

**New Generation**

# **Make Work Pay**

A NEW AGENDA FOR FAIRER TAXES

BY TOM CLOUGHERTY

FOREWORD BY MAURICE SAATCHI







## **About the Author**

Tom Clougherty is head of tax at the Centre for Policy Studies. He was previously executive director of the Adam Smith Institute. From 2012 to early 2018, Tom worked in the United States, first as managing editor at the Reason Foundation, and then as a senior editor at the Cato Institute.

## **About the CPS**

The Centre for Policy Studies is the home of a new generation of conservative thinking. Its mission is to develop policies that widen enterprise, ownership and opportunity, with a particular focus on its core priorities of housing, tax, business and welfare.

Founded in 1974 by Sir Keith Joseph and Margaret Thatcher, it is primarily responsible for developing a host of successful policies, including the raising of the personal allowance, the Enterprise Allowance, the ISA, transferable pensions, synthetic phonics, free ports and the bulk of the Thatcher reform agenda.

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# Foreword

By Maurice Saatchi

Almost 20 years ago, Peter Warburton and I made a then-revolutionary argument: that it was time to take poor people out of tax.

In a landmark Centre for Policy Studies report, we pointed out that the Labour government had erected a system that saw the working poor taxed on their income, then handed back those taxes via the benefits system.

This wasn't just a financial problem, but a moral one. It denied people independence, forcing them to jump through the hoops of a costly and cumbersome benefits system. And it resulted in all manner of perverse outcomes.

A single mother could more than double her net income if she moved to working for 16 rather than 15 hours a week – but if she worked for 27 hours a week rather than 26, her income would actually fall.

The reform we proposed would, eventually, become the centrepiece of the Conservative Party's economic policy – to raise the personal allowance and take millions of people out of income tax altogether. As this report shows, that policy has been a huge success, significantly increasing the disposable income of millions of taxpayers and greatly simplifying the tax system.

Only last week, Philip Hammond brought forward the latest increase to the personal allowance by a full year – because he recognised that it is one of the best ways of

putting more money into people's pockets, and giving them more control of their finances and therefore their lives.

But now it is time to go further. It is unjust, as Tom Clougherty argues in this paper, that people should be out of income tax but still paying National Insurance – which is simply income tax by another name.

And it is equally unjust that, as people climb the income ladder, they face marginal tax rates – and benefit withdrawal rates – that discourage them from working and earning more, that take away control of their lives.

Hence this report's clear and simple recommendations. First, that everyone should be able to keep the first £1,000 they earn each month – a universal working income, free of income tax and National Insurance alike. And then, that the tax system should always let them keep at least 51p in every extra pound they earn – a guarantee that work will always pay. That includes cutting the Universal Credit taper rate further to avoid the benefits system clawing back what the tax system gives.

This is an agenda – part of a programme of major policy proposals from the Centre for Policy Studies – that tackles the scourge of working poverty, that puts more money in people's pockets and that resonates with the public.

Above all, it gives people that independence, and the control over their lives that they crave.

*Lord Saatchi is Chairman of the Centre for Policy Studies*

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# Executive Summary

The tax system can often seem a boring topic. Talk of thresholds and marginal rates, allowances and tapers, and pretty soon people's eyes start to glaze over.

Yet there is no subject in politics that is more important. Tax is how the state most directly, and often most painfully, interacts with its citizens. It shapes and dictates behaviour; tilts the scales between rich and poor; pays for the public services we all rely on.

And making sure the tax system works properly is not just an economic question, but a moral one. It is the tax system that dictates how much each of us is left with at the end of the month. That can make the difference between food on the table and a trip to the payday lender, between a growing economy that provides jobs for everyone and one in which people are actively discouraged from working to their fullest potential.

This report is part of a series of major new policy initiatives from the Centre for Policy Studies (CPS), part of our efforts to develop a new generation of conservative thinking. The central theme of this programme is about giving people more control of their own lives – which includes, first and foremost, their finances.

It is often said that the hard years since the financial crisis have left the British people disenchanted with tax cuts. That the pendulum has swung back towards higher public spending and higher taxes.<sup>1</sup>

In fact, those years since the crash prove the enduring power of tax cuts to help ordinary people. As this report will show, the increase in the personal income tax allowance – a policy

first put forward by the CPS – has virtually single-handedly caused take-home pay to rise, even as real wages have fallen.

Also, the picture is not as clear-cut as some might think. CPS polling shows that when you ask people what the Government could do to improve their own lives, the most popular answer among all but the youngest and oldest voters is to bring down the cost of living (the young care slightly more about making housing more affordable, the elderly about improving healthcare).<sup>2</sup>

And tax, of course, plays a vital role in the cost of living. The less the Government takes from your pay packet, the more that is left in your pocket – and the more control you have over your life.

Thanks in large part to the efforts of the Cameron and May Governments, Britain has one of the most extraordinary job creation records in the world. Employment is at its highest level since records began, unemployment is at a 47-year low, and the number of job vacancies is at an all-time high. Since 2010, Britain has created more new jobs than France, the Netherlands, Portugal, Denmark, Norway, and Ireland – combined.<sup>3</sup>

However, while employment has soared, average earnings have stagnated. Real wages remain 3 per cent below their pre-financial-crisis level, and are only up by 3.9 per cent since 2002/03.

The great challenge facing us, then, is not getting people into work, but ensuring they increase their salaries when they get there. And one of the most powerful ways to do that is to make sure that they are rewarded and incentivised for every extra hour they work.

For the past few months, we have been investigating and analysing the state of the British tax system.

Our research team have read countless reports, crunched endless numbers, modelled a wide range of different tax changes, carried out focus groups and in-depth polling – all with the goal of giving people, especially those who are struggling the most, more of their own money to spend, and more control over their own lives. We have been determined, in the process, to ensure that those proposals are fully costed and affordable, even with the Government's existing commitments to fund public services.

What we found was that voters on low or middle incomes – the “just about managings” whom Theresa May singled out for support – know to the penny how much they will gain or lose in benefits for every extra hour worked, and tailor their lives accordingly. But all too often, they say, the system makes “fools” out of them for trying to do the right thing – by punishing them rather than rewarding them for working longer.

They believe that work matters. In particular, there is near-universal support for the idea that work should always pay – that whether you are earning £10,000 or £100,000, you should never be punished via taxation for trying to better yourself.

What we suggest, therefore, is not an individual tax cut here or there. It is a fundamental change in our tax and welfare system: to ensure that work always pays. That you are always – always – rewarded for working. And that whoever you are, whatever your situation, you keep the majority of every extra pound you earn.

In other words, that you have control over your finances, your future and your earnings, rather than shaping them to fit the demands of the state.

The first part of this is the introduction of the **universal working income**. This is an expansion of the personal allowance to include National Insurance – ensuring that you pay no tax at all on the first £1,000 you earn every month.

From that foundation, we will then ensure – via the reforms spelt out in this paper – that you **keep at least 51p of every extra pound you earn**. A further guarantee, embedded within the tax system, that work will always pay. That you will be in control of your finances, rather than working more for the state than for yourself.

As part of this package, we also propose significant changes to Universal Credit, which would see the rate at which benefits are withdrawn post-tax slashed to 50p. It is hard to encourage people to work via the tax system if you then punish that impulse via the sharp withdrawal of their benefits, which can leave people facing marginal tax rates of up to 75p in the £1 – or sometimes even higher.

We have shown how the money could be found for this – but if the Government felt unable to make the necessary savings, it could easily implement many of the individual changes we suggest and improve many millions of lives in the process.

“Whether you are earning £10,000 or £100,000, the British public believe you should never be punished for trying to better yourself.”

Each part of this agenda is, we believe, a good thing in itself. And each part is instinctively grasped and supported by the public. Yet taken together, these proposals are more than the sum of their parts. They represent a simple promise to the public. A powerful and necessary guarantee: that work will always pay.

They also represent a targeted tax cut that will put more money in the voters' pockets, and in particular the pockets of the “just about managing”: the universal working income would, for example, give someone working full-time at the national living wage a 25 per cent tax cut, leaving them £459 a year better off.

The message that shines forth from every conversation with ordinary voters about this agenda is a belief in the power of work – that government should focus its efforts on ensuring that work pays. They want a tax and welfare system that supports and empowers them rather than dictates its own terms. We therefore urge the Treasury to ensure that every measure it takes moves the tax system towards delivering on that promise.

Our mission, at the Centre for Policy Studies, is to give people more control of their lives. This report provides a powerful blueprint for how that can be done.

# Introduction

## What does it mean to make work pay?

Ask that question to a public policy specialist, and they will point to a pressing and urgent challenge. The UK is experiencing a “jobs miracle”: employment is at its highest level since records began, and unemployment at a 47-year low. However, while employment has soared, average earnings have stagnated.

We therefore need to ensure that work pays in the long term – by making sure that people enjoy rising wages, and better standards of living, through improving Britain’s anaemic levels of productivity growth.

But for most ordinary people, making work pay also means ensuring that – whatever the broader macroeconomic picture – people are rewarded for doing the right thing. They should be better off in work than on welfare. And as people work harder and earn more, they should see their incomes and living standards rise accordingly. In short, there should be a clear and obvious link between effort and reward.

A YouGov poll conducted on behalf of the CPS for this report underlines the importance of this message. When we asked what the Government’s aim should be when making decisions about taxation, 23 per cent said it should be to bring in as much money as possible for public services; 25 per cent thought the goal should be to redistribute wealth from the rich to the poor. But the most popular response, backed by 35 per cent of those polled, was that the Government should try to “provide people with the strongest incentives to work”.

But making work pay is more than just a financial matter: it is a moral issue. In the literal sense, virtually all work pays a wage or salary; if it didn’t, people would just sit on the sofa. But how much of the money that someone earns should go directly towards improving their living standards, as opposed to being co-opted by government for some broader social purpose?

If the Government levied no taxes at all, it is quite obvious that work would pay. Every penny with which you were compensated for your labour could be used for your own purposes. On the other hand, work clearly wouldn’t pay if all the money you earned was taken from you in tax, and you had nothing left to spend on yourself and your family.

Both of these extremes are, of course, impractical: we have neither anarchy nor Communism, and are not likely to “enjoy” them any time soon.

In between those two extremes, however, there are many shades of grey, and it is hard to judge objectively the point at which work pays or doesn’t pay, in the broader moral sense. At some stage – which will be different for everyone – it simply won’t be worth working, or won’t be worth working as much, if there is too little marginal reward for the effort required.

We often think about this in terms of the very rich. It is commonly argued, with some justification, that if income tax rates are too high at the top, they will discourage enterprise and entrepreneurship, and may even drive the highest achievers overseas, where they can receive a greater reward for their labour.



If anything, though, the question of whether work really pays is more germane to those at the bottom of the income distribution. For it is people trying to move from welfare into work who often see the least reward for their industry – not just in absolute, cash terms, but also as a percentage of their earnings that they end up being able to spend for themselves.

Whether or not work pays for the highest earners has economic consequences. It is, of course, a terrible thing if the best and brightest decide not to capitalise on their full potential – if it doesn't pay for them to open new businesses and create new jobs, or to bring new and improved goods and services to the market, or even to remain in the country. In the long run, if these people are discouraged from working, it will lead to lower living standards across the board.

Yet for the lowest earners, the problem is acutely personal. A rich man or woman may decide it is not worth their while to work as much, or to leap at a new opportunity that presents itself. For their poor cousin, it may be a question of whether to work at all, or whether to work more than the minimum required to be eligible for government benefits.

It is well documented that work has powerful social, psychological, and health benefits.<sup>4</sup> What's more, the public seem well aware of this: 83 per cent say work is good for physical health, and 90 per cent say work is good for mental health. Indeed, 6 in 10 Britons say that they would enjoy work even if they didn't need the money.<sup>5</sup>

So while no one begrudges the assistance given to those genuinely and unavoidably in need, it is a near-universal belief among voters that those who can work, should work – and that they should be rewarded for it. This has been a key finding of focus groups carried out by the CPS.

If we have a tax and benefits system that traps people in dependency – that discourages them from leading a full, active, and engaged life – then we end up not just with an economic problem, but a serious social and moral one too. In short: it is every bit as important that

work pays at the bottom, as it is that work pays at the top.

So how can we do this?

A common answer is via direct intervention: for example, hiking minimum wages so that people make more money for every hour worked. But such interventions in the labour market have their limits. Minimum wages can only rise so far before they start to cause low-skilled unemployment; they also encourage the “bunching” of incomes at the lowest level.

More radical proposals – such as a universal basic income – are unaffordable and probably unworkable too. They break that crucial link between effort and reward, and also seem to be unpopular. Our focus groups were thoroughly unimpressed by the idea of a universal basic income, thinking it wrong that anyone and everyone should get a “no strings attached handout”. Our polling found similarly little enthusiasm.

If the Government really wants to help make work pay in the short term, it would do better to focus its efforts on the things that it can control directly, and which do not risk unintended consequences for the economy as a whole.

“The public seem well aware of the power of work: 83 per cent say work is good for physical health, and 90 per cent say work is good for mental health.”

Fortunately, there are a number of powerful levers that government should be able to pull. After all, the amount you earn is only one part of your disposable income. The amount you have to pay in taxes – and the amount you lose in any withdrawn benefits – also crucially affects how much extra spending power you will gain from any given amount of work.

From our discussions with experts, and our conversations with the public, we have settled on a single, powerful principle to express this. It takes as its starting point the idea of ownership – that what you earn belongs primarily to you, and should be available to satisfy your basic

needs before the Government takes any of it away. That you, not the state, should have control of your fate and your future.

We therefore suggest that, in so far as is practically possible, everyone should benefit from a guarantee that the state will not start taking their earnings until those earnings reach a certain minimum level – £12,000 a year, in our proposal. And from that point, they will always get to keep at least half of every additional £1 they earn, irrespective of their circumstances. More than that, and in a very real way you are working for someone else, rather than for yourself.

That sense of ownership gets to the heart of what we mean by “making work pay”. And it also speaks to the issue of control. If the nature of your working habits – the jobs you take, the hours you work – is dictated by the tax and benefits system, then you are not in control of your life.

This obviously matters to the British public. When we asked in a recent poll whether people approved or disapproved of a policy that said “the Government should never take more than half of every extra pound someone earns in tax”, the results were surprisingly clear cut. Only 18 per cent disapproved of that *work guarantee*. More than three times as many – 61 per cent – supported it. Our focus groups believed that marginal tax rates of 50 per cent or higher were not just unfair but actively immoral.

With that in mind, it makes sense to start by asking how well the British tax and benefits system currently lives up to the aspiration that work should always pay. To what extent do British workers today get rewarded for their efforts? The uncomfortable truth is that if the Government wants to deliver on this promise, there is a lot of work to be done.

## What Tax Rate Do You Really Pay?

Most Britons, if asked what tax rate they paid, would say 20 per cent (the basic rate), 40 per cent (the higher rate), or 45 per cent (the additional rate).

Table 1: Income Tax Bands, 2018/19

| Income (£)     | Tax Rate (%) |
|----------------|--------------|
| 0–11,850       | 0            |
| 11,850–46,350  | 20           |
| 46,350–150,000 | 40           |
| 150,000+       | 45           |

However, actual taxpayers seldom pay those precise rates. The reality of how Britain taxes income is far more complex – and much messier – than the simple representation above suggests.

For one thing, Britain operates a second system of earnings taxation alongside income tax: National Insurance. People often think of this as something separate from the tax system – either the bit that pays for the NHS, or some ill-defined system of social insurance that will see them right in their old age.

Yet despite the name, National Insurance is not really *insurance* in any meaningful sense.<sup>6</sup> There is no fund that is being built up, no devoted stream of revenue to particularly worthwhile parts of the public services. Instead, as any economist will tell you, National Insurance is to all intents and purposes a second income tax – albeit one with a slightly different tax base, different thresholds, and different rates.

