved, transform the benefits system from its current condition:

1. The state should provide a basic minimum to all citizens of working age, and through them, to all children, at an affordable cost to taxpayers.

2. Work should not be discouraged by excessive benefit taper rates.

3. There should not be too many people on middle or higher incomes unnecessarily receiving means-tested benefits.

4. The welfare system should be comprehensible for people to understand and to navigate.

5. The welfare system should be responsive to changes in people's circumstances without a high level of fraud and error.

Currently none of these objectives is met.

This report also considers a number of questions that are crucial to getting the design of a new system right. These include how assets and savings are treated, how disabled people and carers are treated, Housing Benefit, and administration.

A reform proposal

This report sets out a proposal for a negative income tax to replace the majority of benefits paid to working-age households. It is a radical, costed plan that would save money in the short-term as well as the longer-term:

- Each working-age household would be entitled to a certain percentage of the median income (net of tax and social security benefits), adjusted for the size of the household using the current equivalence scales. We have calculated the cost for 50 per cent, 55 per cent and 60 per cent. *This is the first policy parameter.* This would represent a major simplification.
- If the household had no income from employment, self-employment or investment, the household would be paid its full entitlement as a negative income tax. Part of this would be conditional on undertaking work-related activity and accepting job offers, unless no-one in the household was capable of work.
- Households with income would face a constant overall taper rate, comprising income tax, NICs and negative income tax withdrawal. The rate of negative income tax withdrawal would be adjusted depending on the rate of income tax and NICs at

different levels of income. We have calculated the cost for overall taper rates of 50 per cent, 55 per cent, 60 per cent and 70 per cent. *This is the second policy parameter.*

- Administration of the new system would be through "back-to-work" providers, while for households in work, contact between employers and providers would ensure that the system was responsive to changes in income. (The full administrative proposals are contained in Appendix A.) This would represent a major simplification.
- This proposal applies to working-age households only. Pensioner households would be unaffected. A number of other working-age benefits, including Disability Living Allowance, Carer's Allowance and Statutory Maternity Pay would remain, and would be paid in addition to the negative income tax (Appendix B contains a full list of the benefits that would remain). We do not aim to penalise those whose condition or circumstances make it difficult or impossible for them to support themselves.

We have constructed a model using extensive survey data from the Office for National Statistics to estimate the cost of our reformed system (full details are contained in Appendix B). While we have calculated the cost for a range of negative income tax levels and taper rates, we discard a number of these options as being more expensive than the present system, and so they are shown for illustration only.

Our costings are based on 2007-08, as this is the most recent year for which full survey data on household income is available, and we compare the negative income tax system with the cost of the current system in the same year:

- In 2007-08, the benefit expenditure that we would replace totalled £63.7 billion. Our preferred option – a 50 per cent of median income poverty threshold (which was previously the definition) and a 55 per cent taper rate – would have cost £62 billion in the same year. Our costings assumed a 100 per cent take-up (which should be an aspiration for any new system) and are therefore likely to be on the cautious side.
- While a 50 per cent poverty threshold is a lower threshold than today, a 55 per cent overall taper rate is far lower than the 70 per cent faced by most families receiving tax credits and paying income tax and NICs, and an even greater reduction compared with the 95.5 per cent rate faced by a household receiving Housing Benefit and Council Tax Benefit as well.
- Over time, the costs of a reformed system relative to the current arrangements would save more money, as work incentives would be so greatly improved, although, to be cautious, we do not take account of any "dynamic" effects in our model.

These proposals look at how benefits could best be varied on the basis of income. But there could be huge benefits to also varying benefits over time for each claimant, while still maintaining a vastly simpler system than that in operation today. While such proposals have not been costed in this paper, we do set out the different ways that time could be introduced as a tapering factor to improve incentives to work. This is an area that would reward further study and should be considered as the DWP works toward instituting reform of the benefits system.

There are serious objections to using a measure of relative, rather than absolute, poverty as a standard to evaluate a benefits system. As a concept, relative poverty suffers from major flaws. Assuming that benefit levels remain constant, relative poverty would tend to increase in a period of strong economic growth, as real median income rose, and fall in a period of recession, as real median income fell. This would imply that less economic growth would reduce poverty, which is clearly not the case.

It would be far better to devise an appropriate measure of absolute poverty and ensure that no household fell below it, rather than continue to rely on relative poverty measures. In the UK, there is not yet an agreed definition of absolute poverty, and how such a measure would be increased year-on-year, but absolute poverty is used as a measure in the US.

Appendix C provides an alternative, costed reform proposal based on the US standard of absolute poverty. More work should be carried out to establish an absolute standard for poverty suited to the circumstances in the UK.

In the meantime, moving from a 60 per cent to a 50 per cent poverty target, ensuring that all households were above the new 50 per cent target, and delivering a major simplification and cut in taper rates, would represent a major break from current practice, and would ensure that the UK had one of the best benefits systems in the developed world for working-age people.

A call for action

It will be impossible for any government to reform the benefits system without creating some measure of controversy, anger and resentment. The days when reforms could be designed to ensure that no one lost out are over.

When fiscal times were better, reforms could have been accompanied by more spending to minimise the number of losers, but there is no money left, and reforms now have to demonstrate that they can save money in the short-term as well as the longer-term.

Nobody should pretend that the proposal we have set out is easy. It does involve making tough choices over poverty thresholds and benefit withdrawal rates. To minimise disruptions it could be phased-in rather than introduced in one go, but reality must be faced.

Welfare reform, however, should not be doom and gloom. We believe that the proposal laid out in this report would be enormously beneficial, both in the short and longer-term:

- For most working-age households, it would mean that they only had to apply for one benefit. Most working-age households would know exactly what their overall taper rate was. This would greatly reduce confusion and worry for claimants, increase take-up and reduce administrative costs – an improvement for all.
- It would greatly reduce (ideally eliminate) the number of households living in severe poverty (less than 40 per cent of median income), while disabled people, carers and those with other exceptional circumstances would still receive other benefits on top of the negative income tax. Far fewer families would fall through the net.
- It would dramatically improve work incentives, reducing the financial penalties for people who want to work and progress in work. It would reduce the persistence of long-term unemployment after the UK economy has fully recovered from this recession, a problem that affected so many people following the recessions of the 1980s and 1990s.
- It would hugely reduce the number of people on higher incomes receiving either means-tested or universal benefits that they don't need.
- Perhaps most importantly, it would end the plethora of "sticking plaster" reforms to the welfare system that have occurred over so many decades, and that have done so much to increase dependency and so little to eliminate poverty.

Iain Duncan Smith, the new Work and Pensions Secretary, has said: *"A system that was originally designed to support the poorest in society is now trapping them in the very condition it was supposed to alleviate. Instead of helping, a deeply unfair benefits system too often writes people off."*[1] Our proposal would offer a genuine chance for so many families on benefits to break the cycle of dependency. This would be the greatest benefit of all.

[1] Rt Hon Iain Duncan Smith MP, *Welfare for the 21st Century speech,* 27 May 2010

Introduction

The purpose of this report is to set out how a better and cheaper benefits system could be designed: better because it is widely acknowledged that the current system of benefits leaves much to be desired, and cheaper because, with a deficit of over £150 billion to reduce, it seems unlikely that the £80 billion or so of benefits paid to people of working age can be left entirely untouched.

The primary aim of a good welfare system should be to help people who have fallen on hard times. For most people, it should not be a permanent source of financial assistance, although there are clearly groups of households for whom benefits do, and should, make up the bulk of the household's income. For the majority, however, a welfare system should relieve poverty as much through supporting work as through giving unconditional financial assistance. It has been well documented elsewhere that work is the most sustainable route out of poverty.[2]

Reform of the welfare system overall should be concerned with three principal elements:

- Improving the provision of back-to-work support, so that people on benefits are given the help they need to get back into the labour market.
- Introducing greater conditionality into the benefits system, so that claimants who are not making efforts to find work lose part of their benefit income. The system must contain sticks as well as carrots.
- Redesigning the benefits system so that it is simpler for claimants and providers to understand, provides better work incentives and costs taxpayers less money.

This report is primarily concerned with the third of these elements – redesigning the benefits system to simplify, to save taxpayers money and to reduce the penal marginal tax and benefit withdrawal rates facing people moving into and progressing in work.

There are a number of authoritative reports that have investigated these issues, of which several are mentioned below:

[2] See, for example: Centre for Social Justice, *Dynamic Benefits: Towards welfare that works,* September 2009

- **2006:** *Reforming Welfare* was published by the think tank Reform, which set out how back-to-work providers could be paid by results from getting claimants into lasting jobs, as in Australia.[3]

- **2007:** The Centre for Social Justice published *Breakthrough Britain,* which argued that back-to-work support must be tailored to the individual, through payments to providers that were primarily based on results, and that clear work expectations must be attached to the receipt of benefits for people who can work.[4]

- **2007:** The *Freud Report* for the DWP made similar recommendations: that support for the hardest to help should be contracted out, that stronger benefit conditionality should be introduced, and that there was a strong case for moving towards a single system of working-age benefits.[5]

- **2008:** The *Gregg Review* carried out for the DWP recommended that a single system of personalised conditionality and support should be adopted, consisting of three broad groups to which different levels of expectation and support would be attached.[6]

- **2009:** The Centre for Policy Studies published *Benefit Simplification: How, and why, it must be done,* which showed how an integrated system could allow a single agency to offer a complete and localised service to each benefit claimant, and how a single form for all benefits claims could be developed.[7]

- **2009:** The Centre for Social Justice published *Dynamic Benefits: Towards welfare that works,* which proposed a re-design of the benefits system that would reduce the rate at which benefits are withdrawn to 55 per cent of post-tax earnings, increase earnings disregards before benefits are withdrawn, and replace current benefits with two streamlined payments (Universal Work Credit and Universal Life Credit).[8]

- **2010:** Policy Exchange published *Escaping the Poverty Trap: How to help people on benefits into work,* which showed how many benefit claimants would be *worse off* in work, once commuting costs and the cost of being appropriately dressed were taken into account, and which recommended raising the earnings disregards for all means-tested benefits to the equivalent of 16 hours a week at the minimum wage,

---

3 http://www.reform.co.uk/Research/Welfare/WelfareArticles/tabid/111/smid/378/ArticleID/631/reftab/72/t/Reforming%20welfare/Default.aspx
4 http://www.centreforsocialjustice.org.uk/client/downloads/economic.pdf
5 http://www.dwp.gov.uk/policy/welfare-reform/legislation-and-key-documents/freud-report/
6 The Welfare Reform Act 2009 implemented much of the Freud and Gregg Reviews. http://www.dwp.gov.uk/policy/welfare-reform/legislation-and-key-documents/realising-potential/
7 http://www.cps.org.uk/cps_catalog/benefit%20simplification.pdf
8 http://www.centreforsocialjustice.org.uk/default.asp?pageRef=310

paid for by tapering away the Family Element of the Child Tax Credit at a lower level of income and means-testing Child Benefit.[9]

This report builds on the work that has been done in these, and other, papers. It is clear from these studies that a better benefits system can be designed, one that would reduce high marginal tax and benefit withdrawal rates and likely save money over time. But the most comprehensive of these studies, *Dynamic Benefits,* estimated that its proposed reforms would cost an extra £2.7 billion a year in the short-term. Can a better benefits system also save money in the short-term? This report will attempt to set out how.

