What's the issue?

People on low incomes keep very little of the extra money they earn due to tax and, especially, the withdrawal of benefits. Most people receiving benefits are entitled to a wide range of payments which are withdrawn at a rate of between 73 and 91 per cent.[1] Universal credit is replacing most benefits, however, and the 'taper' is 63 per cent above a small work allowance. Subtract employee national insurance, which is payable on earnings above £157 a week, and the deductions amount to 67 per cent. Subtract, too, employer national insurance and deductions add up to 71 per cent. Finally, on income above £11,850, income tax is charged, bringing deductions up to 78 per cent (or 75 per cent if you ignore employer national insurance).

How does it hold down productivity?

Higher taxes reduce the time that households sell on labour markets. As a recent paper by the IZA Labour Market Insistute put it, "households decrease their market hours and devote more time to leisure and home production", adding that the effect is "especially large in the service sectors". The study finds that "higher taxes are associated with lower market hours" and that the link is more than doubled for low-skilled women.[2] But it's not just that people work fewer hours with higher taxes. Higher tax also reduces pay per hour.

Economists at the University of Uppsala found "a marked response in hourly wage rates" to changes in tax rates, adding "wage responsiveness to tax changes is just as important as hours of work responses, or perhaps even more so".[3]

Taxes hold down productivity via several mechanisms. By introducing a tax wedge between 'home production' and buying in services, tax reduces the extent that corporate organisation can carry out tasks more efficiently than households themselves. By reducing the number of hours that employees work, it reduces their ability to gain skills and on-the-job training. By reducing the incomes of employees, it impairs their ability to finance education and training. By reducing future expected incomes, it reduces employees' incentive to acquire education and training. By reducing the marginal income from extra output, taxes reduce the incentive for employees to take on additional responsibilities and promotions. While this might most obviously be found in formal additional responsibilities or promotions, it might also show up less formally in lower expectations of diligence in exchange for lower wage rates.

By penalising extra earnings beyond a threshold required to be eligible, in-work benefits operate much as taxes do on employees' decisions regarding additional work. So while policies like tax credits and universal credit encourage employment, their withdrawal with higher earnings acts as a barrier to earning more. This trade-off was addressed by Lord Flight in 2015, highlighting the similarities with a similar system abolished in the nineteenth century: "there was a substantial movement of labour out of

[1] Hood, A. & Keiller, AN. *IFS Briefing Note BN13: A survey of the UK benefit system*, Institute for Fiscal Studies, 2016, https://www.ifs.org.uk/bns/bn13.pdf#page=84, (accessed 17 April 2018).
[2] Duval-Hernandez, R., Fang, L. & Ngai LR. *Taxes and Market Hours: The Role of Gender and Skill,* IZA institute of Labor Economics, 2017, http://ftp.iza.org/dp11002.pdf, (accessed 17 April 2018).
[3] Blomquist, S. & Selin, H. *Hourly wage rate and taxable labor income responsiveness to changes in marginal tax rates,* Journal of Public Economics, 2010, http://faculty.smu.edu/millimet/classes/eco7321/papers/blomquist%20selin%202010.pdf, (accessed 17 April 2018).

agriculture into the new iron, coal and steel industries of the day, leading to the Industrial Revolution take-off over the following 20 years. This was accompanied by large increases in real pay."[4]

Policy response

There is no easy answer on benefits. In-work benefits hamper productivity per hour by acting, effectively, as a higher tax rate for recipients but they strengthen the incentives to enter employment by removing cliff edges for those on the margins. Lower taper rates improve incentives for those in the range being lowered, but they mean that the taper extends further up the income scale, weakening incentives for those caught in them. They also entail greater overall spending, which means higher taxes and worse incentives for those required to pay for them.

- Relax planning restrictions and regulations in energy and childcare markets to bring down the cost of housing, energy and childcare. Also remove barriers to imports (such as tariffs) to reduce the cost of food and other essentials. This will lower the level of welfare necessary to sustain a minimum standard of living which means that we can reduce the extent of the damage to incentives caused by withdrawing in-work benefits.

On taxes, policy choices are clearer:

- Abolish employer national insurance to increase wages.
- Cut employee national insurance to 10 per cent and then merge it with income tax into a single 30 per cent rate.

Summary

High taxes discourage low earners from taking on promotions and learning new skills by weakening incentives. Reducing the need for welfare by reforming planning, energy, childcare and trade policy can cut the number of people caught in the low-wage welfare trap. Cutting employer national insurance will boost wages while cutting employee national insurance will reduce the impact of tax on incentives to earn more.

Further information

The TaxPayers' Alliance has long campaigned for policy reform to simplify welfare and reduce the tax burden on people with low incomes. In 2010 we published *Welfare reform in tough fiscal times: creating a better and cheaper benefits system* which advocated a negative income tax to replace much of the benefits system. In 2011 we published *Abolish National Insurance*, which recommended cutting national insurance rates and then merging it with income tax. In *The Spending Plan*, we advocated policy reform in housing, energy, childcare and food markets to reduce the need for welfare, a subject explored again in 2017 in our *Why the cost of living is so high* report.

[4] TaxPayers Alliance, *the Spending Plan*, 2015, https://d3n8a8pro7vhmx.cloudfront.net/taxpayersalliance/pages/5255/attachments/original/1425976126/The_Spending_Plan_WEB2.pdf#page=96, (accessed 17 April 2018).