On an annualised basis, employee National Insurance contributions in 2018/19 are charged at 12 per cent on earnings between £8,424 and £46,350, and at 2 per cent on earnings above that level.<sup>7</sup>

If you combine this with the income tax schedule outlined above, you get a rate schedule that looks like this:

Table 2: Combined Rates, Income Tax and National Insurance, 2018/19

| Income (£)     | Tax Rate (%) |
|----------------|--------------|
| 0–8,424        | 0            |
| 8,424–11,850   | 12           |
| 11,850–46,350  | 32           |
| 46,350–150,000 | 42           |
| 150,000+       | 47           |

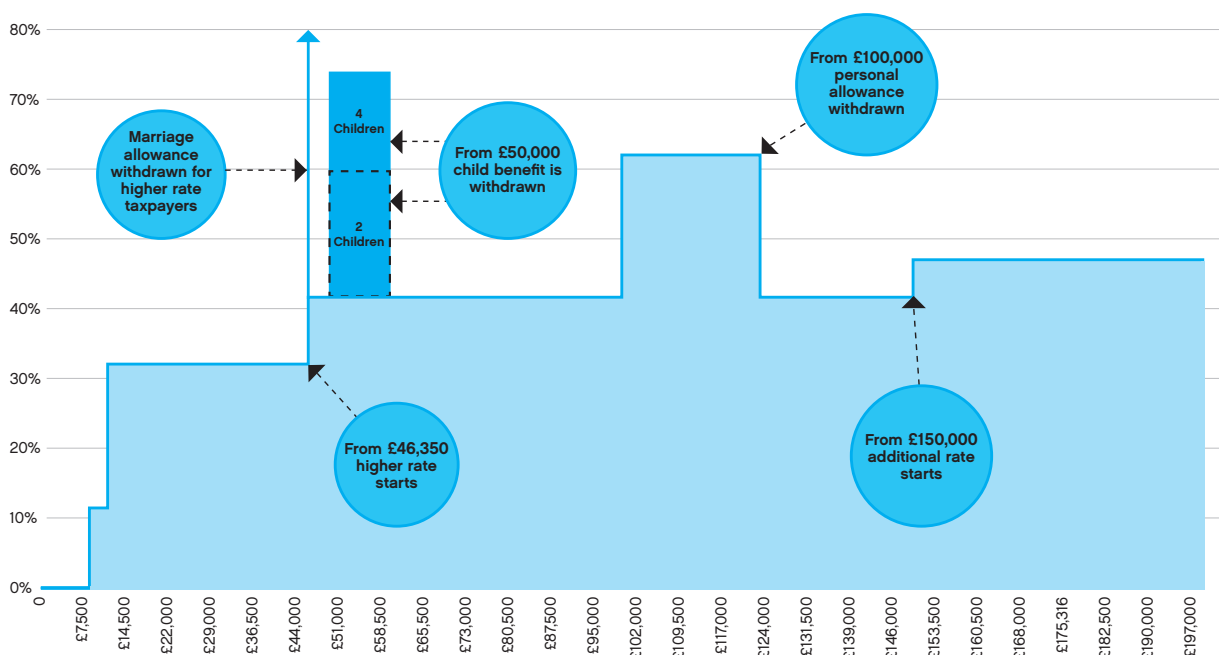
Yet this is only the beginning of the story. As this report will show in some detail, the British tax system is riddled with a multitude of different effective marginal tax rates – that is, the rate you pay on the next £1 you earn – which affect people in particular sets of circumstances.<sup>8</sup>

These effective marginal tax rates are usually hidden from view. For example, the table above suggests that the top rate of tax on earnings in the UK is 47 per cent. Yet the withdrawal of the personal allowance from high earners means that people with incomes between £100,000 and £123,700 actually face an effective marginal tax rate of 62 per cent.

It isn't just the very wealthy that suffer from this "stealth tax" phenomenon, either. For a family with three children, the high income child benefit charge will hit someone earning £50,000 – above the national average, but hardly hedge-fund territory – with an effective marginal tax rate of 67 per cent. The withdrawal of the marriage allowance can similarly lead to an extraordinary effective marginal tax rate – 23,800 per cent in 2018/19 – on the penny of income that pushes someone into the higher rate income tax band.

This isn't just about numbers, either. High effective marginal tax rates distort behaviour and damage economic growth. Some people manage their affairs to keep their adjusted net income below some arbitrary threshold. They might make excess pension contributions as their income

Figure 1: Britain's Tax Rate Structure on Earnings



approaches a particular threshold, or transfer assets to a spouse. Others respond to high tax rates by working less, or by shifting their income into different forms that are more lightly taxed, such as dividends and capital gains. In many cases, tax revenues suffer as a result.

Taken together, the various complications and distortions produce a tax system that looks something like Figure 1, on the previous page.

In stark contrast to the simple, progressive income tax structure outlined in Table 1, this graph shows that Britain's contemporary system of taxing earnings is complex, arbitrary, and – at certain points in the income distribution – actively regressive.

It is *complex* because comprehending the tax rate you actually face requires an understanding of how multiple tax measures interact. It is *arbitrary* because the effective marginal tax rate you face sometimes bears little relation to your ability to pay it – why, for instance, should a single-earner family of six, with an annual income just over £50,000, lose nearly three-quarters of any additional income to the taxman? And it can be *regressive* because higher earners sometimes face lower effective marginal tax rates than people earning less than them.

Yet the key point here, and the reason why the proposals in this report are overwhelmingly targeted at those on low incomes, is that things are even worse at the bottom of the income distribution. The harshest effective marginal tax rates have long been found in the benefits system – and particularly where tax and benefits overlap.

Universal Credit was designed to ameliorate this problem, and to dramatically simplify the benefits system. It will certainly help. Yet as things stand, someone facing income tax, National Insurance and the Universal Credit taper will still face an effective marginal tax rate on the next £1 they earn of 75 per cent.

For people moving from welfare into work, *participation tax rates* matter a great deal as well. These represent the percentage of gross income that is lost in tax and withdrawn in benefits when someone enters the workforce.

Imagine someone with a £10,000 Universal Credit entitlement who gets a job paying £18,400 a year – which the Joseph Rowntree Foundation describes as a “minimum income standard” for a single adult.<sup>9</sup> In 2018/19, they will pay £1,310 of income tax and £1,120 of National Insurance, leaving them with take-home pay of £15,790. But they will also lose all of their Universal Credit. They will have earned £18,400, but their net income will have only risen by £5,790, which implies a participation tax rate of 69 per cent.

As with so many elements of Britain's tax and benefit system, that can hardly be described as “making work pay”.

““ We want to give people more control over their lives – not just to put more money in their pockets, but to ensure that they are always rewarded for working harder and earning more. ””

## **A New Agenda for Tax and Welfare Reform**

We want to give people more control over their lives – not just to put more money in their pockets, but to ensure that they are always rewarded for working harder and earning more. As the overview above shows, there is plenty of room for improvement.

To that end, this report makes a case for refocusing the tax and benefits system around one simple and unarguable economic, social, and moral principle: that work should always pay. In policy terms, this breaks down into three distinct sets of reforms.

First, to ensure that people are always able to meet their own needs before they have to start funding other people's, the Government should

establish a new universal working income – a combined threshold for both income tax and National Insurance that allows everyone to earn £1,000 a month without facing any direct taxes on their earnings at all.

Second, to ensure that people do not get stuck in a cycle of dependency, and are able to improve their lives by moving from welfare into work – and then by progressing in the workplace – the Government should look again at the taper rate on Universal Credit, aiming to cut it from 63p to 50p.

Third, to ensure that workers always get to keep at least half of every additional £1 that they earn, the Government should fix the various problems in the tax system that cause very high effective marginal tax rates for some taxpayers.

Better policies don't always come cheap, of course, which is why the final section of this report assesses the fiscal situation, and outlines how the policies proposed in this report should be funded.

Nevertheless, the reforms detailed here, when taken together, constitute an exciting new agenda for tax and welfare reform – one which would encourage enterprise, empower workers, and perhaps even change the way we view the relationship between the individual and the state.

A better and fairer tax and benefits system is within our reach. This report aims to show how we can get there.

# PART I – MAKING WORK PAY

## 1. Towards a Universal Working Income

One of the most straightforward ways Government can make work pay is by increasing the amount people are allowed to earn before they are liable to pay income tax and National Insurance.

Indeed, this was the motivation behind significantly raising the personal allowance – the amount you can earn before basic rate tax kicks in – from £6,475 in 2010/11 to £11,850 today.

In their 2010 general election manifesto, the Liberal Democrats argued that raising the personal allowance would “help people who are struggling to make ends meet and provide an incentive to work and save”. It was an idea eagerly seized on by George Osborne, when announcing the first in a series of above-inflation personal allowance increases in the Coalition’s first Budget in 2010:

“I believe it is important to lift people out of the income tax system and allow them to keep more of their hard-earned money... there are many thousands of people who have their income taken away in tax, only to have to apply to get it back in benefits. This does not reward work. So today I can announce that we will increase the personal allowance...”

But the argument for raising the personal allowance goes back much further. In fact, it was the Centre for Policy Studies that first made the case for a £10,000 personal allowance in 2001, when Maurice Saatchi and Peter Warburton argued that “poor people should stop paying tax”.<sup>10</sup> Taking millions of the lowest earners out of income tax altogether would, they wrote, offer a “universal opportunity for young and old, married and single, primary and secondary earners to throw off the mantle of dependency”.<sup>11</sup>

Like Osborne, Saatchi and Warburton highlighted the issue of *fiscal churn*, the perverse situation in which the Government simultaneously deducts money from people’s pay packets and gives it back in the form of means-tested welfare payments.

Such a system unnecessarily fosters a sense of dependence upon the state, and undermines people’s incentives to work. To make matters worse, the complex web of overlapping tax and benefit withdrawal rates that fiscal churn creates tends to impose staggeringly high effective marginal tax rates on low income workers, meaning that they see precious little reward for their labour (an issue explored further in the next chapter).

One great virtue of raising the personal allowance is that it takes many benefit recipients out of income tax altogether, dramatically simplifying the tax system from their perspective. It reduces effective marginal tax rates, participation tax rates, and overall tax rates – all of which helps to make work pay.



## The Impact of Raising the Personal Allowance

As the table below makes clear, the personal allowance has risen by vastly more than the rate of inflation over the last nine years. Overall, the personal allowance increased in real terms by 53 per cent from 2010/11 to 2018/19. As a consequence, more than five million low earners were taken out of the

income tax net.<sup>12</sup> The effect of above-inflation increases in the personal allowance has been to deliver a significant income tax cut for low and medium earners.

In 2017/18 the median wage for a full-time worker was £550.40 per week, which works out to £28,620.80 per year. Had the personal allowance only risen in line with CPI inflation since 2010/11, this median earner would have paid £4,217.16 of income tax.

Table 3: Personal Allowance, 2010/11–2018/19

| Tax Year                   | Personal Allowance | Increase (year-on-year) | CPI Inflation (preceding calendar year) |
|----------------------------|--------------------|-------------------------|---|
| 2010/11                    | £6,475             | --                      | --                                      |
| 2011/12                    | £7,475             | 15.4%                   | 3.3%                                    |
| 2012/13                    | £8,105             | 8.4%                    | 4.5%                                    |
| 2013/14                    | £9,440             | 16.5%                   | 2.8%                                    |
| 2014/15                    | £10,000            | 5.9%                    | 2.6%                                    |
| 2015/16                    | £10,600            | 6.0%                    | 1.5%                                    |
| 2016/17                    | £11,000            | 3.8%                    | 0.0%                                    |
| 2017/18                    | £11,500            | 4.5%                    | 0.7%                                    |
| 2018/19                    | £11,850            | 3.0%                    | 3.0%                                    |
| <i>Cumulative increase</i> | <i>£5,375</i>      | <i>83.0%</i>            | <i>19.9%</i>                            |

The above-inflation increases that actually occurred reduced this tax bill to £3,424.16 – a £793 (19 per cent) tax cut. Overall, that median full-time worker was 3.6 per cent better off after taxes than they would have been otherwise.

The impact of the higher personal allowance is felt even more strongly among lower-earning workers. Someone working 40 hours a week at the national living wage in 2017/18 (£7.50/hour) saw their income tax bill cut by 49 per cent relative to the CPI-adjusted baseline, leaving them 6.1 per cent better off after taxes. A part-time worker doing 20 hours a week at the national living wage actually received a 100 per cent income tax cut – though they would only have paid £53 of income tax in the CPI-adjusted scenario.

Crucially, the above-inflation rise in the personal allowance helped to offset the effects of Britain's post-financial crisis wage

squeeze. From 2011/12 to 2017/18, average earnings fell by 2 per cent in real terms before taxes. Real take-home pay, however, actually rose by 1 per cent over the same period.<sup>13</sup> Above-inflation increases in the personal allowance prevented post-tax incomes from falling in line with wages, and thereby helped to protect people's living standards.

Of course, when it comes to making sure that work always pays, effective marginal tax rates and participation tax rates are just as important as overall tax rates. The higher personal allowance has had an impact on this front as well.

At the simplest level, people who used to pay income tax and no longer do have seen their effective marginal rate fall by 20 percentage points. Any simultaneous withdrawal of benefits would complicate this picture slightly, but the gains are still significant. For example, someone who would have been subject to the Universal

Credit taper and income tax simultaneously, but now only faces the taper, sees their effective marginal tax rate fall by 8 percentage points (the difference comes about because the taper applies to *post-tax* earnings).

Participation tax rates have fallen too. To see how, imagine a single, 30-year-old man, with a Universal Credit entitlement of £10,000 per year. Thanks to above-inflation increases in the personal allowance, his participation tax rate is 0.8 percentage points lower if he moves from unemployment to part-time work, and 1.8 percentage points lower if he moves into full-time work.<sup>14</sup>

How does National Insurance factor in to all this? Well, just as National Insurance is in many respects a second income tax, so the primary threshold – the point at which earnings become subject to National Insurance – is effectively a second personal allowance. And on the face of it, the primary threshold has also increased above inflation since 2010/11, rising (on an annualised basis) from £5,720 to £8,424 – a 23 per cent increase in real terms. However, virtually all of that real-terms increase happened in 2011/12, when it accompanied a rise in the main rate of National Insurance contributions from 11 to 12 percent. The primary threshold has barely moved since.

### **Time to Build on Success**

As successful as the post-2010 rise in the personal allowance has been, there remains scope for significant progress to be made in taking the low-paid out of income taxation altogether.

For one thing, it is surely strange that the Government is overseeing a quite dramatic rise in the minimum wage while simultaneously levying income tax and National Insurance on people working more than 29 hours a week at that level.<sup>15</sup> Indeed, back in 2013, the Resolution Foundation and IPPR suggested that the main beneficiary of a “living wage” (then defined as £8.55/hour in London and £7.45/hour outside the capital) would be the Treasury:

“It collects more than half the financial gains from the living wage in higher income tax payments, higher National Insurance contributions and reduced spending on in-work benefits.<sup>16</sup>”

Of course, things have changed since 2013. In inflation-adjusted terms, the actual national living wage is not as high as that analysis assumed; meanwhile, the personal allowance is much more generous. But the principle remains: why increase labour costs to employers – and risk low-skilled job losses<sup>17</sup> – only to take part of the resulting income away before workers even receive it? It doesn't make a lot of sense as a joined-up approach to economic policy.

Tim Worstall made a similar point in a 2015 study for the Adam Smith Institute.<sup>18</sup> Arguing that “greedy government” was the principal cause of in-work poverty, he showed that without tax, someone working 37.5 hours a week at the minimum wage (then £6.50/hour) would only be 32p per hour worse off than someone earning the proposed living wage (£7.85/hour) after they had paid income tax and National Insurance. This surely raises an obvious question: if a particular wage really is a “minimum”, how can you justify taxing it?

One of the big problems here is the way the National Insurance primary threshold has lagged behind the personal allowance. As recently as 2007/8, the two thresholds were aligned. Yet since 2010/11, the gap between them has widened from £755 to £3,426. The result is that many of the people the Government claims to have “taken out of tax” are actually still paying National Insurance. Paul Johnson, the director of the IFS, complained in 2016 about the “disingenuousness of the rhetoric on the personal allowance”, saying:

“The Chancellor boasted yesterday that this increase means another 1.3 million of the lowest paid workers are taken out of tax altogether, but it doesn't mean that at all. They're taken out of income tax, but they're not



taken out of direct taxes on income because it remains the case that NI contributions... start being paid at about £8,000.<sup>19</sup> ”

This speaks to a wider point about the bifurcation of income tax and National Insurance: the artificial division between the two is frequently used to conceal the true nature of the way Britain taxes earnings, and to make it appear that people are paying less tax than is really the case.