It is worth pointing out, however, that it is relatively straightforward to reduce the welfare bill without reforming the structure of the benefits system, by means-testing a number of the benefits that are currently paid out universally, such as Child Benefit. With a government deficit of over £150 billion in 2009-10, such measures are undoubtedly necessary, since we cannot afford to continue to pay benefits to households that don't need them. But this is no substitute for comprehensive reform.

The year that is used for comparison of the existing benefits system with a reformed one is 2007-08. This is because 2007-08 is the most recent year for which the data that are needed to cost proposed reforms are available. Helpfully, it is also pre-recession, so the figures are not distorted by the current high level of unemployment.

Further work would clearly be needed to bring the comparison up to date, but if a reformed system could have saved money and improved work incentives in 2007-08, it could do so today. Higher unemployment will not make the negative income tax proposed in this report more expensive compared to the current welfare system, though more people being out of work will increase costs under either system.

As the economy recovers and more jobs are created, the dynamic effect of improved incentives to work should provide a further much-needed boost to the public finances, but that effect is not included in this report's costings.

With the new Government displaying such an appetite for genuine welfare reform, and with such tight fiscal constraints, there is no time like the present to do something that should have been done a long time ago – radically re-design the benefits system to save money and reduce the ever-increasing cycle of dependency

[9] http://www.policyexchange.org.uk/images/publications/pdfs/Poverty_Trap_-_Mar_10_WEB.pdf

The problems with the current welfare system

Much has been written about the British welfare state in recent years. Coherent analysis by the Centre for Social Justice, Reform, Policy Exchange and other groups, has generally found little that is praiseworthy about the current arrangements, and much to criticise.[10] There is no need to duplicate their work here, except to summarise some of the main problems and trends. It is encouraging that the new Government is determined to tackle the problem – the recent "State of the nation" report from the DWP, published at the end of May, set out a comprehensive indictment of poverty and welfare dependency in the UK.[11]

There are numerous problems with the current welfare system for people of working age and for their children.

1. It is almost impossible for people to understand

- There are over 50 different benefits, all with different eligibility conditions, rules and taper rates.
- As has been pointed out elsewhere: *"The DWP issues a total of 14 manuals, with a total of 8,690 pages, to its decision makers to help them to apply DWP benefits. A separate set of four volumes totalling over 1,200 pages covers Housing and Council Tax Benefits, which are primarily the responsibility of local authorities. The Tax Credits manual used by HM Revenue and Customs is a further 260 pages."*[12]

2. It is administratively chaotic

- Tax credits are administered by HM Revenue and Customs, while other benefits are run by the Department for Work and Pensions. Individual households are forced to fill out multiple forms in order to receive the benefits they are entitled to. A woman with a disabled son, for example, had to complete ten different application forms, containing over 1,200 questions, to apply for the benefits she needed.[13]
- It is perhaps not surprising, therefore, that the take-up rate for Working Tax Credit is only 57 per cent, for Child Tax Credit 81 per cent and for Housing Benefit between 80 and 87 per cent.[14] The objective should not be to save taxpayers'

[10] See the Introduction to this report for a number of the most noteworthy recent studies.
[11] HM Government, *State of the nation report: poverty, worklessness and welfare dependency in the UK,* May 2010 (Crown copyright)
[12] David Martin, *Benefit simplification: How, and why, it must be done,* Centre for Policy Studies, July 2009, p. 5
[13] Ibid.
[14] Centre for Social Justice, *Dynamic Benefits: Towards welfare that works,* September 2009, p.142

money by making the system so complicated people don't receive what they are entitled to

3. Due to the systemic and administrative complexity described above, there is an excessive amount of fraud and error

- While it may be impossible entirely to eliminate fraud and error, the sums of money and the number of people affected are staggering. Benefit fraud and error is estimated at £4.5 billion a year.[15]
- Over 1 million households are overpaid tax credits each year.[16] Some of the tax credit overpayments made by HMRC are clawed back by the Department, resulting in hardship for low-income families who have already spent the money they thought they were entitled to.
- The Institute for Fiscal Studies estimates that there are 200,000 more lone parents claiming tax credits than actually exist in the UK.[17]
- The total amount of money owed to the DWP as the result of benefit overpayments is now £1.85 billion and is rising as recoveries are not keeping pace with the increase in referrals.[18]

4. Couples are unfairly treated

- Economies of scale mean that two single claimants will always need more than a couple. However, the Government reduces benefit payments to couples by far more than is saved through cohabiting. Approximately 1.8 million low-earning couples are materially worse off – each couple losing an average of £1,336 per year – because they live together.[19]
- On this basis, the Government saves £2.4 billion a year by giving couples less than is fair (i.e. an equivalised level).[20] Given that all the evidence shows that children do better when they live with both parents and have a working role-model in the household, it is especially perverse that couples doing the right thing are so penalised.

---

[15] HM Government, *State of the nation report: poverty, worklessness and welfare dependency in the UK,* May 2010, p.34 (Crown copyright)
[16] House of Commons Public Accounts Committee, *HM Revenue and Customs: Tax Credits and Income Tax,* March 2009, p. 7
[17] Mike Brewer et al., *Poverty and Inequality in the UK: 2009,* Institute for Fiscal Studies, Appendix D
[18] House of Commons Public Accounts Committee, *Department for Work and Pensions: Management of Benefit Overpayment Debt,* March 2010
[19] Centre for Social Justice, *Dynamic Benefits: Towards welfare that works,* September 2009, p.112
[20] Ibid.

5. Working and progressing in work can often be of little financial benefit

- Currently, for example, a claimant who loses Housing Benefit, Council Tax Benefit and tax credits for each extra pound of income, at the same time as paying income tax and NICs on that extra income, has an effective marginal tax and benefit withdrawal rate of 95.5 per cent.[21] For someone working at the minimum wage of £5.80 an hour and facing such a marginal rate, the effective marginal hourly pay would be just 26p.
- There are 2.5 million non-disabled working-age households facing marginal tax and benefit withdrawal rates of over 60 per cent.[22] For someone working at the minimum wage and facing a marginal rate of 60 per cent, the effective marginal hourly pay would be £2.32.
- One study found that for a range of typical claimants of JSA, Income Support and Employment and Support Allowance, once the costs of work (such as commuting and work clothing) are included, working 16 hours a week at the minimum wage would leave them hardly better off or actually worse off. The effective wage from working 40 hours a week at the minimum wage for these case studies varies between 60p and £1.38 an hour.[23]

The above list is by no means exhaustive, but the problems described above have led to shortcomings in the previous Government's efforts to reduce the number of children living in poverty (defined as 60 per cent of median income):

- While the number of children living in poverty has fallen by around 1 million to 2.3 million since 1998-99,[24] the number of people living in households in severe poverty, defined as 40 per cent or less of median income, has actually risen. The Institute for Fiscal Studies has estimated that the number of people in severe poverty has increased from 5 per cent to 6 per cent over the last decade.[25]
- This implies that the previous Government focussed its efforts on moving households with children from just below the 60 per cent of median income poverty threshold to just above it, which in many cases is rather meaningless.

---

[21] David Martin, *Benefit simplification: How, and why, it must be done,* Centre for Policy Studies, July 2009
[22] HM Treasury, *Budget 2010,* Table 5.2. The footnote to the table states: "Marginal deduction rates are for working heads of families in receipt of income-related benefits or tax credits where at least one person works 16 hours or more a week, and the head of the family is not receiving pensioner or disability premia."
[23] Lawrence Kay, *Escaping the Poverty Trap: How to help people on benefits into work,* Policy Exchange, March 2010
[24] HM Treasury, *Budget 2010,* p.75
[25] Institute for Fiscal Studies, *What has happened to 'severe poverty' under Labour,* 2010 Election Briefing Note No. 3, cited in HM Government, *State of the nation report: poverty, worklessness and welfare dependency in the UK,* May 2010, Figure 1.1 (Crown copyright)

There is little especially new about these failings of the welfare state. While the system has undoubtedly become more complex in recent years, welfare policy over many decades has generally consisted of "sticking plaster" solutions to immediate problems:

- One of the side effects of Conservative Governments' efforts to create a real market in rental housing (in 1972, 1980, 1982 and 1988), while the supply of housing remained limited, was large increases in local authority and private rents. To minimise the impact of these increases on lower earners, Housing Benefit (and its predecessors, such as Rent Rebates) became much more generous. Between 1970 and 2005, spending on housing benefits increased from 2.2 to 23 per cent of the non-pension welfare budget.[26]
- A Return to Work Credit of £40 a week has recently been introduced for claimants of Incapacity Benefit, Employment and Support Allowance, Income Support paid because of sickness or disability, or Severe Disablement Allowance. It is payable for up to 12 months, is non-taxable, and does not count as income for the purposes of determining Housing Benefit, Council Tax Benefit or tax credits.[27] But many of the eligible claimants will be facing marginal tax and benefit withdrawal rates of up to 95 per cent. The Return to Work Credit is therefore literally a "sticking plaster", a further form to fill in, with no change to the underlying system of benefit withdrawal.
- A similar charge could be levelled at the previous Government's recent guarantee – made in the 2009 Pre-Budget Report – that anyone in work will always be better off than they were on benefits. This would have been delivered through a new "Better Off in Work Credit", which *"will ensure that all claimants who have been receiving benefits for six months will be entitled to a top up payment so that their in work income is greater than their benefit income."*[28] It would be better to deal with causes rather than symptoms.

