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TAX CREDIT REFORM SHOULD FOCUS ON ONE ISSUE: THE MARGINAL RATE

- Tax credits have made the low paid better off but have created a poverty trap.
- Under George Osborne's original plans Britain's lowest paid would have been discouraged further with an even higher marginal tax rate of up to 93%.
- The Chancellor should remove this huge barrier to the low paid being rewarded for taking on more work.
- A guiding principle should be that no-one should pay a higher marginal tax rate than the top rate income tax payer.

1. INTRODUCTION

Widespread concern over the financial impact of the Government's planned tax credit changes on Britain's poorest workers is understandable. Although the intentions of the plans

– to reduce the deficit and to move to a high wage, low welfare economy – are commendable, they fail to achieve a fundamental principle: to ensure work pays.

As originally set out, the Chancellor's plans to lower the withdrawal threshold and increase the taper rate would have exacerbated the existing high marginal tax rate faced by the lowest paid. This high marginal tax rate has remained the fundamental flaw in the tax credits system since its introduction by Gordon Brown, as it undermines the incentives of recipients to increase their income.

The Government must now make sure that those workers whom tax credits are intended to help are not discouraged even further to aspire to earn more. As the Chancellor now returns to the drawing board he should use the opportunity to fix Britain's broken tax credit system once and for all.

2. TAX CREDITS IN THE UK ARE FLAWED

The 2005 Treasury policy document on tax credits defined the original intention clearly: [1]

'The tax and benefit system should ensure that work is financially rewarding… For those who can, work provides the best form of security and independence.'

However, a serious conceptual error was then made:[2]

*'The first principle of tax and benefit reform… is that a modernised welfare system should **promote incentives to work, by reducing the tax burden on the low paid**…'*

The aim of improving incentives is right, but simply reducing the tax burden will not achieve it. The incentive to work is driven by the marginal tax rate, not by the tax burden. This analytical error is the fundamental reason why Gordon Brown's tax credits failed to support the lowest paid to earn more.

The average rate of tax – the tax burden – is important for a different reason. The average rate of tax has a static welfare effect on the taxpayer, it lowers their income and what they have to spend, save and invest. It does not refer to incentives, but rather whether low income earners have enough post-tax income to live on. On the other hand, the marginal rate of tax – the proportion of income paid in tax on the next pound earned – has a larger effect on a worker's incentive to earn more. The higher the marginal tax rate, the greater the disincentive the worker will have to work more and increase their household income. As currently structured tax credits make the low paid better off (than without tax credits) but can penalise them strongly when they try to earn more.

1 HM Treasury (March 2005), paras 3.2 and 2.21.

2 Emphasis in the original. The text goes on correctly to address the importance of reducing the number of households on high marginal withdrawal rates. HM Treasury (March 2005), para 4.1.

3. WHAT SHOULD BE DONE?

Gordon Brown's tax credits had extremely high marginal rates of tax of up to 70% – which George Osborne's original reform could have raised to as much as 93% in some cases. These create a huge barrier to the low paid being rewarded for working more: in other words, they inadvertently create a significant poverty trap. In-work payments to top up the wages of the low paid might be necessary. Simply abolish tax credits and four and a half million families would be much worse off.

The Earned Income Tax Credit (EITC) in the US works much better and should be examined for lessons which can be applied in the UK.

4. TAX CREDITS IN THE US: THE EITC

The debate that shaped policy in the US was initiated in the 1960s by Milton Friedman. In 1962, Friedman published his book *Capitalism and Freedom* in which he advocated a negative income tax as a solution to the disincentives caused by the high marginal tax rates which result from the interaction of tax and the welfare system. Instead of lots of different welfare benefits, a negative income tax would provide a minimum income guarantee whether or not someone worked and give them what they would value most – cash, rather than benefits in kind. It could streamline the benefit system, replace a rag-bag of different programmes and cut marginal tax rates at the bottom of the income scale.[3]

Such were the attractions of the proposal that in 1966 Friedman's negative income tax formed the capstone of the Johnson administration's war on poverty. However, Johnson himself disliked the idea on the grounds that a guaranteed annual income undermined work effort. In 1969 a negative income tax was adopted by the Nixon administration as the Family Assistance Plan (FAP). But the Democrat chairman of the senate finance committee, Senator Russell Long, opposed it on similar grounds as President Johnson had.

As senators began to understand how existing welfare programmes had heavy disincentives on work, a policy which merely reduced and redistributed those disincentives was not politically acceptable. As the economist Robert Moffitt notes, 'work requirements are fundamentally at odds with the idea of a Friedman-style negative income tax. With such a tax, non-workers are not queried about the reason for their lack of work.'[4]

After the defeat of FAP in 1972, Senator Long developed the idea of a 10% income bonus scheme for the low paid. A variant was passed with the 1975 tax bill as the Earned Income Tax Credit. It added a 10% supplement to wages up to $4,000 a year which was phased out at 10% over the next $4,000 of income. In 1978, a flat range was added after the phase-in to give it its present shape. The EITC had support of both Republicans and Democrats.