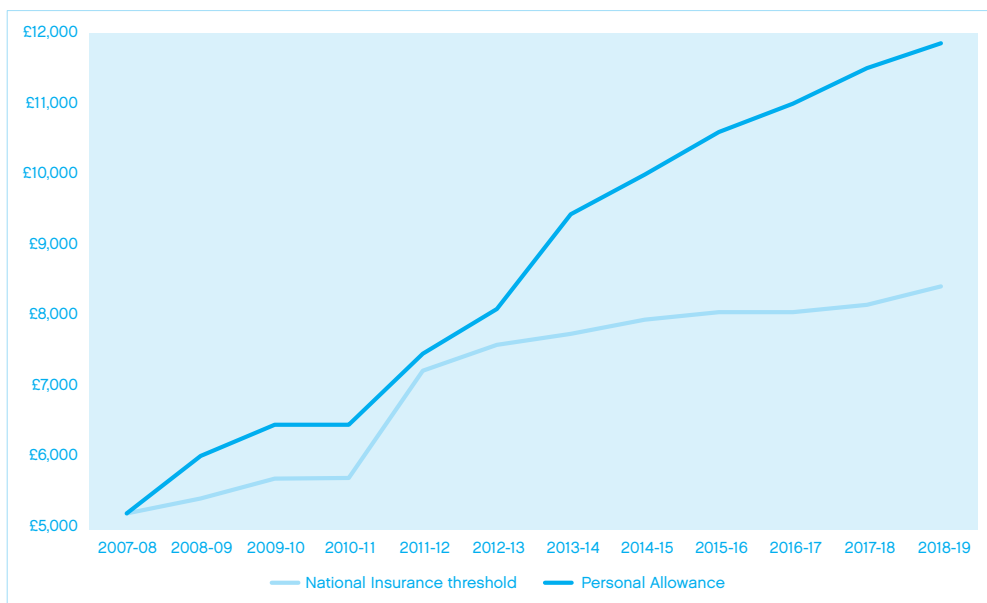
The situation is certainly expedient for Governments that need to raise money without the public kicking up too much fuss. But it does not necessarily make for the sort

of principled, transparent policymaking that people ought to demand in a free society.

More importantly, it is certainly felt in people's pay packets. This gap between the National Insurance threshold and the personal allowance can cost a low-income worker as much as £411 of additional tax per year. When money is tight, such a sum makes a real difference.

The divergence between the income tax and National Insurance thresholds also means that more recent increases in the personal allowance have not necessarily helped the poorest workers – that is, the ones who had already been taken out of income tax.

Figure 2: Thresholds for Employee NICs and Income Tax (Nominal)



That is not to say that raising the personal allowance was the wrong thing to do – overall, it has been a very successful policy, as the analysis above should make clear. However, a greater focus on the National Insurance threshold would, at this point, do most to help those in need.

Worstell (cited above) recommended that the primary threshold and the personal allowance both be raised to the level of the minimum wage for a full-time job.

Jonathan Dupont came to a similar conclusion in a report for Policy Exchange:

“The most straightforward way to ensure every full-time worker earned a Living Income would be to align the income tax and National Insurance thresholds at the annual equivalent of the minimum wage.<sup>20</sup> ”

In the long run, if we really want to make sure that work pays, this is the right ambition.

In the nearer term, however, achieving that goal may be unfeasibly expensive, not least because the minimum wage has itself risen above inflation in recent years.

In his October 2018 Budget speech, Philip Hammond announced that he was bringing the pledge to raise the personal allowance to £12,500 in 2020/21 forward by a year, so that it takes effect from April 2019. The personal allowance would stay at that level through the 2020/21 tax year, and rise in line with inflation thereafter.

On the face of it, this is a welcome move that would put an extra £130 a year in the basic rate taxpayer’s pocket. Yet we would argue for a slightly different approach. Instead of raising the personal allowance to £12,500 next year, the Government should instead set a new, combined threshold for both income tax and National Insurance at £12,000 per year.

By doing so, it could establish a new *universal working income* – a generous annual sum that we would all be able to earn before we had to start handing over any money to the Treasury.

Our polling suggests that such a reform would be popular with the public. When asked whether they approved or disapproved of a policy that said “everyone should be allowed to earn £1,000 per month [£12,000 per year] completely free

of income tax and National Insurance”, 76 per cent approved. Forty-one per cent approved strongly. Our focus groups also found very high support for the universal working income – although, if anything, people were keener still on an across-the-board tax threshold pegged to full-time work at the minimum wage.

In practical terms, meeting the £12,000 target would require a significant, above-inflation increase in the primary threshold for National Insurance, coupled with a slightly lower than anticipated rise in the personal allowance.<sup>21</sup> And while we would prefer that our universal working income was immediately indexed to inflation, we accept the compromise inherent in the Government’s own plan for the personal allowance – namely, that the proposed universal working income should stay at £12,000 in 2020/21, but rise in line with CPI inflation thereafter.

Compared with the overall approach outlined in the 2018 Budget, the cost of the universal working income would be around £6.8 billion.<sup>22</sup>

Crucially, this universal working income would not be a breach of that the Government’s manifesto promise to raise the personal allowance to £12,500. It would actually be an amplification of it.

Table 4: The Universal Working Income Compared with Today’s Tax System

| Pre-tax income             | Income tax and National Insurance paid now | Tax paid under universal working income | Total tax reduction | Percentage tax cut |
|----------------------------|--|---|---------------------|--------------------|
| £11,700 (5th per centile)  | £393                                       | £0                                      | £393                | 100%               |
| £16,100 (25th per centile) | £1,771                                     | £1,312                                  | £459                | 26%                |
| £23,200 (50th per centile) | £4,043                                     | £3,584                                  | £459                | 11%                |
| £35,600 (75th per centile) | £8,011                                     | £7,552                                  | £459                | 6%                 |
| £75,000 (95th per centile) | £23,484                                    | £23,025                                 | £459                | 2%                 |

In total, the Government pledge implied a £380 boost in disposable income for a basic rate taxpayer compared with 2015. By contrast, the universal working income would give anyone earning £12,000 or more an extra £459 per year of spending power compared with the tax system today. And unlike cuts to income tax alone, the universal working income would also help those on the lowest incomes, currently earning between £8,424 and £11,850.

Indeed, while the publicly available data on National Insurance is somewhat patchy, we estimate that there are currently around *2.4 million people* who pay National Insurance but do not pay income tax. The universal working income would take them out of the direct tax net altogether.

If we compare the proposed universal working income with today's tax system (as in Table 4 on the previous page), we find that someone earning £11,700 would see their direct tax bill cut by 100 per cent. Someone earning £16,100 would get a 26 per cent tax cut. At £23,200, the decrease would be 11 per cent; at £35,600 it would be 6 per cent; and at £75,000 it would be 2 per cent.<sup>23</sup>

Thus, while we propose in subsequent chapters to iron out many of the incongruities within the tax system, the core of our proposal is to help the lowest-paid. A tax cut of this magnitude would go a long way towards making work pay for all direct taxpayers.

Yet the universal working income could have more than just a financial effect – it might also spur a psychological shift in the way both individuals and Government view Britain's tax system.

The current language of an “allowance” gives the impression that exempting some portion of a person's earnings from tax is an act of charity by the Treasury. Such an allowance is, then, not a right but a privilege – one that can be taken away if the Chancellor decides he is not feeling so generous after all.<sup>24</sup>

By contrast, the universal working income implies a sense of ownership – an idea that the first £1,000 a month you earn belongs to you and you alone, and is not available to the Government to fund its spending plans. Over time, it could lead to a more widespread acceptance of the notion that until people have earned enough money to enjoy a certain minimum standard of living, they shouldn't face any tax on their income at all.

This proposal also has political advantages.

Some Conservatives complain that the post-2010 rises in the personal allowance have been near-invisible electorally – that voters have felt the benefits financially, but not explicitly associated them with Government policy.

“Universal working income would give anyone earning £12,000 or more an extra £459 per year of spending power.”

Of course, this says little about whether the proposed universal working income is a good idea from an economic or policy standpoint – or, indeed, from a moral one. But politicians do have to win elections, and may therefore be sceptical about taking on a fairly expensive policy if the public is not going to give them much credit for it.

Sure enough, our polling found that while 56 per cent of people were aware of the rise in the personal allowance over the last decade, they tended to underestimate its extent.

Since 2008/09, the personal allowance has actually risen by £5,815 in nominal terms. Yet only 9 per cent of our poll respondents believed that the personal allowance had “increased by over £5,000”. Thirty per cent put the rise between £2,000 and £5,000, while 36 per cent simply didn't know.

More worryingly, 58 per cent said they had not personally noticed the impact of the much-increased personal allowance.

How do we square these findings with the strong support for the proposed universal working income?

One explanation may be that the language of the “personal allowance” leaves taxpayers cold. The shift to a universal working income therefore represents an opportunity to talk about tax thresholds in a different way – to make them part of a more inspiring vision for the future of the tax system as a whole.

What’s more, since the universal working income would, in a way, be a new policy – a higher, combined starting point for all direct taxes on earnings – it would have more political “cut-through” than a series of annual adjustments to an existing and long-established part of the tax system. Bold new policies are always more saleable than the mere continuation of old ones.

There may even be ways the Government could make the proposed universal working income more directly visible to taxpayers. For example, the annual tax statement issued by HMRC, and if possible workers’ monthly PAYE statements, should have the universal working income front and centre – as an emblematic new right for all workers.

“The annual tax statement issued by HMRC, and if possible workers’ monthly PAYE statements, should feature the universal working income front and centre.”

Some people are concerned that rises in the personal allowance have taken too many people out of income tax already, and that this is eroding the tax base while creating an unwelcome divide in the tax system between “makers” and “takers”.

The universal working income would not narrow the income tax pyramid any more than existing Government plans. It would, however, take a great many additional people – 2.4 million of them – out of paying employee National Insurance contributions.

Beyond that, we should accept that there is a limit as to how high any tax-free allowance should go. Narrowing the tax base too much can indeed be an unhealthy thing politically

and economically. Nevertheless, it is clear that we have not yet reached that stage – and that there is still something fundamentally wrong with taxing earnings that are not high enough to provide an established minimum standard of living.

A somewhat narrower tax base is surely a price worth paying if it means letting the working poor keep more of their hard-earned cash.

We should also be careful to remember that people are still taxpayers even if they don’t pay income tax and National Insurance. Those with very low earnings will be subject to VAT and other indirect taxes on their consumption, after all. This means that the “makers” and “takers” critique is somewhat overplayed.

Ultimately, then, the universal working income as proposed here should be seen as a starting point, rather than the end of the road. Once it is in place, the personal allowance and primary threshold should be formally linked to one another, and then tied to inflation, so that they rise automatically and in lockstep from 2021/22 onwards.

Indeed, as Britain’s fiscal situation improves, the Government should look to go further and faster towards the ultimate ambition of exempting any earnings below the full-time, national living wage from both income tax and National Insurance. That would be a giant stride towards making sure that work really does pay – for everyone.

**Policy Recommendation:** A combined threshold for income tax and employee National Insurance contributions should be set at £12,000. This universal working income should then rise automatically with inflation, starting in 2021/22. The cost of this reform would be approximately **£6.8 billion** relative to current policy commitments.

## 2. Improving Universal Credit

Whatever the problems with Britain's tax system, it has long been the case that the most punitive effective marginal tax rates are found in the benefits system.

A popular myth has arisen that Universal Credit was introduced as an austerity measure. In fact, the system was first proposed by Iain Duncan Smith and his allies at the Centre for Social Justice as a solution to precisely this problem – that the benefits system erected by Gordon Brown made it so difficult for people to make the transition from welfare into work.

Before the onset of Universal Credit, more than two million people faced a participation tax rate of at least 70 per cent – meaning that when they entered paid work, they would lose at least 70 per cent of anything they earned in tax and withdrawn benefits.<sup>25</sup> In many cases, the effective marginal tax rates these people faced as they increased their earnings were even more punitive.

When the Centre for Social Justice polled benefit claimants in 2008, they found that only 25 per cent of them thought they could be better off if they worked. Thirty-nine per cent of those polled actually thought that working (and earning money for themselves) would make them worse off financially.<sup>26</sup>

Of course, it was often hard for people to work out exactly how earning more money would affect them, because they depended on multiple benefits that had to be applied for

separately, which had different eligibility criteria and various income disregards and taper rates.

Nevertheless, benefit recipients were generally right to assume that working and earning more wouldn't necessarily do them a lot of good – in economic terms, at least.

The fundamental idea behind Universal Credit was to replace six different working-age benefits with a single payment, a single bureaucracy to deal with, a single earnings disregard, and a single taper rate. Universal Credit was thus intended to be simpler to understand, and designed to help ease the transition between welfare and work.

As of December 2017, the roll-out of Universal Credit was 11 per cent complete across Great Britain, but subject to significant regional variation.<sup>27</sup> The Government had initially planned to have Universal Credit fully implemented by 2017/18, but a series of delays have meant the roll-out will not be finished before March 2023.

The administrative problems that have held up the Universal Credit roll-out have been well-publicised. What's more, legitimate concerns have been raised about how long it takes claimants to receive their first Universal Credit payment, and the effect that has on their material circumstances. (It would clearly be more humane, for example, to offer payments up-front, and to pay people weekly rather than monthly.)

The primary problem, however, was that George Osborne, as Chancellor, sharply reduced the benefits intended to ensure that Universal Credit always left people better off as they



climbed the income ladder – sharpening the stick while shrinking the carrot.

Despite this, Universal Credit represents a clear improvement on the legacy benefits system, and its rollout should and must be completed. It represents the best answer we have to the great challenge of our day – not just how to move people into the labour market (something Britain has done extremely well at, to the point where the Office for Budget Responsibility now estimates that unemployment is about as low as it can realistically go), but to move them up the income ladder, by persuading them to take on more hours and ensuring they are rewarded for doing so.

Yet Universal Credit could still be doing much more to make work pay, and incentivise people to move from welfare into work. Indeed, the British public agree: strikingly, CPS polling has found that 50 per cent of Britons still believe that Universal Credit is a good idea, compared with only 29 per cent who think it is a bad one. Yet at the same time, 37 per cent of those polled – a very clear plurality – said Universal Credit was “not generous enough”. Only 15 per cent thought it “gets the balance about right”. And in our focus groups, those we talked to were very clear that everything possible should be done within the system to make work pay.

This chapter will explain how.

### How Universal Credit Works

A person’s Universal Credit entitlement is composed of several different elements. First, the standard monthly allowances: £251.77 for a single person under 25, and £317.82 for someone 25 or older; couples get £395.20 if they’re both under 25, and £498.89 if either of them is older. There are also allowances for first and second children (£231.67 per month each, or £277.08 per month for a first child born before 6 April 2017). There are additional allowances for disabled children, and adults with limited capability for work can get an extra £382.32 per month. Universal Credit will reimburse up to 85 per cent of childcare costs for working parents, subject to a monthly maximum of £646.35 for one child and £1,108.04 for two or more children.

The other main point – although there are many more wrinkles in the system – is the housing element. The number of bedrooms you can claim for is determined by your household circumstances. If you are renting in the private sector, your Universal Credit payment then includes a sum of money based on market rents in your area (called the Local Housing Allowance). In Northampton, where the median private sector rent is the same as it is in England as a whole, the maximum Universal Credit housing payments are as follows:

*Table 5: Maximum Universal Credit Housing Payments for Private Renters, Northampton Broad Rental Market Area*

| Type of Property   | Maximum Payment (£ per week) |
|--|------------------------------|
| Shared accommodation (applies to single, childless claimants under 35) | 66.32                        |
| One bedroom  | 103.05                       |
| Two bedrooms   | 130.10                       |
| Three bedrooms   | 139.84                       |
| Four bedrooms  | 187.14                       |

You can calculate the maximum Universal Credit entitlement for any given household by adding up the various payments they qualify for, including standard allowances, payments for children, childcare, disabilities, and housing.

For some families, the maximum entitlement (excluding childcare payments) is further subject to the benefits cap, which limits the total amount of benefits that a household can receive. Outside Greater London, benefits are capped at £20,000 per year for a couple or a single person living with their children, and £13,400 for a single person without children living with them. In London, the corresponding figures are £23,000 and £15,410, respectively.

Families working the equivalent of 16 hours a week or more, or in which someone is in receipt of a disability benefit or the carer’s allowance, are exempt from the benefit cap.

It is worth pointing out that child benefit and a few other benefits are also included within the cap. This means that the total amount of Universal Credit someone can receive might actually be somewhat lower than those benefit caps imply (households with children currently make up 93 per cent of those subject to the cap).