One of the main reasons for the "sticking plaster" approach that has so often been followed has been an excessive focus on present conditions. Welfare policy has taken a largely static approach, losing sight of the dynamic changes that result from changed incentives. The welfare state may have alleviated immediate hardship, but it has taken away many people's dignity and independence, and over time has trapped increasing numbers in dependency. As a result, it has failed to solve the problems of poverty and worklessness, and it has been inexorably growing, long before the last decade:

---

[26] Nicholas Boys Smith, *Reforming Welfare,* Reform, November 2006, Table 4
[27] Citizens Advice, *Benefits – In England*, http://www.adviceguide.org.uk/index/your_money/benefits/benefits_and_tax_credits_for_people_in_work.htm#return_to_work_credit_after_a_period_of_ill-health
[28] HM Treasury, *Pre-Budget Report 2009,* p.79

- Since 1948, the number of benefits has increased from 7 to 51.[29]
- In 1950, five per cent of the British working population relied on out of work benefits. In 1990, the proportion had increased to 14 per cent.[30]
- As a share of GDP, non-pension benefit expenditure increased from 2.7 per cent in 1950 to 6.1 per cent in 1990.[31]

To be fair to the previous Government, the Welfare Reform Act 2009 introduced measures to simplify the benefits system, improve the delivery of welfare and employment services by making greater use of outside providers paid by results, and increase conditionality. But it did not address the welfare system as a whole, having little to say on, for example, Housing Benefit or the complex interaction between the rules and taper rates of different benefits.

With a new Government so committed to reform, it must surely be time for a more comprehensive re-design.

[29] Nicholas Boys Smith, *Reforming Welfare,* Reform, November 2006, Slide 2
[30] Ibid, Slide 6
[31] Authors' calculations using data from DWP Benefit Expenditure Tables and Office for National Statistics Economic Trends Annual Supplement (GDP at market prices)

The need for radical simplification and the constraints and trade-offs involved

In practice, the current benefits system almost always pays out more to households that are not working, and, despite the fact that the Working Tax Credit is only paid to people working at least 16 hours a week, benefits generally taper away as earnings progress.[32]

Given the number and complexity of benefits and their interaction with each other, individuals and households do not experience a straight line of falling benefits as earnings increase; rather, the line has different slopes and numerous kinks, and can therefore be very hard to understand:

- Generally speaking, marginal tax and benefit withdrawal rates are around 85-100 per cent for households earning less than £15,000, before falling to 70 per cent for households earning up to around £30,000, although there will be numerous exceptions to this.
- A claimant who loses Housing Benefit, Council Tax Benefit, and tax credits for each extra pound of income, at the same time as paying income tax and NICs on that extra income, has an effective marginal tax and benefit withdrawal rate of 95.5 per cent.
- A claimant who loses Working/Child Tax Credit at the same time as paying income tax and NICs has an effective marginal tax and benefit withdrawal rate of 70 per cent.

There is nothing wrong with the principle of paying out more to people who are not working, as people with an income clearly have less need of state benefits. It would be a great simplification, therefore, to replace the current plethora of benefits with a single benefit / negative income tax that tapers away at a constant rate as earnings increase. Individuals and households should face something like the benefit schedule displayed in Figure 2.1.

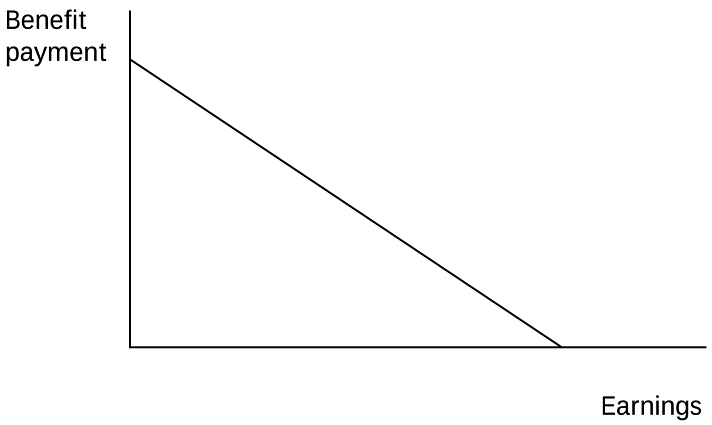
[32] For example, the Working Tax Credit is worth a maximum of £1,920 a year or £36.92 a week (£2,710 a year or £52.11 a week) for a single childless person aged over 25 working 16 hours (30 hours) a week (see HM Treasury, Budget 2010, Table A7). This is far less than the £64.30 per week paid out in Income Support/Jobseeker's Allowance to the same person not working (http://www.direct.gov.uk/en/MoneyTaxAndBenefits/BenefitsTaxCreditsAndOtherSupport/On_a_low_income/DG_185670; http://www.direct.gov.uk/en/MoneyTaxAndBenefits/BenefitsTaxCreditsAndOtherSupport/Employedorlookingforwork/DG_10018757

As the independent Freud Report for the Department for Work and Pensions stated:

> *"There is a strong case for moving towards a single system of working age benefits, ideally a single benefit, in order to better support the Government's ambition of work for those who can and support for those who cannot. A range of international evidence suggests that complexity in the benefit system acts as a disincentive to entering work, and that badly designed systems create unemployment and/ or poverty traps."*[33]

With a single benefit / negative income tax system, everyone would know where they stood, the need for complicated "better off" calculations would cease, and there would be a clear financial benefit from working and from progressing in work.

Figure 2.1: Simplified benefit schedule



Unfortunately, nothing is ever quite that simple. As the Freud Report also stated:

> *"If fundamental benefit reform was straightforward then it would have been done by now .... [A single benefit system] could also be very expensive – and, depending on where the benefit rate was set, have significant costs in terms of the adverse impact on work incentives."*[34]

Welfare reformers do have to acknowledge what has been called the "iron triangle" of reform. It is generally, at any one time, only possible to fulfil two of the following three

---

[33] David Freud, *Reducing dependency, increasing opportunity: options for the future of welfare to work: An independent report to the Department for Work and Pensions,* March 2007, p.9
[34] Ibid, pp.99-102

objectives: directly raise the incomes of the poor, increase the employment of the poor and reduce welfare spending.[35]

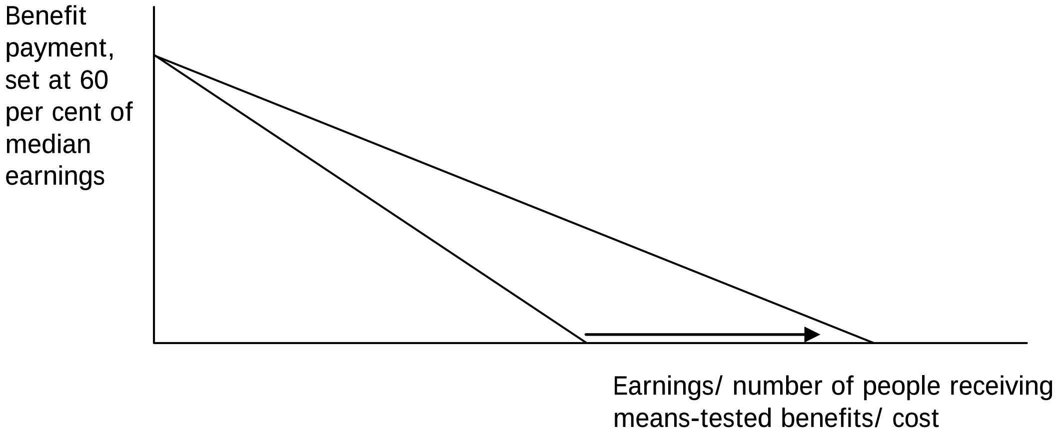
The latter two of these three "iron triangle" objectives are most important: to increase the employment of the poor and reduce welfare spending. Over time, it is likely that increased employment among low-income households would increase the income of those households, so the iron triangle may only provide a short-term dilemma.

All reform proposals, however, need to acknowledge two essential constraints of the present system, which prevent the overall benefit award to people who are not working being reduced from its current level:

- Firstly, the existing definition of poverty as 60 per cent of median income.
- Secondly, given the existing definition of poverty, the need to prevent any group of people being made worse off by the reforms.

This results in an inevitable trade-off between the taper rate and the number of people receiving means-tested benefits and therefore the cost. With a constant initial benefit award, lower taper rates increase work incentives and hence employment but also increase the number of people receiving means-tested benefits and consequently the cost of the system. This trade-off is shown in Figure 2.2, where the arrow shows how the number of people receiving benefits rises, and hence the cost, with benefits tapering away at a lower rate.

Figure 2.2: Benefit trade-off



[35] Richard Blundell, *Welfare-to-Work: Which Policies and Why?,* Proceedings of the British Academy, vol 117, 2002, p.477

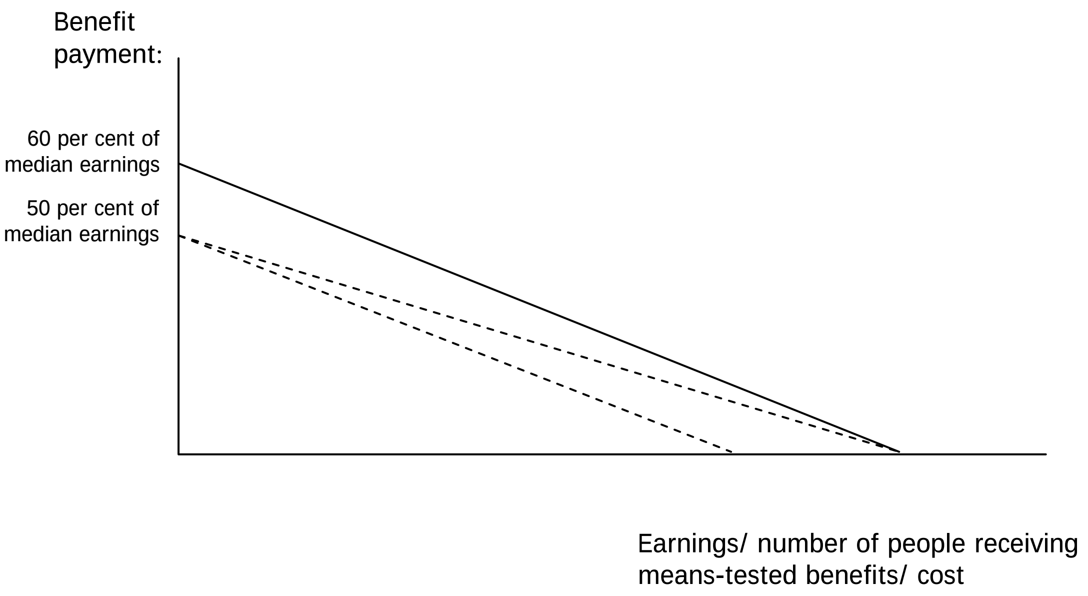
To achieve a better and cheaper benefits system, it will be necessary to relax these two constraints that have hitherto blocked any attempt at fundamental reform. Dropping one or both of these two constraints would mean effectively reducing the poverty target from 60 per cent of median income. It would therefore mean that certain groups of people would initially be made worse off through receiving less in state benefits than before.