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3 The account here of negative income tax and the Earned Income Tax Credit is taken from Robert Moffitt, 'The Negative Income Tax and the Evolution of US Welfare Policy', *Journal of Economic Perspectives*, 2002, revised 2003; and *The Earned Income Tax Credit,* Joseph Hotz and John Schloz, 2000, NBER.

4 Moffitt, p. 18.

President Reagan expanded the EITC as part of the 1986 Tax Reform Act, enabling Reagan to declare that 'millions of working poor will be dropped from the tax rolls altogether.'[5]

In the early 1990s, expanding the EITC became a signature issue for President Clinton. In his first state of the union speech, Clinton proposed a huge expansion of the EITC: [6]

> *By expanding the refundable earned income tax credit, we will make history; we will reward the work of millions of working poor Americans by realizing the principle **that if you work 40 hours a week and you've got a child in the house, you will no longer be in poverty.***

5. HOW THE EITC WORKS

The EITC is an employment subsidy paid as a fully refundable tax credit to families. It is pitched towards families with children, although low paid workers without children are eligible at a lower rate. Today, the tax credit is phased in, the top rate being 45% for families with three or more children. For every $1 of pre-tax income, they get an extra 45¢ up to $13,650 of pre-tax income, to give a maximum tax credit of $6,143.[7] At $23,260, the tax credit is phased out at the rate of 21.06%. Different phase-in, phase-out rates and maximum tax credits apply to families with a single child and childless workers.

Aside from the relative simplicity of the EITC compared to the child and working tax credits, the biggest difference is that the EITC has a phase-in. This means that the value of the credit raises income. This provides an unambiguously pro-work incentive. Unlike the UK child tax credit, no work income results in no tax credit. Getting an extra 45¢ for each dollar earned is a strong signal that work pays.

The EITC's phase-out rate or taper is lower than the British tax credits – a maximum of 21.06% compared to 41% – which would have been increased to 48% under the Chancellor's original proposals. These lower rates are layered on top of a lower rate tax structure, which also has higher allowances and personal deductions. Phase-out of the EITC is completed within the 15% band of federal income tax. Together with employee payroll taxes (similar to our employee NICs) of 7.65%, this results in a maximum marginal tax rate of 43.7% as EITC is tapered away compared to 70% in the UK – or 93% under the Chancellor's original proposals.[8] Another lesson for Britain: tax credits require low income tax rates to work.

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5 22 October 1986.

6 17 February 1993.

7 All figures are for the 2014 tax year.

8 In addition, there are state incomes taxes, which vary from state to state, and some states have their own EITC.

6. EITC OUTCOMES

Unlike the British tax credits, alignment of policy design with objectives means the EITC delivers positive results in terms of incentivising work. According to the Nobel economist Gary Becker:[9]

> *Empirical studies confirm the prediction of economic theory that the EITC increases the labour force participation and employment of people with low wages because they need to work in order to receive this credit.*

The EITC reduces poverty: a report by President Clinton's council of economic advisers after the expansion of the EITC in the 1990s says it lifted 4.3 million people out of poverty in 1997 and reduced the number of children living in poverty by 2.2 million.[10] In their analysis, Hotz and Schloz found that the EITC creates a strong incentive for non-workers to enter the labour force, since it increases the marginal value of working by raising the effective wage.[11]

Any means-tested payment such as the EITC involves some redistribution of incentives and disincentives. In the case of EITC, the trade-off is between higher labour market participation at the bottom of the income scale for a reduction in hours offered, typically by the second earner in two earner couples, further up the income scale.

In explaining broad public and political support for the EITC, Hotz and Schloz note that the EITC:[12]

> *…subsidizes the incomes of people who in some sense are "doing the right thing." The appeal of this reaches across party lines. In addition, unlike the safety net programmes, the EITC has unambiguously positive labour market participation incentives.*

7. THE CASE FOR REFORM

Gordon Brown's tax credits made the lowest paid workers better off. However, costing around £30 billion they are unaffordable and have created a poverty trap. George Osborne's new proposals would have exacerbated this – raising the marginal rate of income tax even higher to as much as 93p for each extra £1 earned. The tax credits system in Britain should be reformed along the lines of the highly successful EITC in the US. This reform must achieve two clear objectives:

- As with President Clinton's reforms in the US: anyone who works 40 hours a week and has a child at home should no longer be in poverty.
- No-one should be on a higher marginal tax rate than the top rate income tax payer.

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9 *Business Week*, 3 June 1996.

10 Council of Economic Advisers, *Good News for Low Income Families: expansions in the Earned Income Tax Credit and the Minimum Wage*, 1998.

11 Hotz and Schloz, p. 22.

12 Ibid., p. 62.

8. MUST BE READ

- A better way to help the low paid – Rupert Darwall
- Is there a smarter way to cut tax credits? – Monique Ebell

9. MUST BE READ ON CAPX

- 10 ways to clean up the Tory mess on tax credits – Tim Montgomerie
- Brown and Blair messed up on tax credits and the Lords – Bruce Anderson

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