In any case, it would be wrong to equate the benefit cap with the maximum Universal Credit entitlement – in most cases the latter will be considerably lower than the former. Indeed, as of May 2018, the Government reported that only 65,800 households were subject to the benefit cap; this compares with 4.5 million working-age households who received more in benefits than they paid in tax in 2015/16.<sup>28</sup>

A household's maximum Universal Credit entitlement effectively represents the payment they will receive if they earn no additional income – provided, of course, that they adhere to any requirements they may be subject to in return for receiving benefits, such as having to look for a job.

The main innovation of Universal Credit comes in how it reduces the benefits that are paid as people enter the workforce and earn more.

|   |  |
|---|--|
| Standard allowance (over 25):             | $£317.82 \times 12 = £3,813.84$ per year |
| Child element (born before 6 April 2017): | $£277.88 \times 12 = £3,324.96$ per year |
| Housing element (two-bedroom flat):       | $£130.10 \times 52 = £6,765.20$ per year |
| <b>Total:</b>                             | <b>£13,908 per year</b>                  |

If Jane didn't do any paid work, but nevertheless fulfilled all the conditions of her Universal Credit claim, she would get £13,908 per year in Universal Credit. Indeed, since Jane is responsible for a child, she has a £198 per month work allowance, which means she can earn £2,376 per year without losing any of her Universal Credit.

But let's say that Jane starts working 20 hours a week at the national living wage (£7.83 per hour from April 2018). That would give her annual earnings of £8,143.20. The first £2,376 of that would be covered by Jane's work allowance,

For starters, claimants who have limited capability for work or who are responsible for a child have a monthly "work allowance" – an amount they can earn without suffering any withdrawal of benefits whatsoever. For a claimant receiving housing support, that allowance currently stands at £198 per month; claimants who do not receive housing support have a monthly allowance of £409.

Beyond that, the Universal Credit payment is tapered away at 63p for every £1 earned after tax. It is the interaction of this taper with the tax system that determines the effective marginal tax rates that a recipient of Universal Credit will face.

### Universal Credit and Effective Marginal Tax Rates

Let's imagine a household consisting of a single mother – Jane, aged 28 – and a school-aged child. They live in Northampton and receive the maximum Local Housing Allowance for a two-bedroom property. For the sake of simplicity, let's assume they don't receive any support for childcare costs. This household's maximum Universal Credit entitlement would be as follows:

but her benefits payment would be reduced by 63p for each additional £1 she earned. In this case, Jane has earned £5,767.20 over the work allowance, which means she loses £3,633.34 of Universal Credit. Her income is still below the National Insurance primary threshold and the income tax personal allowance, so she doesn't pay any tax.

Recall that Jane started off with £13,908. She then earned £8,143.20. That reduced her Universal Credit payment by £3,633.34. Ultimately, then, she is left with £18,417.86.

For doing £8,143.20 worth of work, her overall income has risen by £4,509.86. That implies a participation tax rate of 45 per cent. However, the effective marginal tax rate she faces on every new £1 she earns is 63 per cent – that is, the Universal Credit taper rate.<sup>29</sup>

Things get even more complicated as Jane earns more and starts paying tax. If Jane's earnings coincided precisely with the National Insurance primary threshold (£8,424 in 2018/19), she would lose £3,810.24 of Universal Credit, and have an overall income of £18,521.76. But what happens if she earns another £1,000 and starts paying National Insurance?

Well, Jane's National Insurance contributions (at 12 per cent of earnings over the primary threshold) come out of her pay first, leaving her with post-tax earnings of £9,304. Jane's Universal Credit taper is based on those post-tax earnings, which means she also loses £4,364.64 of Universal Credit. Her overall income is £18,847.36. (Notice that Jane's pre-tax earnings have gone up by £1,000, but her net income has only risen by £325.60.)

All this means she has been taxed at an effective marginal rate of 67 per cent – the rate

that Universal Credit recipients face when they are subject to benefit withdrawal and National Insurance at the same time.

The situation deteriorates further once income tax takes effect. Imagine, again, that Jane earns precisely at the level of the personal allowance (£11,850 in 2018/19). She'd pay £411.12 in National Insurance contributions, and lose £5,709.61 of her Universal Credit, giving her an overall income of £19,637.27.

Now let's add another £1,000 of earnings, so that Jane becomes an income-taxpayer. With £12,850 of earnings, Jane pays £531.12 of National Insurance contributions, and £200 of income tax – a total tax bill of £731.12. Jane also loses £6,138.01 of Universal Credit, which means her final income is £19,888.87.

In this case, Jane has earned an additional £1,000, but her net income has only risen by £251.60. She has been taxed at a 75 per cent effective marginal rate. This is the rate that Universal Credit recipients face when they are subject to benefit withdrawal, National Insurance, and income tax simultaneously. It is also the very opposite of “making work pay”.

*Table 6: Effective Marginal Tax Rates on Universal Credit Recipients, 63p Taper*

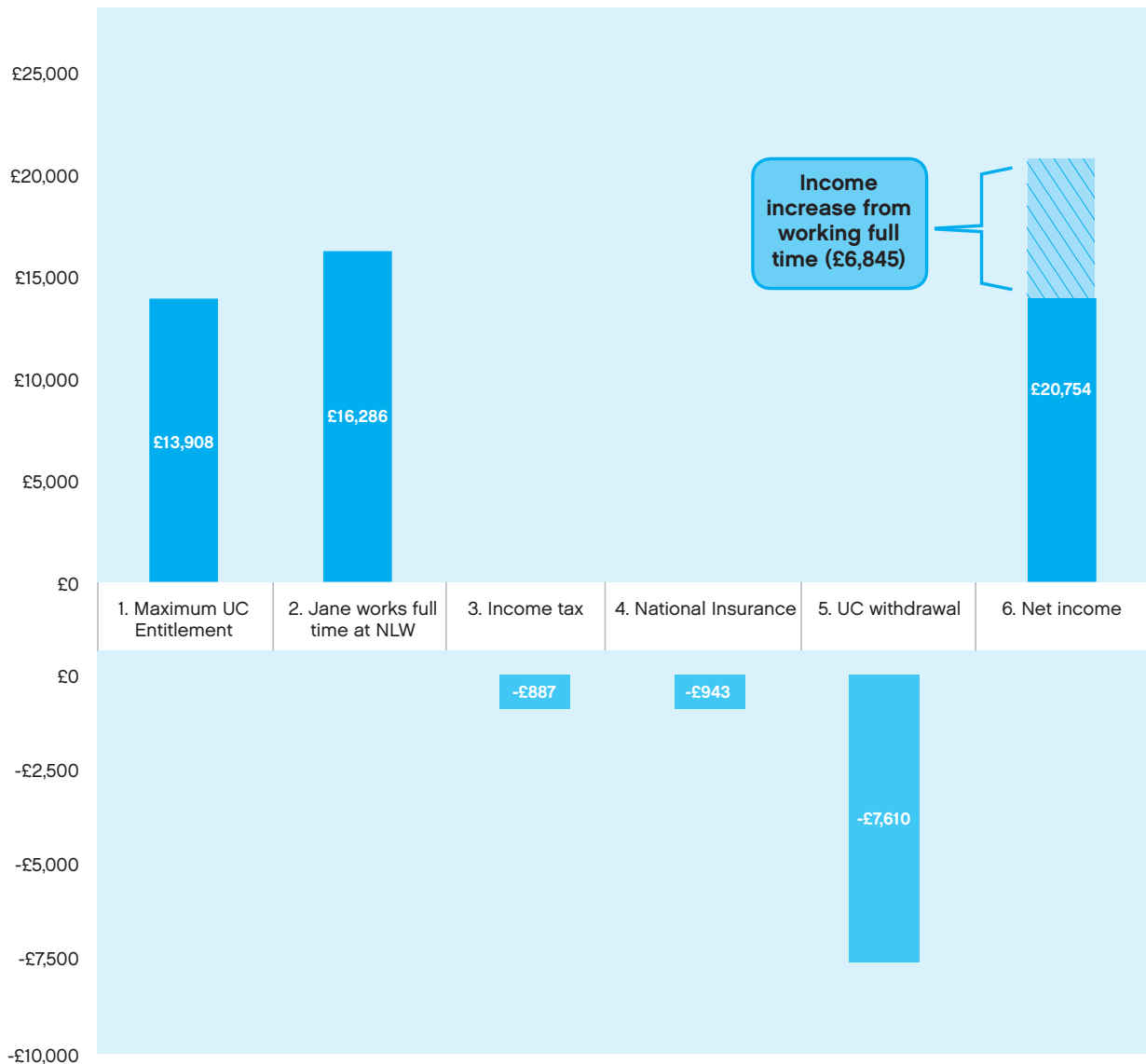
| Situation   | Effective Marginal Tax Rate (%) |
|---|---------------------------------|
| Earnings below any work allowance   | 0                               |
| Earnings subject to Universal Credit taper  | 63                              |
| Earnings subject to Universal Credit taper and National Insurance contributions                         | 67                              |
| Earnings subject to Universal Credit taper, National Insurance contributions, and basic rate income tax | 75                              |

At this point, it is worth considering the participation tax rate that Jane would face if she went from being completely unemployed to a having a full-time job – 40 hours a week at the national living wage. In that scenario, she would earn £16,286.40. She would pay £1,830.77 in tax, and lose £7,610.17 of Universal Credit, giving her a net income of £20,753.46.

By doing £16,286.40 worth of work, Jane has increased her net income by £6,845.46. That implies a participation tax rate of 58 per cent. And, of course, the effective marginal tax rate on the next £1 Jane earned would be 75 per cent. She would continue to face that effective rate until all her Universal Credit had been withdrawn. This would require pre-tax earnings



Figure 3: The Impact of Income Tax, National Insurance, and Universal Credit Withdrawal



just short of £31,000. In other words, a single mother, fighting her way up the income scale, is facing a higher effective tax rate on every extra pound she earns than a multi-millionaire. That cannot be right.

### Reducing the Taper Rate

The system described above clearly acts as a significant disincentive to work, making it hard for people to break the cycle of dependency and get on in the world.

Universal Credit has certainly improved matters. In 2016, the Institute for Fiscal Studies (IFS)

estimated that it would reduce the number of people facing participation tax rates in excess of 70 per cent from 2.1 million to 0.7 million, while also ensuring that 800,000 people who previously faced effective marginal tax rates in excess of 80 per cent would get to keep at least 23p of every £1 they earned.<sup>30</sup>

In 2017, a report from the Department for Work and Pensions found that Universal Credit recipients were three percentage points more likely to be in work six months after a claim than those receiving Jobseeker's Allowance.<sup>31</sup> They were also four percentage points more likely to have been in work at some point in that six-month period.

Nevertheless, there is still work to be done.

Some people have suggested that the best (and most cost-effective) way to ameliorate the situation would be to increase the work allowances within Universal Credit.

This, indeed, was the approach taken by the Chancellor in his recent Budget. As well as additional help for those transitioning from the old benefits system to Universal Credit, he promised to increase work allowances by £1,000 a year, at a cost of £1.7 billion.

This is obviously welcome news, in that it gives more money to those trying to get off welfare into work. Yet it still leaves us with the problem we have identified – of working claimants losing most of the extra money they earn when they increase their hours or progress in their job. They just get to keep more of their money before reaching that point.

In other words, while it would improve participation tax rates (i.e., the cost of moving from unemployment into work), it would not improve the effective marginal tax rate of anyone currently earning above the level of the work allowance. Furthermore, as outlined above, work allowances are not available to all Universal Credit claimants.

We therefore suggest an alternative – or, if the Government is feeling particularly generous, a complementary package.

Given our focus on making work pay across the earnings scale, we propose that the Government should instead – or also – reduce the Universal Credit taper rate. A sensible – but still ambitious – goal would be to reduce the Universal Credit taper rate from 63p to 50p. This would mean that Universal Credit claimants got to keep at least half of every pound they earned as they moved into work, right up until they earned enough to pay tax.

Recent CPS focus groups suggest that such a policy would definitely prove popular, provided that it was promoted in the right way. Our attendees had a negative view of Universal

Credit's implementation – but strongly backed the underlying idea that we should do as much as possible to get people off benefits and into work. Indeed, they saw work as a highly moral matter, not just an economic one. The general view was that anyone who was fit and able could get a job, and should be encouraged to work as hard as possible.

As a consequence, our proposal to strengthen work incentives by cutting the Universal Credit taper rate to 50p was very well-received. The people we spoke to – a mixture of Conservative and Labour voters in two marginal constituencies – believed that a lower taper would encourage people to work harder and longer. In their view, this was a very good thing.

So how would cutting the Universal Credit taper affect Jane, our illustrative Universal Credit claimant?

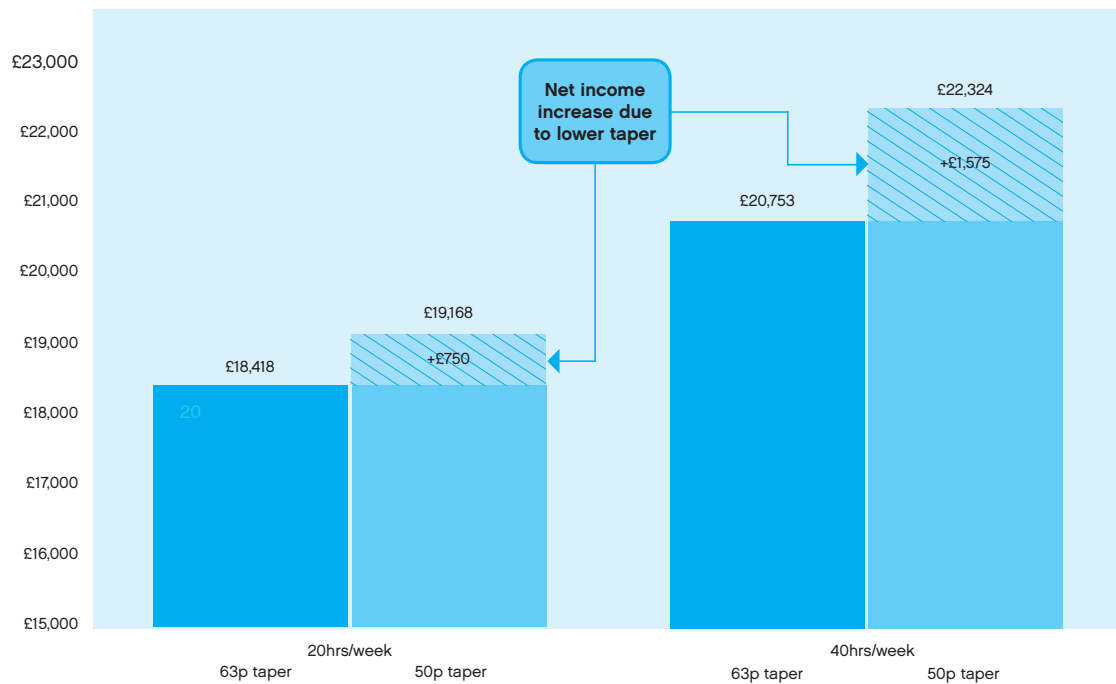
Firstly, rather than losing £3,633.34 per year of Universal Credit when she went from not working at all to working 20 hours a week at the national living wage, she would lose just £2,883.60. As a proportion of her income, that is an extraordinary improvement.

“Rather than losing £3,633 per year in Universal Credit when she went to working 20 hours a week, Jane would lose just £2,883.”

Overall, reducing the Universal Credit taper to 50p would make Jane just under £750 a year better off compared with the current system. And rather than facing a participation tax rate of 45 per cent when she went to work part-time, her participation tax rate would only be 35 per cent – another huge improvement.

It would be a similar story when Jane takes a full-time job, working 40 hours a week at the national living wage. Instead of losing £7,610.17 of Universal Credit, she loses £6,039.82. As a result, her net income rises from £20,749.46 to £22,323.81 – an increase of £1,574.35, or 8 per cent. Her full-time participation tax rate falls from 58 to 48 per cent.<sup>32</sup>

Figure 4: Jane's Total Net Income, 63p vs 50p Taper



What about Jane's effective marginal tax rates? She would still have a zero per cent effective marginal tax rate if she earned less than her work allowance. Beyond that, she would face a rate of 56 per cent when the 50p Universal Credit taper overlapped with National Insurance, and 66 per cent when it overlapped with both National Insurance and income tax.

Obviously, if the reform outlined in the previous chapter was adopted, and the primary threshold for National Insurance were raised to match the income tax personal allowance, that 56 per cent effective marginal tax rate would cease to exist. In that case, the structure of effective marginal tax rates on Universal Credit recipients would look like Table 7, opposite.