It would, however, have three very positive effects:

- Firstly, the trade-off described above would be eased. Reducing the initial benefit award would either allow the taper rate to be reduced without increasing the number of people receiving means-tested benefits, or allow the taper rate to be held constant, so reducing the number of people receiving means-tested benefits. It would also allow any combination of the two, as shown in Figure 2.3. Indeed, as will be shown in the following chapters, it is possible to investigate the effects of various combinations of poverty targets and taper rates.
- Secondly, although it would make some people worse off initially, such a simple system would greatly increase take-up and so reduce the incidence of severe poverty (40 per cent of median income or less). It is surely far better to have a lower poverty target with nobody below it than a higher target with many hundreds of thousands of families slipping through the net.
- Thirdly, people would have a far greater incentive to work and to progress in work. Although a number of people would be worse off in a static sense, the dynamic effects would be likely to improve their prospects over time, as work becomes more attractive.[36] This can never be certain, and there would indeed be greater financial hardship for some, but over the last 60 years a more generous benefits regime has entrenched poverty and dependency and so has not benefited the poor in a dynamic sense. Reversing dependency requires tough choices to be made.

[36] Numerous studies have shown that work is a far more effective route out of poverty than an increase in cash benefits. See, for example, Centre for Social Justice, *Dynamic Benefits: Towards welfare that works,* September 2009

Figure 2.3: Eased benefit trade-off with constraints dropped



There are, however, serious objections to using a measure of relative, rather than absolute, poverty as a standard to evaluate a benefits system. As a concept, relative poverty suffers from major flaws. Assuming that benefit levels remain constant, relative poverty would tend to increase in a period of strong economic growth, as real median income rose, and fall in a period of recession, as real median income fell. This would imply that less economic growth would reduce poverty, which is clearly not the case.

It would be far better to devise an appropriate measure of absolute poverty and ensure that no household fell below it, rather than continue to rely on relative poverty measures. In the UK, there is not yet an agreed definition of absolute poverty, and how such a measure would be increased year-on-year, but absolute poverty is used as a measure in the US.

Appendix C provides an alternative, costed reform proposal based on the US standard of absolute poverty. More work should be carried out to establish an absolute standard for poverty suited to the circumstances in the UK.

The following chapters of this report will show how it is possible to design a better and cheaper benefits system, by replacing many of the current benefits paid to people of working age with a single benefit / negative income tax, tapered away such that people would face a constant marginal tax and benefit withdrawal rate well below the current rate of 70 per cent faced by so many households.

Before moving on to detailed proposals for an income taper though, another aspect to controlling costs whilst maintaining incentives is to think about how withdrawal rates, and benefit eligibility, vary over time. Proposals to do so have not been costed and developed for this report in the way income tapers have, but they should be considered as a part of thorough benefit reform. There are three elements to consider.

1. Taper rate changing over time

At the point that a benefit claimant considers the possibility of taking some paid work, the incentive that results from their expected net increase in earnings is a key short-term factor. The trade-off analysis shows the tricky issue:

- A lower taper rate means more retained additional income and a strong incentive. But if this lower taper rate were to remain, then the cost to taxpayers would be high, and welfare expenditure would be poorly targeted.
- A higher taper rate, whilst cheaper for taxpayers in the short-term, would mean a reduced incentive and more long-term welfare dependency.

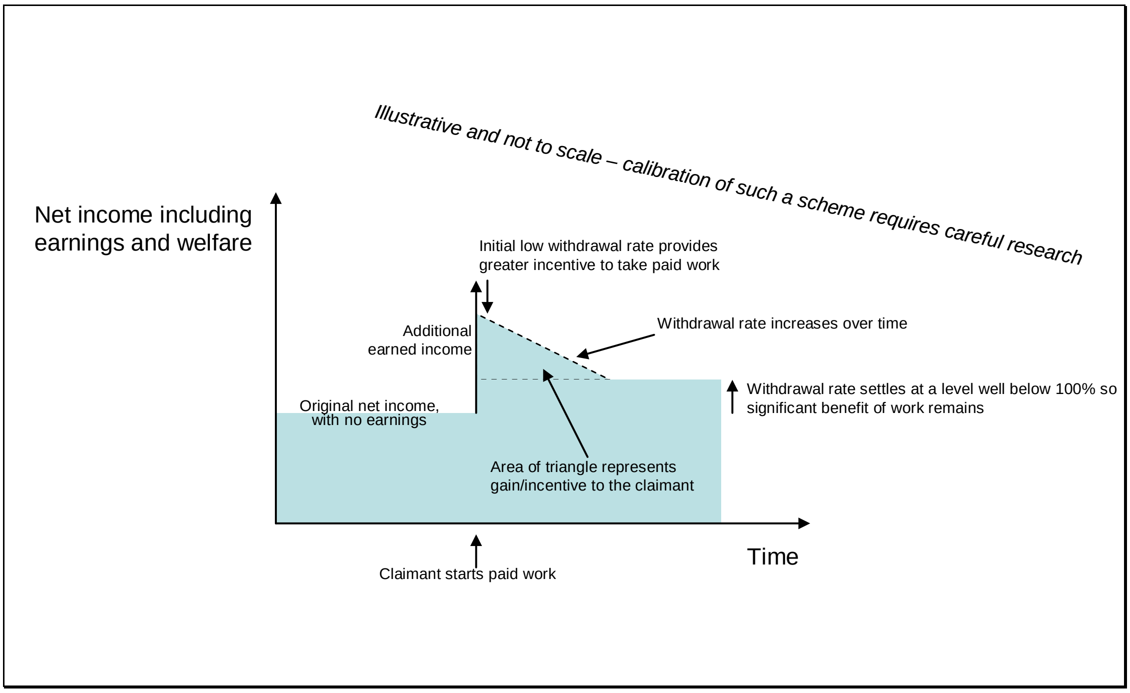
As well as using the lever of changing the poverty threshold, a further conceptual solution to this, which we have not modelled in detail, is illustrated below: taper rates based on time as well as earnings.

The concept is to vary taper rates over time, in the weeks after a claimant starts (or increases) their paid work. The parameters are as follows:

- "Initial taper" rate is the amount of additional earned income that is lost in the first week of paid work;
- "n" is the number of weeks over which the taper rate changes;
- "Eventual taper rate" is the amount of earned income that is lost each week from week n onwards.

If the initial taper rate is low, then the incentive to take work is higher, encouraging more claimants to enter the workforce. The length of taper, n, should be calibrated to be long enough to maintain the incentive and for the claimant to form the habit of work. The eventual taper rate should be calibrated based on affordability and fairness. Figure 2.4 illustrates this concept.

Figure 2.4: Taper rate changing over time



If these parameters are calibrated carefully, there are many combinations that can both sharply increase the incentive to take up paid work at the same time as being cost-neutral or beneficial to the taxpayer versus a fixed taper rate even before the benefits of changed behaviours are assessed.

For illustration, the initial taper rate could be 25 per cent (i.e., the claimant would retain 75 per cent of their additional earnings in the first week), and the eventual taper rate could be 65 per cent, changing over eight weeks. Compared to a flat taper rate of 60 per cent, this scheme would break even after the claimant had maintained this level of earnings for 36 weeks.

If the sharply increased incentives act to help more claimants into consistent paid work, then the effect of this scheme could be very positive for taxpayers and the economy as a whole.

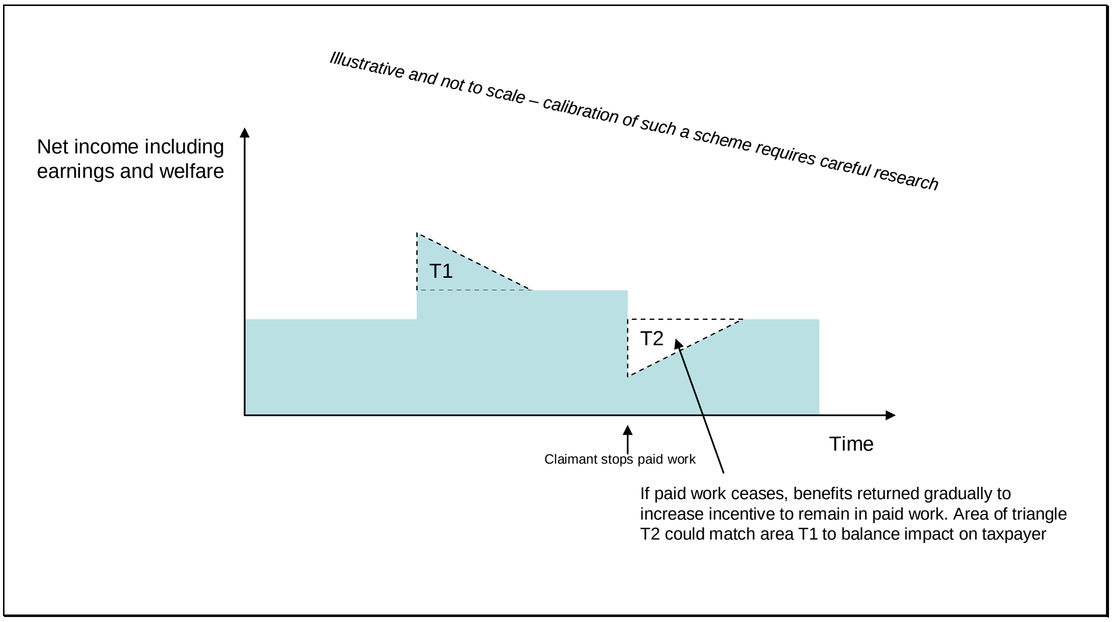
To recap, if a claimant can foresee keeping 75 per cent of incremental earnings initially, that represents a very strong incentive. The overall impact on taxpayers' funds can be held neutral by varying the eventual taper rate, even before considering the potentially very large benefits from responses to the sharply improved incentives.

This introduces new parameters into the system. But given the enormous complexity of the current tax and benefit system, and the massive simplifications we are proposing elsewhere in this paper, this should not be seen as a barrier.

2. Changing benefit eligibility rate over time

Similarly, at the point that a claimant who is in some paid work considers stopping work, for instance if one placement or contract ends and they are considering whether to start another one immediately, the tax and benefit system needs to provide the right incentive. A phased increase in benefit would be better than the current total delay of benefit payment due to slow administrative processes. It would also provide some saving to the taxpayer. Figure 2.5 shows how such a phased eligibility could balance the impact of taper rates changing over time. If the size of T1 and T2 were the same, then the overall impact on taxpayers would be neutral. But crucially, the claimant has a sharply higher incentive to take up paid work and also to retain it.

Figure 2.5: Changing benefit eligibility rate over time



The effect of this system is that, for instance, a claimant facing the prospect of a short-term contract faces an increased incentive to take it (due to the upfront cash flow) but the total impact on taxpayers of the same behaviour is unchanged versus a flat taper rate. Again, the improved incentive could lead to significant positive impacts for the economy.

3. Time-limiting part of out-of-work benefits

A third element to consider is whether there should be any time limits to certain benefits, or a portion of certain benefits.

This option may seem like a major departure from current policy, but contribution-based JSA is only payable for 6 months, so the principle has not been entirely lost in the UK welfare system. However, once contribution-based JSA ends, income-based JSA – paid at exactly the same rate – is paid to those whose savings are less than a certain threshold. In practice, therefore, JSA is only time-limited to those with at least a certain level of savings.

In the US, reforms pioneered in Wisconsin, including the time-limiting of certain benefits and an obligation for most people to work in return for benefits, were adopted to a great extent at the federal level in 1997. One of the key changes relevant to this discussion was the replacement of the "Aid to Families with Dependent Children" benefit with the "Temporary Assistance for Needy Families" benefit. The new TANF benefit is payable for a maximum of five years, with certain US states enforcing shorter limits, and there is an obligation for non-exempt recipients to attempt to find work. These reforms led to a huge fall in the number of out-of-work benefit recipients.

Introducing such changes in the UK would be controversial to say the least, but they should be considered in the policy discussion, and, as we recommend in Chapter 4, there should certainly be a much greater degree of conditionality in the benefits system than at present.

Objectives and design considerations for a new system

The following five objectives would, if achieved, transform the benefits system from its current condition:

1. The state should provide a basic minimum to all citizens of working age, and through them, to all children, at an affordable cost to taxpayers

2. Work should not be discouraged by excessive benefit taper rates

3. There should not be too many people on middle or higher incomes unnecessarily receiving means-tested benefits

4. The welfare system should be comprehensible for people to understand and to navigate

5. The welfare system should be responsive to changes in people's circumstances without a high level of fraud and error

Currently none of these objectives are met:

- Given the low take-up rates of many means-tested benefits, and given the increasing number of households in severe poverty, it is clear that the state *does not* provide a basic minimum to all citizens of working age. Nor is the welfare state cheap.
- Work is discouraged by marginal tax and benefit withdrawal rates of, in some instances, close to 100 per cent.
- Households earning £50,000 are still entitled to the Family Element of the Child Tax Credit and Child Benefit, although they do not need it.
- Given that the handbooks for benefit professionals run to thousands of pages, it cannot be said that the welfare system is comprehensible to ordinary people.
- £4.5 billion per annum of benefit fraud and error is a considerable sum.

There are a number of ways to implement the above objectives. The following design considerations apply:

1. The level of the initial benefit / negative income tax award

- As discussed in Chapter 2, the choice of poverty target would determine the level of the initial benefit / negative income tax award.

2. Households and individuals

- It would be possible to give each working age adult an identical initial award, which would greatly reduce bureaucracy, since benefit / negative income tax payments could be perfectly aligned with the individual income tax and NIC system. However, it would also have serious distributional consequences, with lone parents losing out substantially and childless people gaining.
- Alternatively, the initial award could be based on household type, with the award based on the number of working-age adults and the number of children and shared equally between all working-age adults in the household. This would reduce the distributional consequences and eliminate the couple penalty, but mean that the actual award paid to each individual would depend on household, rather than individual, income. This would increase bureaucracy, although administration headaches would still be greatly reduced relative to the current system.

3. The administration of the benefit / negative income tax

- This is an important consideration. When people are in work, there would be some scope for integration with the payroll system, although it would be necessary to use outside providers to collate data from employers of different members of a household and to make payments, or issue instructions to adjust PAYE codes. Given the need for these outside providers, they could cater not just for employees, but for households in which all were unemployed or self-employed. We set out full details of our proposal in Appendix A.
- The outside providers could be public, private or voluntary organisations. They could be paid to put people in lasting jobs, and so would have an incentive to work with entire households to encourage the adults to find employment. Suggestions for incentives are also set out in Appendix A.
- It would also mean that if claimants didn't engage with the "back-to-work" providers, they would get less money. As noted in Chapter 1, there has already been a move towards making greater use of outside providers paid by results and increasing conditionality – welcome developments which would mean that much of the infrastructure to administer this proposal would already be in place.

4. Work requirements

- It would be possible to pay the initial award to all workless households without any conditions. This would ensure that no household falls below the poverty threshold, but may discourage work effort.
- Alternatively, a percentage of the initial award could be withheld if no work or job search effort was made, although this would mean accepting that some children would fall into poverty as a result.

5. A pure negative income tax?

- Paying the award in the form of a pure negative income tax would mean that households did not pay income tax or employee national insurance contributions until the entire award was tapered away. It would therefore reduce to zero the number of people paying tax and receiving benefits at the same time. However, it has proved impossible to design an affordable system along those lines.
- Alternatively, the payment could run alongside tax and NICs, meaning that people would still pay tax and receive benefits at the same time, which would reduce the cost. In this context increasing the tax-free personal allowance, as the new Government is proposing, would allow the benefit / negative income tax to be tapered away faster, and so would reduce the number of people both paying tax and receiving benefits. It would also increase the proportion of a household's net income coming from earnings, and decrease the proportion coming from benefits, which would increase financial independence for low-income households. The higher personal allowance would also represent a tax cut for everyone else.
- A single benefit / negative income tax that replaced most existing benefits would improve the interaction of the benefits system with the tax system, by reducing the number of circumstances that would affect the amount of benefit to be paid out. Overlap would still occur, but would be more straightforward.

6. Disabled people, carers and maternity

- People with disabilities could still receive the universal Disability Living Allowance, as well as other benefits such as the Severe Disablement Allowance, while carers could continue to receive Carer's Allowance. It is also reasonable to keep such benefits as Statutory Maternity Pay. The negative income tax payment need not replace every single benefit, but should replace most benefits.

7. Assets and saving

- It may seem wrong to pay out money to people of working age who choose not to work but who have valuable assets from which they are not currently earning income (income from savings and investments would be included in household income for the purposes of calculating the benefit / negative income tax award). On the other hand, an asset test set too low would likely discourage saving.
- Currently, entitlement to a number of benefits, such as Housing Benefit, is prevented if the claimant has savings of £16,000 or more. This certainly seems too low.

8. Housing Benefit

- Housing Benefit is still most often paid directly by the local authority to the landlord. For landlords, this clearly makes offering rental properties to low-income households less risky. But at the same time, the welfare system is effectively saying to low-income households that they are not trusted to manage their money. Surely this entrenches dependency still further.
- The benefit / negative income tax could therefore include Housing Benefit, and be targeted on incomes using the "Before Housing Costs" (BHC) measure. Having said that, there would need to be some regional variation, to take account of different rental costs in various parts of the country.

9. Passported benefits and in-work credits

- Low-income households are eligible for a range of "passported benefits", such as free school meals and subsidised travel to hospital. Some lone parents are now eligible for a £40-a-week Return to Work Credit for the first year of employment.
- These benefits could be administered by the public, private or voluntary back-to-work providers, who would be paid to find people lasting jobs and would have discretion over making these sorts of payments to individual households. Providers on the ground are likely to make far better decisions about individuals than one-size-fits-all rules imposed by Whitehall.
- Such a move would also acknowledge that added incentives to people to keep a job help to give confidence about the transition back to work and financial independence, which should be recognised as a process rather than an event. In other words, a claimant loses some of the benefit / negative income tax when he or she starts earning, but in the early months this benefit / negative income tax loss could be eased by discretionary extra payments, giving a substantial early boost to household income from working.

10. Responsiveness of the system

- One issue that receives less attention than it should is the delays that can sometimes occur in receiving benefits, which are likely to put people off temporary, seasonal or unreliable work. If people risk destitution if they take on work that doesn't last and then leave work again – if the benefits take time to kick back in – they may consider it safer not to enter work at all.
- A new system must be designed to be responsive more quickly to changes in circumstances.

A Reform Proposal

This chapter sets out a radical, costed plan for a better benefits system that would save money in the short-term as well as the longer-term. Immediate fiscal constraints should not delay necessary reform.

4.1 Financial proposal

1. Each working-age household would be entitled to a certain percentage of the median income, net of tax and social security benefits (we have calculated the cost for 50 per cent, 55 per cent and 60 per cent), which is the *first policy parameter*. This would replace most working-age benefits and tax credits, except for the ones listed in the following section.

2. This figure would then be adjusted for the size and composition of the household, with larger households receiving more and the smallest households receiving less. In other words, each household would be entitled to 50, 55 or 60 per cent of the median *equivalised* income net of tax and social security benefits.

3. If the household had no income from employment, self-employment or investment, then the household would be paid the full entitlement as a negative income tax (NIT).

4. For households with income, the NIT would be tapered away at a certain percentage, which is the *second policy parameter* (we have calculated the cost for 50 per cent, 55 per cent, 60 per cent and 70 per cent). Note that this overall taper rate would be a maximum taper rate, and for each band of income, the marginal income tax and national insurance rate would be deducted. For example, if an individual had earnings of £10,000, he or she would face a taper rate on the next £1 of earnings of, for example, 55 per cent, comprising 20 per cent income tax, 11 per cent national insurance and 24 per cent NIT withdrawal. If an individual had earnings of £4,500, he or she would face a taper rate on the next £1 of earnings of, for example, 55 per cent, comprised of 0 per cent income tax, 0 per cent national insurance and 55 per cent NIT withdrawal.