Universal Credit recipients who were only subject to the 63p taper (not National Insurance or income tax) before the proposed reforms would see their effective marginal tax rate cut by 13 percentage points. Those who were previously subject to the 63p taper and National Insurance would see their effective rate fall by 17 percentage points. For those previously subject to the taper, National Insurance, and income tax, the effective marginal tax rate would fall by 9 percentage points.

Table 7: Effective Marginal Tax Rates on Universal Credit Recipients, 50p Taper

| Situation  | Effective Marginal Tax Rate (%) |
|--|---------------------------------|
| Earnings below any work allowance  | 0                               |
| Earnings below £12,000 subject to Universal Credit taper only                                | 50                              |
| Earnings above £12,000 subject to Universal Credit taper, income tax, and National Insurance | 66                              |

It is still the case, regrettably, that workers earning above £12,000 and coming off Universal Credit would face marginal tax rates above 50p. This is the one exception, throughout this report, to our universal principle that everyone should keep the bulk of every extra pound they earn. But due to the complexities of the benefits system, it is impossible to remedy this for every single household without spending a gargantuan amount of money – or seeing

Universal Credit taper off so gradually that it is still being claimed by those whose incomes are far above the national average, which would be both impractical and unpopular.

Our proposed reforms would, however, still represent a giant stride towards making work pay for everyone. And a particularly happy outcome of the reduction in the Universal Credit taper rate is that the greatest improvement in work incentives goes to those currently working 21 hours or so per week at the national living wage.

Before the reforms proposed here, such workers would face a 67 per cent effective marginal tax rate if they increased their hours; after reform, their effective marginal tax rate falls to 50 per cent. This is particularly important because, as mentioned above, Britain has an underemployment problem more than it has an unemployment one. Lower-wage men, in particular, seem to be working fewer hours today than in the past.<sup>33</sup>

The UK has a truly enviable record of job creation: unemployment currently stands at 4 per cent, the lowest for more than 40 years. It is therefore unlikely, at least in percentage terms, that we will be able to expand the workforce *much* further – though we should still do our utmost to move people into work.

Instead, the key challenge is not unemployment but underemployment and low pay. This reform to Universal Credit would be a real way to make work pay for those who need help the most.

**Policy Recommendation:** The Government should drastically reduce the Universal Credit taper rate to 50p for every £1 earned after tax over any applicable work allowance. This reform would cost **£3.3 billion a year** to implement if done instead of the planned increase to work allowances, or **£5 billion** if done in addition.<sup>34</sup> However, that figure would be reduced if people responded to significantly improved work incentives by increasing their hours and earnings.

## Further Considerations

Some will doubtless object that the effective marginal tax rates faced by Universal Credit recipients would still be too high after the proposed reduction in the taper rate. Others might object that reducing the taper rate so significantly spreads Universal Credit too far up the income distribution, and makes too many middle-class households potentially eligible for Government support.

Both objections have some merit. As mentioned above, a 66 per cent effective marginal tax rate for a single parent on the minimum wage is still higher than anyone would like. At the same time, a 50p taper rate means that some households with high maximum entitlements could earn far more than the national average before losing their Universal Credit entitlement.

The latter problem is, fortunately, more theoretical than real. Various Universal Credit rules significantly reduce the likelihood that middle-class households will be able to claim. For example, any savings above £6,000 reduce entitlement, and those with more than £16,000 in savings are not eligible at all. Homeowners will also have lower maximum entitlements because they do not receive support for housing costs.

The bureaucratic demands of claiming Universal Credit are also such that few middle-class professionals would endure them for the sake of the comparatively small amounts on offer – unless they had an overwhelming need for the money.<sup>35</sup> Certainly, those we have consulted within Government do not view this as a major obstacle to reducing the taper rate.

The proposal outlined here significantly reduces both participation tax rates and effective marginal tax rates for those moving from unemployment to work, and then from part-time to full-time employment. It fulfils our guarantee that the tax system should make sure people keep the majority of what they earn – while making sure that the benefit system does not claw enough of it back to make the whole thing pointless. And it tackles the greatest problem in our labour market: the fact that for all too many of the working poor, work does not currently pay enough for them to seek more of it.

## PART II – THE WORK GUARANTEE

### 3. Redesigning the Marriage Allowance

The first two chapters of this report focused on how to make work pay for everyone – with particular reference to those at the bottom of the income distribution.

For example, while the universal working income would represent a significant and welcome tax cut for every worker, its benefits would be most keenly felt by the “just about managings”, as a way to cut their cost of living, offer them a more attractive pathway towards employment, and give them more control of their money and their lives.

These sections of the report are the most important – they are the ones which are responsible for the lion’s share of our suggested spending changes, and which would have the greatest impact.

But it is not only at the bottom end of the income spectrum that work does not pay – where the fundamental guarantee we seek to provide that the tax system will always let you keep more than half of what you earn is in jeopardy. Across the tax system, there are points at which incentives are distorted and behaviour altered – where it does not pay people to work more, and as a result they are in many cases not doing so.

The next three sections of this report focus on that simple idea: that the Government should never take more than half of every extra pound someone earns in tax. This is what we term the work guarantee – a key principle that should be embedded in the tax system.

Certainly, it is an idea that strikes a deep chord with the public: those who agree with it outnumber those who disagree by more than three to one. And those who strongly approve outnumber those who strongly disapprove by five to one.

The idea is understandably popular with Conservative voters. But even Labour voters approve by two to one. Both wealthy ABC1 and hard-pressed C2DE voters strongly back this principle. And our focus groups were even more emphatic that no matter how rich you were, it was wrong to expect you to work more for the Government than for yourself, and that no one should pay more than half of every extra pound in tax.

The next three short chapters focus on these areas. Each of the three proposals is very much worth doing in its own right – and none of them would cost the Treasury significant sums. But if we want to fulfil our guarantee that work will always pay, all three should be tackled.

*Table 8: Approval/Disapproval for the Work Guarantee (% of YouGov Respondents)*

|                           | ALL       | CON       | LAB       | LIB<br>DEM | ABC1      | C2DE      |
|---------------------------|-----------|-----------|-----------|------------|-----------|-----------|
| <b>Strongly approve</b>   | <b>28</b> | 35        | 21        | 30         | 28        | 26        |
| <b>Tend to approve</b>    | <b>33</b> | 36        | 33        | 37         | 34        | 33        |
| <b>Total approve</b>      | <b>61</b> | <b>71</b> | <b>54</b> | <b>67</b>  | <b>62</b> | <b>59</b> |
| <b>Tend to disapprove</b> | <b>13</b> | 11        | 18        | 17         | 14        | 11        |
| <b>Strong disapprove</b>  | <b>5</b>  | 2         | 7         | 4          | 5         | 4         |
| <b>Total disapprove</b>   | <b>18</b> | <b>13</b> | <b>25</b> | <b>21</b>  | <b>19</b> | <b>15</b> |
| <b>Don't know</b>         | <b>22</b> | 15        | 22        | 11         | 19        | 26        |

## How the Marriage Allowance Works

Introduced in 2015, the marriage allowance lets people transfer up to £1,190 of unused personal tax allowance to their spouse, provided that the spouse earns more than them but is, nevertheless, a basic-rate taxpayer. In other words, the spouse must be earning between £11,850 and £46,350 (in 2018/19) to take advantage of the allowance.

Where one partner earns less than £10,660 and the other earns more than £13,140, the marriage allowance effectively saves the couple £238 per year in income tax.

Here's how it works. Say that you earn £20,000. The first £11,850 of that would be free of income tax. The next £8,150 would be taxed at 20 per cent. Your total income tax bill would be £1,630. Now let's say you have a spouse who only earns £10,000. They have £1,850 left of their personal allowance, which means they are able to transfer £1,190 to you. That increases your personal allowance from £11,850 to £13,040, which in turn means you only pay basic rate tax on £6,960 of income. This leaves you with an income tax bill of £1,392, which is £238 lower.

Note in the example above that the transferred allowance itself is not actually the amount of personal allowance the lower-earning partner has left over. Instead, it is a flat 10 per cent of the standard personal allowance (rounded up to the nearest £10). The lower-earning partner then has their own personal allowance reduced by that same amount – which for the 2018/19 tax year means their allowance would go down to £10,660.

If the lower-earning partner in the previous example were earning £11,000, they would in fact be dragged into the income tax system, paying £68 so that their spouse could gain £238 from the marriage allowance. This seems a peculiar way to operate a tax system.

There is a further problem: the marriage allowance is withdrawn in its entirety as soon as one partner becomes a higher-rate taxpayer. At that threshold, an extra penny

of income costs a married couple £238 in additional tax. It is possible to think of this as another tax band, just 1p wide, in which income is taxed at a rate of 23,800 per cent.<sup>36</sup> To see any increase at all in post-tax income after crossing the higher rate threshold, the taxpayer in question would have to increase their earnings by almost £400.

Admittedly, the number of couples affected by this quirk in the tax system is likely to be small. In total, about 4.2 million of the UK's 12.4 million married couples (and civil partners) are thought to be eligible for the marriage allowance. But by June 2018, only 2.6 million couples had claimed it.<sup>37</sup> It may be that the allowance is poorly advertised, or simply too complicated to be readily understood. It is also possible that the tax break is not significant enough to make the bureaucratic rigmarole of applying worthwhile.

“To see any increase at all in post-tax income after crossing the higher rate threshold, the taxpayer in question would have to increase their earnings by almost £400.”

In any event, at least 1.5 million eligible couples have not yet signed up for the marriage allowance. Of those that have, only a small fraction of them are likely to face losing it by becoming higher rate taxpayers – not least because, according to the IFS, those receiving the marriage allowance are “typically in the lower-middle of the income distribution”.<sup>38</sup> They are also quite likely to be pensioners, whose incomes are unlikely to rise significantly in retirement.<sup>39</sup>

Nevertheless, the slow take-up of the marriage allowance, the fact it can drag some lower-earning spouses into the income tax system, and the extremely high effective marginal tax rate that it creates at the boundary between basic rate and higher rate income tax are all indicative of a poorly designed policy. The country can surely do better.



## Options for Reform

The most obvious response to the marginal rate problems caused by the marriage allowance, as well as its lacklustre take-up, would be to abolish it. Further across-the-board increases in the personal allowance and the National Insurance threshold could ensure that people were not left financially worse off as a result. Based on the current level of marriage allowance take-up, you would expect its abolition to save the Treasury £400 million or so.

However, it is unlikely that this proposal would meet with political approval. A desire to recognise marriage in the tax system featured in the Conservative election manifestos of 2010 and 2015, and has assumed a degree of totemic importance among some Conservative politicians and activists.

It helps that the policy is popular. A 2017 ComRes poll for the Centre for Social Justice found that 75 per cent of British adults agreed with the statement that “the Government should recognise marriage in the tax system with a specific allowance for low- and middle-income married couples”.<sup>40</sup> Thirty-three per cent agreed strongly, while only 15 per cent were opposed to the idea.

What’s more, there are sound economic reasons to support some recognition of marriage and civil partnerships in the tax system. A 2010 IFS report suggested that 68 per cent of British couples faced a “couple penalty” in the tax and benefit system, which averaged £45 per week.<sup>41</sup> For working couples with children, things were worse – some 95 per cent faced a couple penalty, averaging £85 per week. (This penalty occurs, according to the IFS, when a couple pay more tax or receive fewer benefits when living as a couple than they would if they lived apart.)

It is important not to overplay those findings. Sometimes there is a good reason to treat individuals differently from one another based on the characteristics of their household: the unemployed spouse of a billionaire could technically be said to face a couple penalty, for

example. Nevertheless, the couple penalty *is* real and ought to be addressed in a pragmatic way.

It is even more striking that the British tax system is, by international standards, rather ungenerous towards families. At the OECD average wage, a one-earner married couple with two children will pay twice as much income tax as a similar family in the United States – and 11 times as much as a German family.<sup>42</sup> Overall, the UK’s income tax burden on this type of household is a third higher than the OECD average.

Britain does better when other taxes on earnings (including employer contributions) and cash benefits are factored in, but our tax and welfare system clearly does not recognise marriage to the same extent as its OECD counterparts. In the OECD as a whole, an average one-earner married couple with two children has a net tax rate 10 percentage points lower than an equivalent single person; in the UK, the difference is only half as much.<sup>43</sup>

One way of preserving the marriage allowance but dealing with the effective marginal rate problem it presents would be to taper it away more slowly, rather than having it disappear abruptly once one partner becomes a higher rate taxpayer. For example, the maximum benefit could be reduced by £1 for every £20 earned over the higher rate threshold. That would mean that no one receiving the marriage allowance would face an effective marginal tax rate in excess of 47 per cent (when combining income tax, National Insurance, and the effect of the marriage allowance withdrawal) if they became a higher rate taxpayer. With this approach, the benefit conferred by the marriage allowance would be tapered away between income levels of £46,350 and £55,110 in the 2018/19 tax year.

Tapering the marriage allowance would fulfil our guarantee to make work pay, but is an awful lot of trouble to go to for a tax break that is only worth £238 a year in the first place. It would complicate an already poorly understood part of the tax system and make administering it significantly more difficult.

Furthermore, any kind of taper would inevitably maintain some degree of regressivity – your effective marginal tax rate would still jump up when you hit the higher rate threshold, and then drop down again once the marriage allowance was completely withdrawn.

Another straightforward option would be to make the marriage allowance universal – that is, to make it available to all married taxpayers, regardless of their income level. This would deal with the marginal rate issue, as there would be no cliff edge or taper left to worry about. It would also simplify the marriage allowance and perhaps encourage more widespread take-up. Eligibility would be a simple matter: if you were married and your spouse earned less than the personal allowance, you would qualify. These are all good things.

There's a strong case for saying, moreover, that Britain's individual-based tax system was always meant to include a transferable personal allowance. Nigel Lawson called for one when he first proposed independent taxation in his 1985 budget speech (until 1990, a wife's income was treated as belonging to her husband for tax purposes). The 1986 "Green Paper on Reform of Personal Taxation" suggested transferable allowances for married couples as well. However, the transferable allowance was watered down when personal taxation was implemented, and then chipped away at by successive Chancellors until it was eventually abolished by Gordon Brown.

Nevertheless, the case made for transferable allowances in the 1980s still applies today – put simply, families in which one parent looks after the children while the other works face a significant tax disadvantage compared with a family in which the same amount of income is split between two working parents. Transferable allowances are the best way of dealing with this problem. They also recognise the fact that what matters most to people is often the family finances – not just their personal situation. From a moral standpoint, it seems right that the tax system should acknowledge this in some way.

Unfortunately, there is a problem with making the marriage allowance universal: namely, that it would represent a new tax break for all better-off married couples. That might seem like an inefficient use of funding at a time when Government budgets are tight, and spending commitments continue to grow.

“Tapering the marriage allowance would fulfil our guarantee to make work pay, but is an awful lot of trouble to go to for a tax break that is only worth £238 a year in the first place.”

A sensible alternative – at least for now – would be to make the marriage allowance universal in terms of income levels, but to simultaneously target it more tightly at households with characteristics that make them likely to contain someone earning less than the personal allowance – such as those containing a young child or an adult with other caregiving responsibilities.

This clearly fits with the underlying rationale for a transferable allowance: that one member of the couple may quite legitimately – even admirably – decide to give up work, or to work only a limited number of hours, so that they can care for a child or an elderly or disabled relative.

We therefore suggest that the Government should replace the marriage allowance with a new *family responsibility allowance*. The simplest way to determine eligibility would be to base it on some existing benefit, such as claiming child benefit for a child aged five or younger, or being eligible for the carer's allowance.

If those criteria were met, one member of a married couple could transfer their unused personal allowance – subject to some maximum amount – to their higher-earning spouse.

To ensure that the transferred allowance didn't give a larger benefit to higher rate taxpayers than to basic rates ones, relief could be given in the form of a tax credit worth 20 per cent



(equivalent to the basic rate of income tax) of the allowance transferred.<sup>44</sup>

Here's an example of how it might work. Adam earns £40,000 a year. His wife, Beth, is a stay-at-home mum, looking after Charlie, aged three. Beth only works a few hours a week and has employment income of £5,000. Under normal circumstances, Adam would pay £5,630 in income tax. However, because Beth is claiming child benefit for Charlie, she and Adam are eligible for the family responsibility allowance. She can therefore transfer her unused personal allowance (capped at 20 per cent of the total personal allowance, or £2,370 in 2018/19) to Adam, who then gets a credit equivalent to 20 per cent of that unused allowance against his tax liability. This reduces his tax bill by £474.

There are a few things to notice about this scenario. The first is that the tax system is acknowledging not just marriage by itself, but also an important family responsibility that often goes along with it. Second, by targeting the new allowance at households in which it makes particular sense for one member of the couple not to work, you can afford to make a larger slice of the personal allowance transferable than under the existing marriage allowance. In other words, for those who qualify, the family responsibility allowance would be a more generous system.

Third, once Charlie turned six and was attending school full-time, Beth and Adam would no longer be eligible for the family responsibility allowance. As a result, Beth would have a stronger incentive to work more and increase her income. This makes economic sense even if, in the long run, we would prefer to have fully transferable allowances as a matter of principle.

Replacing the marriage allowance with a family responsibility allowance on this model would, according to our calculations, cost the Government a little over **£200 million a year**.<sup>45</sup> That seems like a small price to pay for turning a benefit that currently isn't working very well into one that offers targeted help to those couples with the greatest responsibilities and cost pressures – thereby giving them greater control of their budgets at some of the most difficult times in their lives.

**Policy Recommendation:** The Government should roll the marriage allowance into a new family responsibility allowance, which would allow married couples with young children or significant care responsibilities to transfer a capped amount of unused personal allowance from the lower-earning to the higher-earning partner. Although higher- and additional-rate taxpayers would be eligible for this new allowance, they would only ever get tax relief equivalent to 20 per cent of the transferred amount.

## 4. Reforming the High Income Child Benefit Charge

As any parent can attest, having children and having control of your life are two concepts that rarely go together.

The Government has traditionally recognised that having children puts significant cost pressures on a family, and the state should help out – not just as an act of generosity, but to ensure that people are incentivised to carry on producing the taxpayers of the future.

The demands of austerity, however, led George Osborne to argue that child benefit should be means-tested rather than universal – that those wealthy enough to pay high rates of tax could well afford to subsidise their children themselves.

Yet the way in which the change was brought about has had unintended consequences. Two of these, for our purposes, are particularly alarming.

The first is that the more children you have, the more sharply you are punished by the tax system – facing eye-watering marginal tax rates that are as high as those seen for people trying to climb their way out of Universal Credit, and are set to get higher over the coming years.

And the second is that those opting out of the system risk – without realising it – losing a proportion of their eligibility for the state pension, threatening their finances in retirement.

The withdrawal of child benefit may not be putting people off having children (although there could be a marginal effect). But it is certainly distorting the tax system in ways that punish people for working – and pushing middle-income professionals to shape the size of their family according to the dictates of Whitehall rather than their own circumstances and desires.

### How Child Benefit Works

Until the high income child benefit charge was introduced by George Osborne in 2012, child benefit had been a genuinely universal benefit, generally paid every four weeks to all families with children. In 2018/19, child benefit stands at £20.70 per week for a first child, and £13.70 per week for any additional children. A family with two children would thus receive £1,788.80 of child benefit in a year.

The high income child benefit charge was intended to save the Government money by targeting child benefit at families on relatively low incomes. Initially, Osborne planned to withdraw child benefit altogether once a member of the household became a higher-rate taxpayer. This would have created a dramatic “cliff edge” in the tax system, whereby an extra penny earned could theoretically lose a household thousands of pounds. The high income child benefit charge therefore represented a softening of the Government's position – instead of losing child benefit in one go, it would be withdrawn gradually over a specified band of income.

As things stand, the charge kicks in once a member of the household earns £50,000. That taxpayer is then subject to a charge equivalent to 1 per cent of the child benefit their family receives for every £100 over £50,000 that they earn. Someone earning £55,000 will pay back half of their family's child benefit; someone earning £60,000 will pay it back in its entirety.

Two points are worth noting here. The first is that the high income child benefit charge operates through HMRC's self-assessment system. If you earn more than £50,000 and your household receives child benefit, then you must file an annual self-assessment in order to pay the charge.

When the charge was introduced, HMRC estimated that it would require 500,000 additional taxpayers to file self-assessments – a significant increase in the bureaucratic cost of the tax system.

That compliance burden has consequences. Before its introduction, the IFS estimated that the high income child benefit charge would cost around 1.1 million families an average of £1,300, potentially saving the Government £1.5 billion a year.<sup>46</sup> Yet in a recent presentation, IFS researcher Stuart Adam suggested that, in 2016/17, only 840,000 families lost out: 291,000 paid the charge through income tax self-assessment, while 550,000 opted to stop receiving child benefit payments.<sup>47</sup> That leaves 300,000 families unaccounted for. Perhaps a few are trying to cheat the system by not paying the high income charge; most are probably just unaware of its existence.

The greater worry ought to be about the families that have opted out of the child benefit system. That can be a problem, because claiming child benefit is what ensures a parent who earns less than the "lower earnings limit" still receives National Insurance credits for the first 12 years of their child's life.<sup>48</sup> National Insurance credits matter because they determine your state pension entitlement – you need 35 years of National Insurance credits to receive the full state pension. Every year you miss will cost you 1/35th of the full amount.

This means that if a stay-at-home parent isn't claiming child benefit because their partner would face the high income child benefit charge, they risk losing thousands of pounds of future retirement benefits.

Indeed, based on recent HMRC data,<sup>49</sup> pension firm Royal London estimated earlier this year that:

“Around 63,000 will be losing out on credits which would boost their state pension; the total amount in future pension rights lost since 2013 is estimated to exceed £1 billion ... A woman who had a child after the rules changed in January 2013 and has not claimed child benefit could have gaps in her NI record for 2013/14, 2014/15, 2015/16, 2016/17 and 2017/18 ... based on a typical 20-year retirement, this could cost such a woman over £23,000 in lost state pension rights.<sup>50</sup>”

There is a way around this problem: it is possible for families to claim child benefit at a zero rate, which means they are treated as receiving child benefit for National Insurance purposes, but do not have to pay the high income child benefit charge. But how many parents are aware of this option?

The second point to bear in mind about the child benefit charge is how uneasily it sits within Britain's individual-based tax system. The charge is paid once one member of the household earns £50,000 or more. A household in which two people each earn £49,999 can, quite legitimately, keep all its child benefit. A single-earner household, on the other hand, will start paying the charge at £50,000 and lose all its child benefit at £60,000. The unfairness of this situation hardly needs spelling out.

Furthermore, the effect of the high income child benefit charge is to create several additional tax rates which apply to recipients of child benefit earning between £50,000 and £60,000, and vary depending on how much child benefit they are entitled to.

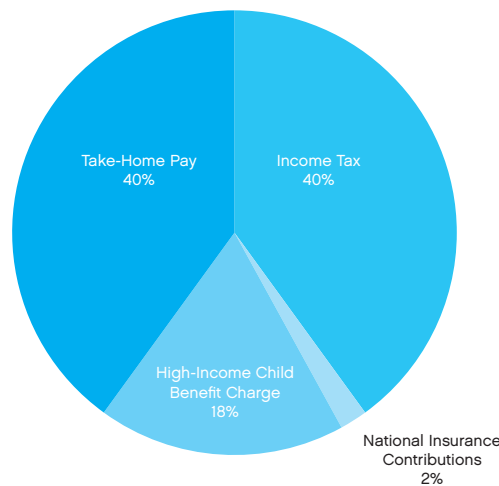
Imagine, for example, a taxpayer who has two children, and earns £50,000 a year. This taxpayer will pay £8,360 in income tax, and receive £1,788.80 in child benefit.

What happens, though, if his salary rises by £5,000? First, his income tax bill rises to £10,360, which is straightforward enough. But now he also has to pay the high income child benefit charge. Because he has earned £5,000 more

than £50,000, the charge is equal to 50 per cent of his child benefit.<sup>51</sup> That's another £894.40 in tax, giving us a total tax bill of £11,254.40.

The taxpayer, therefore, has earned an additional £5,000, but paid an extra £2,894.40 in tax. His effective income tax rate is therefore 58 per cent; add National Insurance contributions, and you get an effective marginal tax rate of 60 per cent.

Figure 5: Earnings Between £50,000 and £60,000, Two Children; Where Does the Money Go?



Notice that the effective marginal rate you face depends on how much child benefit you receive, which in turn depends on how many children you have. The more children, the more child benefit, and the higher the effective marginal rate.

Indeed, if you combine income tax, National Insurance, and the high income child benefit charge, you get the effective marginal tax rates for parents earning £50,000-60,000 shown in Table 9 (right).

These rates are clearly very high – indeed, almost punitive. And there is no easy way to defend it. At best, it represents rather careless tax design; at worst, it looks like a cynical but politically expedient way to grab a few extra billion for the Treasury.

Even worse, the peculiar design of the high income child benefit charge suggests that

this problem is likely to get worse as time goes by.

Remember that you lose 1 per cent of your child benefit for every £100 you earn over the threshold. If child benefit rises, then by definition you must lose a greater cash amount of child benefit for every additional £100 you earn – and that means your effective marginal tax rate will be higher.

Table 9: The Tax Effect of the High Income Child Benefit Charge

| Number of children | Effective marginal tax rate (%) |
|--------------------|---------------------------------|
| 1                  | 53                              |
| 2                  | 60                              |
| 3                  | 67                              |
| 4                  | 74                              |

This hasn't been a problem yet, since child benefit has only risen by 40p per week (for the first child) since the charge came into effect. But let's imagine child benefit started to rise at 2 per cent a year. If we also assume that only higher rate taxpayers will face the high income child benefit charge – which seems a reasonable assumption<sup>52</sup> – then the effective marginal tax rate for a family with two children would be 62 per cent after five years, and 64 per cent after ten.

For a family with four children, those figures would be 77 per cent and 81 per cent, respectively – the kind of marginal tax rates to have made Denis Healey proud.

Effective marginal rates of that magnitude would be difficult to justify for anyone, no matter how well-off. But for families barely into the ranks of higher-rate taxpayers, any justification is nigh on impossible. The high income child benefit charge is therefore a deeply unfair policy that ought to be substantially reformed at the earliest opportunity.

### Options for Reform

One way to deal with the perversities of the high income child benefit charge would be to turn child benefit into a genuinely means-tested benefit.

The IFS proposed two ways of doing this in their 2012 “Green Budget”.<sup>53</sup> The basic idea in each case was to integrate child benefit with Universal Credit.<sup>54</sup> The first version of their proposal would combine child benefit with Universal Credit but withdraw it using a separate taper – at a rate of 1 in 8.7 against net income over £36,000. The second version would simply withdraw child benefit along with the rest of Universal Credit.

The virtue of both these proposals from the Treasury's point of view is that they save money – more money, in fact, than the existing high income child benefit charge. The IFS estimated that their first option, with the separate taper, would save £4.6 billion in 2013/14; the second option, complete

integration with Universal Credit, would save £5.5 billion.

Another advantage of the IFS proposals is that they would target taxpayer resources more tightly on the neediest households. Finally, because Universal Credit is part of the benefits system, eligibility and withdrawal of an integrated child benefit would be based on household income rather than individual income, thus eliminating one of the great injustices of the existing high income child benefit charge.

But for all its advantages, the IFS proposal does not fully address the underlying problem of excessively high effective marginal tax rates.

“A family with four children could face the kind of marginal tax rates that would have made Denis Healey proud.”

Let's take the version with the separate taper first. A £36,000 threshold would, adjusted for inflation, be around £40,000 today; the proposed 1 in 8.7 withdrawal rate would mean households lost around £11.50 for every £100 they earned over that threshold.

Imagine, then, a household in which two people earn £20,000 each; they have two children, and therefore receive £1,788.80 in child benefit. In 2018/19, they would each pay £1,630 in income tax, for a household income tax bill of £3,260. They would also keep all their child benefit.

Now imagine they each earn an extra £2,500, raising their household income to £45,000. In this case, they would each pay £2,130 in income tax, for a total of £4,260. They would also lose £575 of their child benefit.<sup>55</sup> Their total “tax” bill has increased by £1,575, while their income has increased by £5,000. That implies a marginal rate of 31.5 per cent; add National Insurance contributions at 12 per cent and you have an effective marginal tax rate of 43.5 per cent.

On the one hand, that rate is far lower than those created by the high income child benefit tax charge. On the other, it potentially affects many relatively less well-off households. It would be a very brave Government that decided to introduce what could amount to a significant tax increase for basic rate taxpayers with children.

It is also worth noting that, depending on how income is distributed within the household, the effective marginal tax rate could be higher: a single-earner household subject to this form of child benefit withdrawal might well pay higher-rate income tax alongside it, which would produce an effective marginal tax rate (including National Insurance contributions) of 53.5 per cent.

The second version of the IFS proposal – that is, the full integration of child benefit with Universal Credit, and its withdrawal via the standard Universal Credit taper – accentuates both its benefits and its drawbacks. The cost savings of such a policy would be greater, and the focus of resources on the most needy more pronounced; at the same time, the middle class would lose out even more.

An alternative way to address the problems caused by the high income child benefit charge would be to make child benefit universal again. This is effectively the polar opposite of the IFS proposal outlined above.

And there *is* a strong case for a universal child benefit. For one thing, it is clear that households with children have significantly higher costs than households without – and this is true across the income distribution. It seems fair that the tax system should recognise this in some way. Indeed, the Child Poverty Action Group reported in 2012 that every European country except for Italy offered a universal child benefit or tax allowance.<sup>56</sup>

There is also a compelling case for universal benefits more generally. They are easier and less costly to administer. They remove from politicians the temptation to play favourites, giving to their supporters and taking away

from their detractors. Most importantly for the purposes of this report, universal benefits avoid creating the high effective marginal tax rates that are inherent in means-testing, and which also bedevil efforts to withdraw benefits via the tax system.

Indeed, if child benefit were made universal again – if the high income child benefit charge was abolished – it would cease to have any impact on effective marginal tax rates whatsoever. There would no longer be punitive tax rates on income between £50,000 and £60,000, no matter how many children you had.

Yet making child benefit universal again has a couple of clear downsides. The most obvious one is that it would cost the Treasury somewhere in the region of £3 billion. The other problem is that introducing the high income child benefit charge in the first place caused an almighty political row. It is quite likely that a Government without a majority will be keen to avoid reopening that particular can of worms.

“ There would no longer be punitive tax rates on income between £50,000 and £60,000, no matter how many children you had. ”

So if making child benefit a genuinely means-tested benefit would be too harsh on the middle classes, and making it universal again would be too costly and politically undesirable, what is the answer?

By a process of elimination, we are left with reforming the high income child benefit charge so that it does not impose such punitive effective marginal tax rates.

Fundamentally, that requires spreading the impact of the high income child benefit charge over a wider band of income. It would also be important to redesign the charge so that rather than losing a percentage of your total child benefit with each £100 you earn over the threshold, you instead have to repay a specified cash amount for every additional



£100 you earn. Failing to make that change would leave intact the perverse situation in which your effective marginal tax rate at any given point in the income distribution depends on the size of your family.

Let us take as our starting point the fundamental work guarantee that runs through this report – that we should make work pay by ensuring that everyone, even higher rate taxpayers, gets to keep more than half of every additional £1 they earn.

With higher rate income tax at 40 per cent, and National Insurance contributions above the upper earnings limit at 2 per cent, you could accomplish this with a high income child benefit charge of £7 for every £100 earned over £50,000, up to the point at which all of a household's child benefit had been paid back.

The highest earner in a one-child family would face an effective marginal tax rate of 49 per cent on the first £15,400 of income in excess of £50,000; their tax rate would then drop back to 42 per cent until the withdrawal of the personal allowance kicked in. It's the same story for a high-earner in a two-child family, except that they would face a 49 per cent tax rate on the first £25,600 of income over £50,000.

With three children, the 49 per cent effective marginal tax rate band would extend over £35,800 of earnings; with four children, the figure would be £46,000.

With five or more children, things could get a bit trickier, since in principle, the high earner in a household would still be paying the high income child benefit charge when the withdrawal of the personal allowance kicked in at a salary of £100,000. By itself, the withdrawal of the personal allowance (discussed in the next chapter) creates an effective marginal tax rate of 62 per cent. Adding our reformed high income child benefit charge would take that rate to 69 per cent, which is much too high.

Nevertheless, you could make the reformed high income child benefit charge work for all families quite straightforwardly, by simply

capping the total amount of child benefit you ever had to pay back at £3,500. Doing so would ensure that the high income child benefit charge only applied to earnings between £50,000 and £100,000, and avoid any harmful interactions with other aspects of the income tax system, such as the withdrawal of the personal allowance or the additional rate.