5. Households where no-one was undertaking work-related activity, or where individuals were refusing reasonable job offers, would face reductions in the amount of NIT they received. Conditionality would therefore be built into the system.

6. The level of the NIT would be unaffected by holding assets from which income was not earned. Investment and savings income would be treated in the same way as earned income, and would therefore affect the amount of NIT paid out.

4.2 Financial costs

In tight fiscal times, it is clearly essential that any proposal for reforming the benefits system can be delivered within the current spending total. Our proposal achieves that, and can also be straightforwardly flexed to deliver outright savings.

All our calculations are based on financial year 2007-08 (including the income tax and NIC rates and thresholds that were in place in that year), the most recent year for which the necessary data are available.

We start from the spending on existing social security benefits. Since our NIT proposal excludes pensioners, we take account only of benefits paid to those of working age, including the support for their children. We also exclude from our proposal existing benefits paid to those who are of working age but whose physical condition or other extreme circumstances makes it difficult or impossible for them to support themselves. In Great Britain, these benefits comprise: [37]

- Widows'/bereavement benefits
- Maternity Pay and allowances
- Statutory Sick Pay
- Industrial disablement and death benefits
- Disability Living Allowance
- Carer's Allowance
- Severe Disablement Allowance
- Specialised Vehicles Fund
- War Pensions
- Statutory Paternity and Adoption Pay

We assume that all these benefits would continue to be paid alongside our proposed NIT. We do not aim to penalise disabled people.

Note that we would replace universal benefits, such as Child Benefit, and the contribution-based elements of other benefits, such as contribution-based JSA and ESA, by the NIT. In relation to the contribution-based benefits, it would simply reflect the reality that, with respect to working-age benefits, there is no longer any gain from making NIC contributions, since the means-tested benefits available to those who have made no NIC contributions are just as generous. Universal benefits (except for those listed above) would also be replaced, as higher-income households do not need state benefits.

We also take account of what should be significant administration savings at DWP, reflecting the fact that our proposed system would be much simpler and cheaper to operate than the current arrangements. We have assumed that half the administration costs for working age benefits (excluding disability benefits) would be saved.

On this basis, we calculate that the cost of the existing benefits our proposed system would replace totalled £63.7 billion in 2007-08. That is a UK figure, and full details of our calculation are set out in Appendix B.

To cost our proposal we have constructed a model using survey data on household incomes from the Office for National Statistics. Full details are set out in Appendix B, along with the key results. We would urge officials at the DWP to examine our model and to perform and publish their own, inevitably more detailed, calculations.

The model works by comparing each household's own original income, net of income tax and national insurance and *excluding* existing social security benefits, with the income it would be entitled to under our proposed scheme. If the household was getting less than its entitlement, the difference would be at a minimum, made up with an NIT payment.[38]

A household's entitlement would depend on its size and composition, with larger households having higher entitlements. How much higher is calculated using the ONS's published equivalence scales for each of the 30 household types recorded in the survey data. We use the McClements Equivalence Scale (Before Housing Costs), which is the ONS's own preferred measure in its published work on benefits and income distribution.[39]

All entitlements are set relative to a poverty line income, below which no household should fall. The poverty line income itself would be determined by policy, expressed as a percentage of median net income (which in our model is the median equivalised net income excluding social security benefits). We have calculated results for a 60 per cent poverty line, which is the current official definition, and alternative 50 per cent, which used to be the definition, and 55 per cent lines. But our model allows us to rework the calculations for any other line selected.

---

[37] A similar list has been excluded for Northern Ireland, detailed in the Appendix.
[38] For households with earnings above zero, the difference is more than made up, since the NIT tapers away at less than 100 per cent.
[39] For example, see Office for National Statistics, *The effects of taxes and benefits on household income, 2007/08*, 2009

It is worth noting that our definition of the median comprises the median equivalised net income excluding social security benefits. It therefore measures the median of what households would receive net of tax from their own sources – that is, their own earnings, self-employment income, and investment income. It should be noted that this differs from the definition of the median used in most government poverty analysis, which includes social security benefits. We believe it is circular and seriously misleading to target poverty relief on a benchmark that is itself inflated by the inclusion of existing government income support.

Under our proposal, households would only qualify for the maximum possible entitlement if they have no original income of their own. For households with their own income, entitlement would be tapered as their income increases. The overall taper rate (income tax, national insurance and NIT withdrawal) would be policy determined, and we have calculated results for 70 per cent, 60 per cent, 55 per cent and 50 per cent tapers. Again, our model allows us to rework the calculations for any other rate selected.

In summary, our model produces the following cost comparison for the combinations of poverty line and taper rates selected (figures are £ billion for financial year 2007-08):

Table 4.1: Cost of the NIT system under various poverty thresholds and taper rates, 2007-08, £ billion

	50% poverty line	55% poverty line	60% poverty line
50% taper	£72.3	£87.6	£104.1
55% taper	£62.0	£74.9	£89.2
60% taper	£54.7	£65.8	£78.1
70% taper	£45.2	£54.0	£63.6

As noted above, the cost of the existing system in 2007-08 was £63.7 billion, which effectively means we can discard seven of our 12 modelled combinations as unaffordable.

Of the remainder, we can see that with a 60 per cent poverty line, we can't afford a taper rate much below 70 per cent. That's certainly an improvement on some of the current effective marginal tax rates for the low paid discussed in the paper. But by any standards, a marginal rate of 70 per cent is still a serious disincentive to work.

However, dropping the poverty line to 50 per cent of median income allows us to afford a much lower taper rate, at 55 per cent. And a marginal tax rate of 55 per cent, while still higher than anyone would like, would be a huge improvement on the current system.

It must also be noted that our costings assume 100 per cent take-up of the reformed system, and while universal take-up should be encouraged, it is likely that even with the best efforts, a small proportion would not apply for what they are entitled to. In addition, we have not assumed that there is any asset test. While income from savings and investments should be counted as income for the purposes of determining the amount of NIT to pay out, policymakers may also wish to set some eligibility limit on the value of non-income bearing assets. We would hope that such a limit would be set high enough not to deter saving. In both these instances, therefore, our costings are likely to be on the cautious side.

Appendix A – Administration

In this appendix, we set out a proposal for the administration of the system. It is not by any means the only possible proposal. But we can only be confident that we have a workable system if we can come up with at least one highly specific proposal for administration. That is what we do here.

A.1 The system in broad terms

Along the lines of the previous Government's plans to open the provision of welfare and employment support to competition,[40] which are supported by the new Government, voluntary or private sector "back-to-work" providers would manage household caseloads, and would be paid to find lasting employment for members of each household.

Households where no-one was undertaking work-related activity, or where individuals were refusing reasonable job offers, would face reductions in the amount of negative income tax they receive. The rules would be set centrally, but the providers would be responsible for determining whether they were being followed in individual cases. It goes without saying that the provider would not be able to keep any of the withheld negative income tax; indeed, it may be sensible for them to face a small sanction if they fail to keep people engaged with the system.

The negative income tax award would be based on household circumstances, but the award would be shared out equally between all working-age adults in the household, thus ensuring that no one person has undue financial power.

A.2 Employers and employees

In order to avoid new administrative burdens on employers, and particularly in order to avoid a repeat of the unfortunate experience of the payment of tax credits via employers, we want to allow employers to have regard only to the amounts which they pay to individuals, so that they do not have to bother with other income of their employees or with their employees' family circumstances. It is particularly important that employers should not see recipients of negative income tax as undesirable employees on account of additional administrative burdens. So there must be only minimal changes to the PAYE system, and it must remain an automatic process.

---

40 Department for Work and Pensions Green Paper, *No one written off: reforming welfare to reward responsibility,* July 2008, Chapter 7

PAYE would continue as it does now, except that if an employee was notified as one who was in a household which received negative income tax, then a file giving all of the details on each payslip would, on or before payday, be sent to a designated computer run by the back-to-work provider. Non-computerised payrolls are fast becoming computerised anyway, as electronic filing with HMRC becomes compulsory. It would be straightforward to add a field for the destination of each payslip record and to put into a standard format any payslip records which were not already in such a format.

The destination field (the identity of the back-to-work provider) would be notified automatically by HMRC in response to the submission of the P45 or P46 by the new employer. It would however be necessary to give two or three years' notice of the precise specification to software providers, and not to change the specification because Ministers decided that they wanted to tweak the system. That is, it is essential to decide all of the rules for the system of negative income tax before designing the administrative system.

The provider would collect all such records from all members of a household which received negative income tax (including records generated by different jobs held by the same person). On the basis of those records, it would work out the amount due and pay it to designated bank accounts or to accounts linked to prepaid debit cards. The amount due would be shared out equally between all the adults in the household.

The cycle of payment would probably be the longest pay cycle of any member of the household (so if one member was paid weekly and another monthly, payments would be made monthly). Payments would be made a few days after the last payday to be taken into account for a given week or month. Payments would be made for tax weeks or tax months, following the calendar for PAYE.

The provider would also collect information on investment income and anything else which affected entitlement, and would recover over-payments by deduction from later payments. There would be an obligation on households to notify such income or other information, with penalties for failure to notify.

A.3 The self-employed

The self-employed would be paid monthly, based on their profits for the last year, or an estimate of their profits for those in their first year of self-employment, and an estimate of tax on those profits. In order to receive the negative income tax, the self-employed would need to submit profit details faster than the present Self-Assessment deadlines. They should be required to submit monthly summary accounts, which would give revenue, expenses and profit. The providers of off-the-shelf accounts packages could build in the facility for automatic online submission, so long as they were given reasonable notice, just as the providers of payroll software could incorporate the facility for the transmission of payslip details to back-to-work providers. Once actual profits were reported, under-payments or over-payments of negative income tax in the year of those profits would be taken into account by adjusting payments for a later year.

A.4 The computation of negative income tax

In order to specify an administrative system in sufficient detail to ensure that it would work, we need to identify the parameters that might enter into the computation of negative income tax, as follows:

- G = the total gross income of the household for a given tax year. Income would be treated as being for a given tax year if it is attributable to that year under tax law. Income is generally attributed to the year in which it is paid. This applies to most employment income and most investment income. This fact has the advantage of making the system easy to comprehend. It also avoids the need for employers to supply extra information beyond what is already given on payslips, for example information about the period during which work corresponding to a given payment was done.
- T = the total tax and national insurance due from the household for that tax year. Interest on tax paid late and penalties would not count as tax, because counting them as tax would mean that they would be subsidised, blunting their effectiveness as deterrents.
- N = the negative income tax due to a household for that tax year. This would not itself be taxable income.
- M = the minimum income for a household of that type (e.g. single person, or two parents and two children) for that tax year
- r = the taper rate (e.g. 0.55 if we have a 55 per cent taper rate)

There is a complication in relation to the attribution of tax to years. Tax due for a year is often collected in a later year by adjusting the PAYE code ("coding out"). That tax should be attributed to the later year in the interests of simplicity. Some would gain and some would lose by this, the losers being those who had moved out of entitlement to negative income tax by the later year and the gainers being those who were not in it in the earlier year but who moved into it by the later year.