Moreover, there are surely very few households with five or more children and someone earning more than £100,000, so the cost of such a concession would be trivial.

Of course, any attempt to claw back child benefit from higher earners through the tax system will still disadvantage single-earner households in which someone earns just over the threshold, as compared with dual-earner households in which two people each earn just under the threshold. In such cases, some better-off families will continue to escape the child benefit charge, while other families with much lower incomes have to pay it. Yet this problem seems to be inherent to Britain's individual-based tax system. Although the Treasury and HMRC could, theoretically, create a separate self-assessment system for the high income child benefit charge that was based on combined household income, the cost and bureaucratic burden would be prohibitive.

Still, the proposal made here to reform the high income child benefit charge represents a significant improvement on the current system. Crucially, it would ensure that even those subject to the charge would keep more than half of the next £1 they earned. The suggested reform is therefore a sensible and necessary way to make work pay.

**Policy Recommendation:** The high income child benefit charge should be reformed, so that it is levied at a rate of £7 per £100 earned over £50,000.<sup>57</sup> The charge would apply until all of a household's child benefit had been paid back, subject to a cap on the total charge of £3,500. Compared with the existing high income child benefit charge, the reformed version would cost the Treasury approximately **£1 billion per year**.

# 5. Ending the Withdrawal of the Personal Allowance

One of the greatest peculiarities of the British tax system is that the highest headline rates of tax – if you discount the additional impact of benefits withdrawal for the low-paid – are not paid by the richest.

Instead, the highest rate comes when your salary rises above £100,000 – as HMRC starts to claw back the personal allowance that saw your first £11,850 in earnings be free of income tax (though not, as discussed above, National Insurance).<sup>58</sup>

It is obviously not a political priority for the Government – or any Government – to focus on the needs of those earning triple-figure salaries rather than those struggling to get by. But for single-earner families with multiple dependents, living in expensive parts of the country such as London and the South-East, this kind of income is hardly plutocratic.

There is significant evidence – not least anecdotal, from MPs' conversations on the doorsteps – that the £100,000 threshold is a source of pain and aggravation to many people, who either reduce their hours to avoid crossing it, or engage in complicated and (for the Treasury) revenue-sapping attempts to divert their income elsewhere, whether that is pumping surplus salary into pension contributions, or shifting the structure of their employment to get their income another way.

In other words, the withdrawal of the allowance breaches the fundamental work guarantee that you should always keep at least half of every extra pound you earn. It gives people less control of their lives, discouraging them from working more or moving jobs for a higher salary. And by distorting the tax system and labour market, it raises far less revenue than might be expected.

Fortunately, there is an extremely simple fix.

## How Withdrawal of the Allowance Works

The policy of withdrawing the personal allowance from those earning more than £100,000 a year came into effect in April 2010, having been announced by Alistair Darling in his 2009 Budget. Darling's successor, George Osborne, decided not to reverse its introduction when he took office, perhaps reasoning that it would be politically useful to prevent high earners from benefiting from the planned increases in the personal allowance.

The withdrawal of the personal allowance works as follows: once your adjusted net income exceeds £100,000, you lose £1 of your personal allowance for every £2 that you earn. Once your income reaches £100,000 plus twice the personal allowance – that is, £123,700 in 2018/19 – you have no personal allowance at all.

Let's say, by way of illustration, that you earn £100,000 this year. The first £11,850 of that is free of income tax. Income between £11,850 and £46,350, the higher rate threshold, is subject to income tax at 20 per cent, so you



pay £6,900 of basic rate tax.<sup>59</sup> From the higher rate threshold to £100,000 you pay income tax at 40 per cent – so that's £21,460 in higher rate tax, and a total income tax bill of £28,360.

Now imagine you earn £105,000. That's £5,000 over £100,000, which means you lose £2,500 of your personal allowance. So your first £9,350 is free of income tax, your income between £9,350 and £43,850<sup>60</sup> is taxed at the basic rate (£6,900), and then your income between £43,850 and £105,000 is taxed at the higher rate (£24,460). Your total income tax bill comes to £31,360.

Notice that as your income has risen by £5,000, your income tax bill has risen by £3,000. This means that while, on paper, you are still a higher rate (40p) taxpayer, your effective marginal income tax rate – that is, the slice taken by the state on the next £1 you earn – is actually 60 per cent. Once you include National Insurance contributions, the true effective marginal tax rate is 62 per cent.

It is perfectly legitimate, then, to think of the withdrawal of the personal allowance as creating an additional, hidden tax band of 62 per cent between £100,000 and £123,700. This means that the top of the tax system has a strange structure, as set out in the table below.

*Table 10: Combined Rates, Income Tax and National Insurance, Factoring in Withdrawal of Personal Allowance*

| Income (£)      | Effective Rate (%) | Notes   |
|-----------------|--------------------|---|
| 46,350–100,000  | 42                 | Income above the higher rate threshold (income tax) and the upper earnings limit (National Insurance). Income tax paid at 40%, plus National Insurance at 2%. |
| 100,000–123,700 | 62                 | Withdrawal of personal allowance creates effective income tax rate of 60%, plus National Insurance at 2%.   |
| 123,700–150,000 | 42                 | Withdrawal of personal allowance complete, so income tax rate drops back to 40%. National Insurance at 2%.  |
| 150,000+        | 47                 | Income above additional rate threshold, so income tax at 45% and National Insurance at 2%.  |

There are three obvious problems with this rate structure.

First, there is something dishonest about claiming, as the Government does, that we have three rates of income tax (basic, higher, and additional) when in fact the withdrawal of the personal allowance creates an extra rate on a relatively narrow band of income over £100,000.

Leaving aside, for the moment, the question of whether tax rates themselves should be higher or lower, it seems inarguable that people should at least know what tax rate they

are paying. Government should not try to hide their means of raising revenue from the people who foot the bill.

Second, the 62 per cent effective marginal tax rate created by the withdrawal of the personal allowance breaks the progressive structure of the tax system, so that the highest rates are not, in fact, faced by those with the highest incomes. As things stand, someone earning £110,000 actually pays a higher marginal tax rate than someone earning £1,100,000. That doesn't seem right, or logical. One can only surmise that the Government thought those earning £100,000-£123,700 were an easier

revenue-raising target than the highest-earning taxpayers.

In this, at least, the Government is probably correct: someone earning more than £100,000 is comfortably within the top 5 per cent of earners in the UK, but is also likely to be considerably less mobile than the super-rich. Indeed, the Treasury seems to have assumed when introducing the withdrawal of the personal allowance that taxable income elasticity – that is, the extent to which taxable income tends to fall when effective marginal tax rates rise – is very much lower for those earning between £100,000 and £150,000 than it is for those earning over £150,000.<sup>61</sup>

This makes sense: in simple terms, the wealthier you are, the more you are able to reduce your taxable income in response to tax rises, whether by working less or contributing more to a pension (or, in the most extreme scenario, by leaving the country altogether).

But none of that makes it right for Government to have a partly regressive tax structure on earnings. Indeed, the logic that says the tax burden should fall most heavily on those least able to avoid it would also justify swingeing tax rises for the “just about managing” coupled with much lower taxes for the global elite.

Taxpayers with six-figure salaries do not, of course, make the most sympathetic victims. But the principle here – that taxes should be progressive, or at least proportional – is an important one.

The third problem with the tax rate structure shown in Table 10 is that 62 per cent is, quite simply, a very high tax rate. On a moral level, there is a sense that when the Government takes more than half of the next £1 you earn, you are really working for them, rather than for yourself.

In more concrete terms, it is worth remembering that from 1988/89 to 2002/03, the combined income tax-National Insurance rate on the highest earners was 40 per cent. From 2003/04 to 2009/10, it was 41 per cent. The top rate leapt to 51 per cent in 2010/11, and

then to 52 per cent for 2011/12 and 2012/13. Since then, the combined rate on the highest earners has been 47 per cent. In every year since 1988, in other words, the formal top rate of tax has been significantly below the 62 per cent rate that currently applies to those hit by the withdrawal of the personal allowance.

“It is worth remembering that from 1988/89 to 2002/03, the combined income tax and National Insurance rate on the highest earners in Britain was only 40 per cent.”

The present situation, then, is neither just nor sensible. And the public appears to accept this: our YouGov polling shows that more voters think this tax rate is too high than think it is about right, and far more than think it is too low – a sentiment supported by focus group research.

### Options for Reform

If our goal were simply to reduce the effective marginal rate faced by people earning over £100,000, the most obvious approach would be to withdraw the personal allowance more slowly – perhaps over the full £50,000 of income between £100,000 and the additional rate threshold.

Instead of a 50 per cent taper rate (i.e., losing £1 of personal allowance for every £2 earned), 1 per cent of the personal allowance could be withdrawn for every £500 earned over £100,000. With the personal allowance at its current level, that would imply losing £118.50 of allowance for every extra £500 of income.

Recall that under the existing tax system, someone earning £100,000 would pay a total of £28,360 in income tax, while someone earning £105,000 would pay £31,360. Withdrawing 1 per cent of the personal allowance for every £500 earned over £100,000 would reduce that tax bill to £30,834. For an extra £5,000 earned, our taxpayer would pay an additional £2,474 in income tax – an effective income tax rate of 49.5 per cent.

This appears to fulfil our fundamental guarantee that it should always pay to work. But there are some issues with this proposal.

First, taxpayers earning £100,000 to £150,000 would face a total marginal rate, including National Insurance contributions, of 51.5 per cent – in other words, they would still lose more than half of every additional pound they earned. There is no way to avoid this without also raising the additional rate threshold: as things stand, eliminating the personal allowance before the additional rate kicks in requires you to have an effective marginal tax rate in excess of 50 per cent.

The alternative, letting the withdrawal of the personal allowance overlap with the onset of the additional rate, would just create a further problem: another effective marginal tax rate, 56.5 per cent, on a small band of income over the additional rate threshold.

Second, withdrawing a set percentage of the personal allowance for every increment of income has an inherent flaw: as the personal allowance rises, so too will the amount withdrawn for each additional £500 earned. That means that the effective marginal tax rate between £100,000 and £150,000 will increase every year as the personal allowance goes up.

Finally, a lower withdrawal or taper rate might smooth the marginal rate structure, but it wouldn't completely eliminate the problems with the existing system. Any policy that withdraws the personal allowance adds complexity to the tax system, and creates a "stealth" income tax rate outside the generally acknowledged rate structure. Nor can a lower taper rate, by itself, deal with the regressivity caused by the withdrawal of the personal allowance.

Fortunately, there is no point in policymakers tying themselves in knots trying to make the withdrawal of the personal allowance work within a fair, progressive income tax framework – because there is a much more straightforward alternative at hand.

The simplest option, of course, would be to stop withdrawing the personal allowance at all. There's a strong case for saying that it was a bad idea from the outset, and should simply be retained by all taxpayers. That would simplify the tax system, make it more transparent, and help to restore a progressive tax structure. It would also be administratively straightforward.

The trouble, of course, is that abolishing the withdrawal of the personal allowance would be politically difficult. Partly because it would have an upfront cost to the Treasury of as much as £3 billion in lost revenue, and partly because the benefit would go to those at the upper end of the income distribution.

Such largesse in the name of tax simplification might be justifiable if the Government were flush with money – but in the context of continued deficits and worrying demographic trends, it seems distinctly foolhardy, not to mention politically ill-judged in the absence of further tax reforms.

“ The cost of abolishing the withdrawal of the personal allowance could be significantly offset by lowering the starting point for the additional rate from £150,000 to £100,000. ”

However, there is again a simple solution. The cost of abolishing withdrawal of the personal allowance could be significantly offset by lowering the starting point for the additional rate from £150,000 to £100,000 (the threshold should, thereafter, be linked to inflation).

Clearly, no one earning less than £100,000 would be affected by such a change. Those earning between £100,000 and £123,700 (the point at which the personal allowance is currently completely withdrawn) would benefit on a rising scale, with the tax cut peaking at £3,555 (an 8 per cent reduction) for the highest earner in that bracket. The individual gains would then begin to fall again, reaching £2,240 (a 4 per cent tax cut) for someone earning £150,000. Everyone earning more than

that would benefit by the same cash amount – the percentage gains would obviously be lower the further up the income distribution you went.

Compared with simply abolishing the withdrawal of the personal allowance, a combined policy of getting rid of that withdrawal and lowering the threshold for the 45p rate of income tax would cut the gains to the highest-paid taxpayers in half, in cash terms.

Lowering the threshold for the 45p rate to £100,000 would also reduce the cost of abolishing the withdrawal of the personal allowance by at least £1 billion.

However, this figure assumes that abolition would have no effect on behaviour. Such an assumption is by no means clear-cut. Indeed, the Treasury's own estimates of taxable income elasticity at different points in the income distribution (cited above) imply that taxable incomes among those currently affected by the withdrawal of the personal allowance should rise by more than 6 per cent in response to its abolition.

Any such effect, if it materialised, would help to further offset the cost of ending the withdrawal of the personal allowance – perhaps by more than £1.5 billion.

It is therefore reasonable to suggest that ending the withdrawal of the personal allowance while also dropping the additional rate threshold to £100,000 would end up costing the Treasury less than £500 million per year in annual revenue. It would also help ensure that we had a tax system which served, from top to bottom, to make work pay.

**Policy Recommendation:** The withdrawal of the personal allowance should be abolished. This should be accompanied by a simultaneous fall in the additional rate threshold from £150,000 to £100,000. Our modelling suggests that this reform would have an initial cost of **less than £500 million** in foregone revenue.

## PART III – THE FINANCES

### 6. How to Pay for It

It is all very well to argue that the Government should do everything it can to make work pay. But what happens when the rebuttal comes back: yes, but can we afford it?

It is the easiest thing in the policy world to call for ministers to make tax cuts, and the hardest thing to explain how they can actually be paid for. Despite substantial improvement in the public finances since 2010, the Government is still set to borrow £25.5 billion (1.2 per cent of GDP) in the current fiscal year – that's more than £70 million per day.<sup>62</sup>

The fiscal situation is projected to improve further in the short term, with public sector net borrowing set to fall below 1 per cent of GDP in 2022/23. What's more, the Office for Budget Responsibility (OBR) now estimates that the UK's current budget – which excludes capital spending on things like new roads, railways, or school buildings – was in surplus in 2017/18 for the first time since 2002.<sup>63</sup> Public sector net debt is set to fall by around 10 per cent of GDP over the next five years.

None of this, however, is cause for complacency – much less for a new era of fiscal largesse. For one thing, the Government's June announcement of a new funding settlement for the National Health Service significantly altered forward projections of healthcare spending, which already makes up very significant proportion of total Government spending. The OBR believes that healthcare spending in

2022/23 will be £20.5 billion higher as a result of the Government's June announcement than it would otherwise have been.<sup>64</sup>

In the longer term, things look even less rosy. In its July 2018 "Fiscal Sustainability Report", the OBR forecast that thanks to an ageing society, rising healthcare costs, and various unfunded liabilities (such as public sector pensions), the UK's primary budget deficit will rise from 0.3 per cent of GDP in 2022/23 to 8.6 per cent of GDP in 2067/68, assuming no changes in policy. Government debt would also rise from 2023/24 onwards, reaching 282.8 per cent of GDP in 2067/68, and continuing to rise thereafter.<sup>65</sup>

Of course, any fifty-year fiscal projection of this sort is highly artificial. In practice, policy would have to change long before any such dire fiscal predictions became reality. Yet the mere possibility that such disastrous fiscal outcomes could come to pass should be all the encouragement we need to address our vast unfunded liabilities, and to think carefully about how our post-war welfare state can be adapted to the demands of an ageing, 21st century society.

Britain's fiscal outlook, in other words, should give us serious pause before we undertake any policy reforms that could plunge the country back into the days of higher deficits and rising debt. The present temperate fiscal situation – imperfect as it may be – has been hard won over the last eight years, and the progress we have made must not be squandered now, just as the prospect of balanced budgets and falling public debt finally comes into view.

## Finding the Money

How, then, should the proposals advocated in this report be funded?

First of all, we need to recognise that economic growth is absolutely essential to our long-run fiscal health. As prime ministers from Thatcher to Cameron have pointed out, the only way to fund the NHS and other public services is via a growing economy.

One of the best ways the Government can support economic growth is by ensuring that the tax and welfare system is as rational and non-distortionary as possible, and that it encourages people to work and invest. And a pro-growth tax and welfare system should not be riddled with punitive effective marginal tax rates that discourage work and give people an incentive to manage their financial affairs in uneconomic ways – exactly the problem that this report sets out to solve.