However, the gains and losses should be a reasonable price to pay for administrative simplicity, and would not even be obviously unfair if one sees the point of the system as being to provide for needs in a given year, rather than as being to give out an appropriate amount over a lifetime. Furthermore, anyone with a reasonable expectation that they might lose out from this effect could opt out of coding out, and pay any tax due by a separate transaction instead. That tax could then be attributed to the year for which it was paid, and an adjustment could be made to the negative income tax for that year.

N would be some function of G, T, M and r. The function could be structured in different ways, depending on whether one saw the taper rate as a rate to be applied to growth in gross income or to growth in income after tax and national insurance. Taking the former option, one could have the following function:

- N cannot be negative. (There may be a payment from the household to the provider, but only to recover over-payments.) Subject to that:
- If rG – T < 0, then N = M
- If rG – T >= 0, then N = M – rG + T

(It might seem unlikely that rG – T would be less than zero: that would imply a tax rate which was higher than the taper rate. We do however recommend legislating for the possibility. If for example a tax relief were given in one year and clawed back in a later year, it might be appropriate to regard the clawback as tax for the later year rather than re-opening the earlier year.

It would however be important to guard against abuse, with people deliberately obtaining, for example, Enterprise Investment Scheme relief in year 1, extracting funds and thereby triggering a clawback in year 3 and then claiming negative income tax in year 3 in order to fund the clawback.)

The amount of N due would be computed at the start of the year based on estimates, and continually re-computed as information on actual pay and tax came in. The payment for tax month n would be:

- (current estimated N for the year – amounts already paid)/(13 – n)

For weekly payment, the denominator would be (53 – n). There would not be any week 53 payments as such, but if a household was likely to have a week 53 payment of wages, it could opt to use a denominator of (54 – n) and receive an extra payment on the last day of the tax year.

For payments starting within a year, the 13, 53 or 54 would be reduced to reflect the part of the year already elapsed. If, however, income rose in the course of a year to the point where the expected N fell to zero, the formula would run its course to the end of the year, generating payments back by the household to recoup the N already paid.

If a household's composition changed during a year, that would be treated as the termination of one household and the start of another (or others). The entitlement of any household would be:

- (N for that type of household x time during the tax year for which it existed)/one year

Underpayments and overpayments could arise both because of household change, and because of tax payable by separate transactions (though not by coding out – see above) after the year-end. It would theoretically be fairest to attribute such underpayments and overpayments to all members of the relevant households equally, but that would impose a large administrative burden when the household had broken up or was no longer receiving negative income tax, so that it was not possible simply to adjust current year payments of negative income tax.

We therefore propose that where there is a free-standing tax payment or refund for anyone who has been a member of a household which has received negative income tax in the year to which the payment or refund relates, the underpayment or overpayment of negative income tax may be set against the payment or refund of tax, up to the full amount of the payment or refund of tax. Only the residue of the underpayment or overpayment of negative income tax would then need to be dealt with by other means.

There might of course be several people whose tax payments or refunds could be adjusted in this way. The authorities could be required to make equal adjustments to all of the possible assessments or refunds: proportionate adjustments would mean waiting until all returns were in, and going beyond those who were filing returns would involve going to people who were harder to trace and to involve in the administrative system.

Providers might be given a power to instruct employers to change PAYE codes, in order to deliver some of the negative income tax through the pay packet. A formula like $N = M - rG + T$ would still give the amount to be paid by the provider, because changing PAYE codes for one or more members of a household would change T. This would however adversely affect employers' cash-flow, because the more tax they deduct from employees' pay, the more money they have in their own accounts until the 19th of the tax month following the tax month in which a payday falls.

We need to consider the position of benefits in kind provided by employers. Ideally, they should be treated as income and recipients should be compensated for the tax that they suffered on the benefits. There is currently a move towards the payrolling of benefits. Under this system – which is already used by some employers by agreement with HMRC – the value of benefits features as an item of pay. To the extent that this is done, the system described here would automatically produce the correct result for benefits in kind. But it is not clear how quickly this system will become the standard.

To the extent that it does not, a rough and ready alternative would be for the detailed computation of the employee's PAYE code to be given to the back-to-work provider. This would show an amount for the estimated value of benefits in kind. The back-to-work provider could then treat this amount as extra income, and the consequent tax burden on the employee would be taken into account automatically as part of the tax actually paid each month.

When tax had to be paid after the year-end, there could be a rule that it would only lead to an adjustment to the negative income tax if the corresponding benefits in kind were also taken into account as income. This would, unfortunately, involve some manual processing, so the widespread introduction of payrolling of benefits would be preferable.

It would also be necessary to accept that benefits in kind on which the employer bore the tax, through a PAYE settlement agreement, would slip through the net. Employees would receive those benefits in kind without their negative income tax being reduced. On the other hand, such benefits are generally minor or occasional, and the negative income tax would not be adjusted to take account of the tax on the benefits because it would be borne by the employer, not the employee.

Passported benefits and extra discretionary payments to people starting work would be administered by the back-to-work providers. Eligibility rules would be set centrally, while funding would also be provided centrally. The discretionary payments to ease cash-flow problems and provide encouragement for people starting work would be administered and paid out-of-pocket by the providers.

Given the fee structure detailed below, providers would have every incentive to ensure that people made a full transition into work. They might also offer bonuses to people who had remained in a job for a certain period of time. The key point, though, is that these types of payments would be at the provider's discretion. Providers, who know far more about an individual household's circumstances than a Whitehall department could ever hope to, would be free to devise any system of extra discretionary payments that they wished.

A.5 Incentives for providers

It would be important to give the providers an incentive to get people into work, and then into better-paid work, in order to reduce the total that had to be paid out in negative income tax. At the same time, we must not make their entire revenue depend on this, or they would go bust in a downturn.

For each household that a provider takes on, it could be paid a set-up fee and a recurring fee, related to the size of the household but not related to the amounts of money involved.

There could then be an incentive for each time period (possibly a month or possibly a year) which would be:

- some small percentage x (amount of negative income tax for that household per time period at the point when the household entered the system – amount for that household in the current time period)

Rules on incentives would be needed for changes in household composition, for example on the birth of a child or on separation (the effect on amounts payable to households is covered above). The obvious option would be to treat such an event as the formation of a new household, with a new set-up fee, and to set the clock back to zero for the purposes of incentives geared to the reduction of negative income tax.

That is, the provider would benefit from a new set-up fee which would more than cover the costs of set-up, given that the claimants were already known to the provider, but would cease to receive an ongoing regular reward reflecting reductions in negative income tax achieved from when the household first joined the system to date.

Appendix B – The cost of the proposed reform

B.1 Cost of existing system

Total expenditure on UK social security and tax credits in our benchmark year of 2007-08 was £160.5 billion.

We also take account of what should be significant administration savings at DWP, reflecting the fact that our proposed system would be much simpler and cheaper to operate than the current arrangements. We have assumed that half the administration costs for working-age benefits (excluding disability benefits) would be saved. This brings the total cost of the current system in 2007-08 to £162.2 billion.

However, since our proposed NIT system applies only to households of working age, we need to exclude from that total spending on older people. We also exclude certain other specific benefits that would not be supplanted by NIT, such as Disability Living Allowance, Maternity Pay, and Carer's Allowance. These adjustments bring the total spend on existing benefits that would be replaced by our proposed NIT system to £63.7 billion in 2007-08. The detailed calculation is as follows:[41]

Table B.1: Costs of the present system that would be replaced by the NIT, 2007-08

	£ million
Social security benefits	138,700
Tax credits*	21,600
Independent Living Funds**	200
Plus 50 per cent of DWP administrative expenditure on working age (excluding disability)	1,673
Total UK social security and tax credit expenditure	**162,173**
Less	
Great Britain – pensioner benefits	
Total DWP benefit expenditure directed at people over working age	83,348
War Pensions	1,014

[41] HM Treasury, *Budget 2009,* Tables C6 and C9; DWP, *Benefit Expenditure Tables,* Table 5; DWP, *Departmental Report 2009,* Annex B, Table 5; MoD, *Annual Report and Accounts 2008-09,* Departmental Resource Accounts and Annexes, Statement of Net Operating Costs by Departmental Strategic Objectives, p.203; BERR, *Annual Report and Accounts 2008-09,* p.69; Northern Ireland Social Security Agency, *Annual Report and Accounts 2007-08,* Annex 3. NB: Figures for tax credits include income tax credits counted as negative tax by the Treasury; Independent Living Funds not counted in HM Treasury Social Security figure http://research.dwp.gov.uk/asd/asd4/explanatory_notes.asp

	£ million
Northern Ireland – pensioner benefits	
Non-contributory retirement pension	2
Christmas Bonus (pensioners)	1
Income Support for the elderly	5
Pension Credit	315
State retirement pension	1,375
Christmas Bonus	4
Widows' benefits	26
Winter fuel payments	52
Great Britain – other benefits	
Widows'/bereavement benefits	657
Maternity Pay and allowances	1,716
Statutory Sick Pay	48
Industrial disablement and death benefits	443
Disability Living Allowance	6,508
Carer's Allowance	1,236
Severe Disablement Allowance	698
Specialised Vehicles Fund	12
Statutory Paternity and Adoption Pay	43
Northern Ireland – other benefits	
Attendance Allowance	191
Carer's Allowance	87
Severe Disablement Allowance	41
Disability Living Allowance	646
Industrial injuries benefits	27
Maternity Allowance	7
Total to take out	***98,500***
Total UK social security and tax credit expenditure that would be replaced by NIT	**63,673**

* Figures for tax credits include income tax credits counted as negative tax by the Treasury
** Independent Living Funds not counted in HM Treasury social security figure
http://research.dwp.gov.uk/asd/asd4/explanatory_notes.asp

B.2 Cost of proposed reform

Our proposed reform is costed using a model based on household income data from the Office for National Statistics.

The model calculates the cost subject to the two key policy parameters described earlier in the paper. First, the poverty line target in relation to overall median income, and second, the overall taper rate (income tax, national insurance and NIT withdrawal) at which government income support is withdrawn as a household's own income increases.

For each individual household the model calculates the cost of bringing that household's income up to the policy-determined minimum level. The minimum depends on the household's size and composition, the target poverty line income below which no household of that type should fall, the household's own original income, and the rate at which original income net of income tax, national insurance, and NIT is tapered as it increases.

The ONS income data are available only on a calendar year basis, so in order to be comparable with the financial year cost of the existing system, we separately calculate the cost of our proposed scheme for each of the two most recent available calendar years (2007 and 2008), and take a weighted average of the two.

For calendar year 2008 we use the Living Costs and Food Survey (LFS),[42] and for calendar year 2007 the Expenditure and Food Survey (EFS).[43] They are essentially the same annual survey of around 6,000 households in the UK, but it was renamed by the ONS in 2008.

From the surveys we extract household level data on gross and net income, household composition, and McClements equivalence scores. Equivalisation is a standard methodology that adjusts the total annual income of a household to account for differing demands on resources, by considering the household size and composition. In broad terms, a larger household needs a higher income to enjoy an equivalent standard of living to a smaller household. We use the ONS's preferred equivalisation scale, which is the McClements (Before Housing Costs) scale.[44]

We first exclude all households designated in the survey as pensioner households, since our proposal is not applicable to them. For the remaining non-pensioner households, we then rebalance the survey samples to match the national pattern of households by composition. The ONS distinguishes 30 different composition types (one adult, two adults, two adults with one child, two adults with two children, etc), and our rebalancing incorporates that detail.

---

[42] Office for National Statistics, *Family Spending: A report on the 2008 Living Costs and Food Survey,* 2009, UK Data Archive [distributor]
[43] Office for National Statistics, *Family Spending: A report on the 2007 Expenditure and Food Survey*, 2008, UK Data Archive [distributor]
[44] For a detailed explanation, see Chapter 3 in Office for National Statistics, *Family Spending: A report on the 2008 Living Costs and Food Survey,* 2009

For each household in our rebalanced sample we then calculate its equivalised net income, *after* income tax and employee national insurance contributions, and *excluding* any social security benefits the household was receiving at the time of the survey. This is the household's own net income, and principally comprises its earnings from employment and self-employment, plus any investment income.

It is the median of those equivalised net incomes that is the benchmark against which we draw our poverty line: a benchmark that measures what the median equivalised net income would be in the absence of any social security benefits. We calculate the annualised medians as:

- 2007: £19,114
- 2008: £19,938

The poverty line income level is set as a policy determined percentage of the median – one of our two key policy parameters. For example, if we set the 2007 poverty line at 50 per cent of the median, the poverty line net equivalised income is £9,969.

This then allows us to calculate for each household in our sample the minimum net income it would be guaranteed under our proposed system. That minimum is simply the poverty line net income adjusted for each household's particular size and composition using its McClements equivalence score. So for example, with the poverty line net equivalised income at £9,969, a two adult, two child, household with a McClements equivalence score of 1.39 would get a guaranteed £13,857. This is the guaranteed minimum income it gets if it has no original income of its own coming in.

For households that do have original income of their own, our model imposes a policy-determined overall taper rate (income tax, national insurance and NIT withdrawal rate). The taper rate is the second of our policy parameters, and it governs the rate at which a household's guaranteed minimum net income is clawed back as its own original income increases. For example, with a 55 per cent taper rate, our household eligible for a guaranteed minimum of £13,857 would lose 55 pence out of every additional pound it earned for itself, up to the point at which the entire £13,857 of NIT had been clawed back.

For each household, the model calculates the difference between the household's own net income as recorded in the ONS survey, and the net income it would get under our proposal. The difference is that household's NIT entitlement.

The following table shows a few examples from the main household types identified in the survey (figures relate to 2008, with the Poverty Line set at 50 per cent and the taper rate set at 55 per cent – see Section 4; also note that McClements scores for families with identical numbers of children vary according to the precise age of those children).

Table B.2: Household examples under a new NIT system

Composition of Household	McClements equivalence score	Gross annual household income EXCLUDING SOC SEC	Net annual income EXCLUDING SOC SEC	NIT	Net income after NIT
1 adult	0.61	£0	£0	£6,081	£6,081
1 adult	0.61	£7,801	£6,241	£3,351	£9,591
1 adult, 1 child	0.84	£0	£0	£8,374	£8,374
1 adult, 1 child	0.82	£11,422	£10,085	£3,230	£13,315
1 adult, 1 child	0.82	£39,687	£27,086	£0	£27,086
2 adults, 1 child	1.18	£0	£0	£11,764	£11,764
2 adults, 1 child	1.09	£24,639	£19,805	£2,149	£21,954
2 adults, 1 child	1.09	£34,140	£26,662	£0	£26,662
2 adults, 2 children	1.39	£0	£0	£13,857	£13,857
2 adults, 2 children	1.39	£23,097	£17,940	£6,311	£24,251
2 adults, 2 children	1.39	£51,729	£40,577	£0	£40,577
2 adults, 3 children	1.48	£0	£0	£14,754	£14,754
2 adults, 3 children	1.48	£48,845	£36,844	£0	£36,844

The sum of all these NIT entitlements is the cost of our proposal applied to the sample. The final step is to gross up that figure in proportion to the number of non-retired households in the UK as a whole (19.3 million in 2007).

For each of our two calendar years 2007 and 2008, we have run the model to cost 12 possible policy combinations of poverty line and taper rate. We look at 50 per cent, 55 per cent and 60 per cent poverty lines (i.e. the poverty line drawn at 50 per cent, 55 per cent or 60 per cent of median equivalised net income), and 50 per cent, 55 per cent, 60 per cent, and 70 per cent taper rates. The summary results are as follows.

Table B.3: Cost of the NIT system under various poverty thresholds and taper rates, 2007, £ billion

	50% poverty line	55% poverty line	60% poverty line
50% taper	£71.6	£86.9	£103.3
55% taper	£61.2	£74.1	£88.3
60% taper	£53.9	£64.9	£77.1
70% taper	£44.4	£53.1	£62.7

Table B.4: Cost of the NIT system under various poverty thresholds and taper rates, 2008, £ billion

	50% poverty line	55% poverty line	60% poverty line
50% taper	£74.5	£89.8	£106.4
55% taper	£64.4	£77.5	£91.8
60% taper	£57.1	£68.4	£81.0
70% taper	£47.6	£56.6	£66.4

Weighting these two calendar year costs together (0.75 weight for 2007 and 0.25 weight for 2008) gives the following estimates for financial year 2007-08:

Table B.5: Cost of the NIT system under various poverty thresholds and taper rates, 2007-08, £ billion

	50% poverty line	55% poverty line	60% poverty line
50% taper	£72.3	£87.6	£104.1
55% taper	£62.0	£74.9	£89.2
60% taper	£54.7	£65.8	£78.1
70% taper	£45.2	£54.0	£63.6

It must also be noted that our costings assume 100 per cent take-up of the reformed system, and while universal take-up should be encouraged, it is likely that even with the best efforts, a small proportion would not apply for what they are entitled to. In addition, we have not assumed that there is any asset test.

While income from savings and investments should be counted as income for the purposes of determining the amount of NIT to pay out, policymakers may also wish to set some eligibility limit on the value of non-income bearing assets. We would hope that such a limit would be set high enough not to deter saving. In both these instances, therefore, our costings are likely to be on the cautious side.

We would urge officials at the DWP to examine our model and to perform their own, inevitably more detailed, calculations.

Appendix C – Absolute poverty

As discussed in the main paper, basing our NIT proposal on a poverty line defined in terms of relative income is not ideal. We would prefer to use a poverty line defined in absolute terms – that is, the income a household actually needs to provide for its essential support. Unfortunately there is no agreed definition of an absolute poverty line in the UK, and so in our main costings we have used a relative definition, mirroring the current official approach.

However, the US Census Bureau *has* developed detailed measures of absolute poverty. And based on those measures, it publishes annual updates of what it calls poverty thresholds, used to determine poverty status for the various types of US household.[45]

So they have shown it can be done. And to give some perspective on our own *relative* costings we have taken their *absolute* thresholds and run them through our model.

Specifically, we have taken the US Census Bureau's dollar poverty threshold for a household of two non-retired adults, converted it into a sterling equivalent using the OECD's Purchasing Power Parity (PPP) exchange rate,[46] and used that figure as our benchmark poverty line (replacing the percentage of median income used in our main costings). The benchmark figures are as follows:

- 2007: £9,230
- 2008: £9,617

For each different household type our model then calculates a minimum guaranteed income using the McClements equivalisation scores, applies our own policy-determined income taper rate, and generates any required NIT payment exactly as is done in the main costings. The only difference is the use of this US-based absolute poverty line in place of our median-based relative poverty line. The overall costings for our different taper rates are as follows:

Table C.1: Cost of the NIT system under US absolute poverty measure, 2007-08, £ billion

	US absolute poverty threshold
50% taper	£67.4
55% taper	£57.8
60% taper	£51.1
70% taper	£42.4

[45] http://www.census.gov/hhes/www/poverty/threshld.html
[46] http://www.oecd.org/document/47/0,3343,en_2649_34357_36202863_1_1_1_1,00.html

As can be seen, using the US estimate of the absolute poverty line is cheaper than all of our main costings. However, it is only just below the cost of our variant with the 50 per cent relative poverty line, which suggests that a 50 per cent line would be much closer to a realistic definition of absolute poverty than the current official 60 per cent line.

Of course, basing an estimate on US work can never be any more than a sighting shot. While the use of PPP for currency translation means we should be reflecting the differing costs of most major expenditure items, it is an overall average, and spending patterns among the poor are known to be very different to the average. Again, what is really required is more work on defining absolute poverty here in the UK – our own version of what the US Census Bureau has done for the US.

A further issue to consider with an absolute poverty threshold is how it changes over time. A relative poverty threshold changes automatically with changes to median income, but an absolute poverty threshold will need careful calculation each year. One option would be to increase it in line with RPI, or the Rossi index that is used to update benefits such as JSA and Income Support.

Alternatively, and preferably, an absolute poverty threshold could be increased each year in line with inflation for the goods that are consumed by those on low incomes. Expenditure data broken down by income decile does exist, and so it would be possible to construct a “low-income RPI” measure.

www.taxpayersalliance.com