To the extent that the policies proposed here simplify, rationalise, and smooth Britain's messy effective marginal tax rate structure, they represent a contribution to our long-run economic health – even if they may prove costly at the outset.

Moreover, it is certainly reasonable to expect good tax and welfare policies to have income and growth effects that will partially offset their

expected revenue costs: there is a long history, from Nigel Lawson's cuts to higher rate tax to George Osborne's reduction of corporation tax, of lower taxes generating greater economic activity, and paying for themselves.

We at the Centre for Policy Studies believe whole-heartedly in this phenomenon – the so-called “Laffer curve”. It is not, however, sensible to rely on the Laffer curve to immediately and entirely fill any fiscal hole – which is why we have been extremely cautious, throughout this report, in minimising our estimates of the beneficial revenue effects of the reforms we propose.

We must, therefore, identify some ways in which Government can offset the cost of reforming the personal tax and welfare system – either by raising additional tax revenues, or by reducing public spending commitments over the medium term.

If all the reforms outlined in previous chapters were adopted, it would cost the Government roughly **£13.5 billion** in annual revenue, at least in the short term, or **£11.8 billion** if the cut to the Universal Credit taper rate was carried out instead of the planned increase to work allowances (see Table 11).

Clearly, this is a significant sum. Yet it is not one that is beyond our national means – even with the existing commitment to the NHS. Below are some suggestions on measures that could be

Table 11: Estimated Cost of Policy Recommendations

| Policy Recommendation  | Estimated Cost            |
|--|---------------------------|
| Raise National Insurance threshold to create a universal working income                                | £6.8 billion              |
| Cut the Universal Credit taper rate from 63 per cent to 50 per cent                                    | £3.3 billion / £5 billion |
| Replace the marriage allowance with a new family responsibility allowance                              | £200 million              |
| Reform the high income child benefit charge  | £1 billion                |
| Eliminate the withdrawal of the personal allowance and lower the additional rate threshold to £100,000 | £500 million              |
| <b>Total</b>   | <b>£11.8bn / £13.5bn</b>  |



taken to fund our reform package – though there are plenty of others that could serve as alternatives.

## Pension Tax Relief

In a series of reports for the Centre for Policy Studies, financial expert Michael Johnson has made the case for radical reform of Britain's pensions system, with a particular focus on the way that tax relief is applied to pension contributions.<sup>66</sup>

Johnson describes this tax relief as “the lowest hanging fruit in Whitehall”, noting that despite its enormous cost – some £47 billion in 2016-17<sup>67</sup> – the existing system does not seem to be very effective as an incentive to save for retirement. Britain's overall household savings rate has fallen to its lowest level (4.9 per cent) since records began. And according to the Financial Conduct Authority, 38 per cent of working age adults (some 15 million people) claim not to have any private pension savings.<sup>68</sup>

Part of the problem is that pension tax relief is poorly understood. When Opinium polled 1,197 adults for PwC in 2015, they found that 59 per cent were put off saving more by a lack of understanding of the pension system.<sup>69</sup> Among women, that figure rose to 63 per cent; for younger workers, it was 64 per cent. Since then, the rules around retirement saving have only become more complicated.

Another issue is that pension tax relief is poorly targeted, with 68 per cent of the benefit going to higher- and additional-rate taxpayers.<sup>70</sup> Indeed, Johnson points out that the top 1 per cent of earners – those who least need an incentive to save – probably receive twice as much tax relief as the lower-earning *half* of the working population.<sup>71</sup>

The upshot is that, according to one poll, only 1 in 7 people say that the current tax relief on pension contributions incentivises them to save.<sup>72</sup>

Many will object at this point that the income tax relief on pension contributions is actually just a case of deferred taxation, rather than a straightforward tax break.

In theory, this is quite correct. The idea behind the existing system of tax relief is that you should be able to save for old age tax-free, but then pay tax at your usual marginal rate when you convert your pension pot into income and draw it down in retirement.

In practice, though, things aren't so straightforward. For one thing, as Johnson has pointed out, only around 1 in 7 of those who receive higher rate tax relief while working ever pay higher rate tax in retirement. The recent abolition of compulsory annuitisation – the “pension freedom” for which Johnson and the Centre for Policy Studies were leading advocates – has compounded this particular issue, since it allows retirees to control their pension drawdowns so as to minimise their tax bill.

“Britain's overall household savings rate has fallen to its lowest level (4.9 per cent) since records began.”

Another problem, at least from the tax perspective, is the “tax free lump sum”, which allows savers to take 25 per cent of their pension pot completely tax free at the age of 55. This means that a high-income worker could, for example, get 40 per cent tax relief on their pension contributions at age 54, and then withdraw them completely tax-free the following year. In other words, the existing system of pension tax relief is only “taxation deferred” in the loosest sense.<sup>73</sup>

In his most recent work for the Centre for Policy Studies, Johnson has therefore suggested that we turn the current framework for pension tax relief on its head. Rather than giving tax relief when people contribute to a retirement fund, and then taxing subsequent pension income, we should abolish up-front tax relief while also exempting retirement saving from any further tax liability.

In other words, saving for a pension should be just like saving in an ISA: you save out of taxed income, but your savings are not taxed as they grow or when they are later withdrawn for consumption.

From the Government's perspective, the advantage of such a system is that it would significantly increase tax revenues today. From the saver's perspective, an ISA-style system is easier to understand and makes retirement planning more straightforward, as you no longer have to worry about what tax rate you might face in your old age.

Indeed, one of the great advantages of shifting to an ISA-style approach is that it would give Britain a single framework for all forms of lifetime saving. This would represent an enormous simplification. It would demystify pensions and should encourage greater take-up, particularly among less financially sophisticated savers.

It is telling that when the same Opinium survey referenced above asked people to choose the most appealing pension system from a range of options, only 27 per cent of working adults chose the current system. An ISA-style approach was the most popular alternative, with 41 per cent support.

Of course, the problem with an ISA-style approach to pensions is that, all things being equal, it removes the up-front incentive to save, while still requiring people to lock a portion of their earnings up until they reach retirement. Economically, up-front tax relief and the ISA framework are more-or-less equivalent. Psychologically, however, the reformed system could prove a tough sell – no matter how financially rational it might be.

Johnson's response to this concern is twofold. First, he suggests that the Government should offer a capped "bonus" on retirement savings. He offers two alternatives here: either the Government should offer a 25 per cent bonus on the first £10,000 saved each year, or a 50 per cent bonus on the first £2,000 saved, coupled with a 25 per cent bonus on the next £6,000. The first option is simpler; the second option is more progressive, and may do more to encourage those lower down the income distribution to start putting money away. In either case, people would be free to keep saving beyond those caps, but further contributions would not attract any bonus.<sup>74</sup>

The second part is to relax the rules about pension withdrawals. Withdrawals would be penalty-free

once the saver reached a certain age. Johnson would also allow penalty-free withdrawals earlier in life if the funds were used to provide a deposit for a first home purchase. That possibility would make saving significantly more attractive to younger workers, for whom the desire to buy a house looms far larger than the decades-distant prospect of retirement.

“An ISA-style approach to pensions was the most popular model, with 41 per cent support.”

It would also be possible to take money out of one's retirement fund for any other purpose. However, the withdrawal would attract a 20 per cent charge. That would allow the Government to claw back the bonus it had paid out, while also providing a significant disincentive to ill-advised withdrawals – to fund general lifestyle spending, for instance.<sup>75</sup>

It is a well-known element of behavioural economics that people tend to be very loss-averse; requiring that people actively choose to give up 20 per cent of their savings in order to access them early would therefore impose a significant check. Nevertheless, knowing that they could access your savings at any point, if necessary, would help sceptical savers take that vital first step towards a comfortable retirement – namely, actually putting money aside.

These ideas are not just attractive and compelling; they would also save a significant fraction of the current pensions tax relief bill. The exact revenue increase that adopting an ISA-style framework for retirement saving would yield depends on the precise details of the scheme adopted – particularly the structure of the savings "bonus" and the overall limit on contributions – as well as some complex assumptions about the anticipated behavioural response to the reformed system.

However, Johnson estimates that abolishing up-front tax relief on pension contributions, while moving to an ISA-style system with capped bonuses and more relaxed withdrawal rules, would save the Government **at least £10 billion** per year.

## National Insurance Contributions

In 2016, the Office of Tax Simplification published a report examining options for the “closer alignment of income tax and National Insurance”.<sup>76</sup> It proposed a package of reforms that would greatly increase the coherence and rationality of the system, while also potentially generating additional tax revenue. Several of its proposals merit immediate consideration.

For starters, employees’ National Insurance contributions are currently calculated separately for each pay period (i.e., weekly or monthly), without any reference to previous pay or National

Insurance contributions made that year. National Insurance is also assessed independently for each separate employment – in other words, if someone has two jobs, each one is considered in isolation for National Insurance purposes.

The result of this approach is that people with the same total earnings in a given year could actually end up paying very different amounts of National Insurance depending on how many employers they worked for and how their earnings were distributed over the course of the year. The Office of Tax Simplification offers the following example:<sup>77</sup>

Table 11: Same Earnings, Different National Insurance Contributions (2015–16)

| Income  | IT   | NICs | Total Tax |
|---|------|------|-----------|
| £15,000 received from one employer spread equally over 12 months                    | £880 | £832 | £1,712    |
| £15,000 received from one employer in one month with no income the rest of the year | £880 | £572 | £1,452    |
| £15,000 received from three different employers spread equally over 12 months       | £880 | £0   | £880      |

Notice that the amount of income tax paid is the same in each case. That is because income tax – unlike National Insurance – is assessed on an *annual, cumulative, aggregated* basis. And according to the Office of Tax Simplification, putting National Insurance on the same footing was “overwhelmingly the most common reform sought” by the wide range of stakeholders it surveyed.

The peculiar structure of National Insurance belongs to a time when people were less likely to change jobs, work multiple jobs concurrently, or have jobs with fluctuating incomes. It is, as a result, an anachronism that is increasingly out of place in a flexible, digitised economy. Harmonising National Insurance’s “basis of charge” with that of income tax would represent a sensible modernisation of the tax system; it would also be simpler to understand and less

complex to administer. Such a reform could raise around **£500 million** in additional revenue.

There would, of course, be some losers from such a move – most notably those currently earning just below the National Insurance primary threshold in several different jobs. However, while HMRC estimates that moving to an annual, cumulative, aggregated basis of charge would result in 6.3 million people paying more National Insurance, they also suggest that 7.1 million people would pay less.<sup>78</sup>

What’s more, those that benefit would tend to be lower earners overall. And the significant rise in the National Insurance threshold proposed in Chapter 1 of this report – to deliver the universal working income – would offset losses stemming from changes to National Insurance’s basis of charge.

Another reform recommended by the Office of Tax Simplification concerns the treatment of taxable benefits-in-kind for National Insurance purposes. As a rule, benefits-in-kind are subject to income tax regardless of the form they take.

For National Insurance purposes, however, tax treatment depends both on the form that the benefits take, and on the particular contractual arrangements that give rise to them. In some cases, both the employer and the employee pay National Insurance on the benefit in kind; in other cases, only the employer pays.

This adds pointless complexity to the tax system and distorts decisions about how employees should be compensated. Harmonising the National Insurance rules on benefits-in-kind with those of income tax would not only be entirely sensible, but also raise approximately **£435 million a year**.

### Public Spending Savings

Total Government spending in the United Kingdom is set, in 2019/20, to reach £834 billion a year.<sup>79</sup> It is hardly beyond the wit of Whitehall to come up with ways in which at least some of that money could be spent more effectively, without any harm coming to frontline public services.

This, indeed, is the purpose of an exercise the Centre for Policy Studies has been engaged in over recent months with the assistance of several Members of Parliament. We have identified a dozen spending cuts that would cumulatively unlock more than **£30 billion** a year in savings over the next spending review period.

For example, benchmarking government administration costs to those in the private sector could result in savings of more than **£3 billion a year**. A recent CPS report by Matt Warman MP on local government highlighted expert analysis showing that moving to a unitary

authority model in local government could save **£580 million a year**.<sup>80</sup> Warman also pointed to research by the County Councils Network suggesting that **£7.2 billion a year** could be saved by devolving spending decisions to councils.

In addition, our forthcoming savings report has identified wasteful and economically distorting government subsidies in a number of areas, which could be eliminated with the savings recycled into our proposed tax and welfare reforms. That is without mentioning the enormous savings that could result from better use of the portfolio of public sector land: even a limited disposal programme could fund the bulk of our suggested reforms through the next spending review period and well beyond.

“ We have identified a dozen spending cuts that would cumulatively unlock more than £30 billion a year in savings over the next spending review period. ”

We recognise, of course, that the Government has many competing claims on its resources. Yet we would argue that ensuring work always pays should be its highest priority, and that there are more than adequate resources available to fund the package we suggest.

The reforms outlined in this report are not just fiscal, but moral. They rebuild the tax system on the basis that it will always pay you to work – that you will have more control of your finances, and your future. They offer millions of hard-pressed families help with their single greatest concern: the cost of living. They ensure that there is a far more attractive pathway from welfare into work – that the system is no longer, to quote our focus group volunteer, making fools of those who work hard and do the right thing.

The real question, then, is not how we can afford to fund these reforms. It is whether we as a country can afford not to.

# Conclusion

The goal of this report has been to design a set of tax and welfare reforms that give people more control over their finances and their futures.

Our focus groups suggested a deep and enduring belief among the British public in the morality of work, coupled with an overriding concern about the cost of living. We therefore set out to come up with ways the Government could put more money in people's pockets – not through handouts or heavy-handed market interventions, but by making work pay.

For us, making work pay is a moral imperative as much as it is an economic one. It is rooted in the principle of ownership – the idea that what you earn belongs first and foremost to you, and should be available to satisfy your own needs before the state takes any of it away.

The first part of our agenda for making work pay was therefore to establish a new universal working income, a combined threshold for both income tax and National Insurance that would mean everyone could earn £1,000 a month – or £12,000 a year – completely free of tax. In the long run, we would like to see the universal working income taken even further, so that only those earning more than a full-time worker on the minimum wage would find themselves in the direct tax net.

The second part of our agenda was similarly aimed at those lower down the income distribution. Here, we sought to ensure that work would pay in a very direct sense, by proposing a

significant cut to the Universal Credit withdrawal rate, from 63p to 50p. This, we argued, would help to break the cycle of dependency – by getting people into work and then, crucially, by encouraging them to progress in the workplace, working more hours and earning more money. Our focus groups showed that people often know precisely how much they stood to lose or gain in benefits for every extra hour worked. The Universal Credit reform we set out here is intended to address that problem head-on, and to ensure that working for a living always makes financial sense.

Sadly, welfare recipients have long faced punitive effective tax rates as they tried to increase their earnings. But in recent years, that phenomenon has spread upwards through the tax system, particularly affecting families at and beyond the higher rate threshold, as well as those with incomes just into six figures. The third part of our agenda for making work pay thus aimed squarely at fixing these problems in the tax system. In doing so, we have set out a new work guarantee: that people should always keep at least 51p of every additional pound they earn after tax. This means reform of the marriage allowance and the high income child benefit charge, and ending the withdrawal of the personal allowance.

Taken together, the proposals detailed in this report constitute a compelling new blueprint for tax reform – for an approach that puts making work pay at the very centre of policy. Opinion polling suggests that our recommendations would be popular: 61 per cent of those polled backed our work guarantee; and 76 per cent supported the idea of a universal working income.

Yet this is about much more than political popularity. It is about the least well-off being able to keep more of their hard-earned cash. It is about people being able to work harder and longer without the taxman punishing them for it. It is about a fairer deal for middle-class families with children.

Most of all, it is about saying that in Britain you will always be rewarded for doing the right thing – for going out to work every day, for supporting yourself and your family, and for aspiring to whatever level of success you can achieve.

Ultimately, what we want – and what ordinary voters seem to be crying out for – is a tax system that supports and empowers people, rather than dictating its own terms. We want people to have control of their lives, their finances, and their futures. And we want to make sure that whatever your circumstances, and whatever your earnings, work will always pay.

This is, of course, an ambitious and far-reaching vision for Britain's future. The purpose of this report has been to show how we can start turning it into reality.



# Summary of Polling Results

On 25 & 26 October 2018, YouGov put the questions below to a sample of 1,644 British adults on behalf of the Centre for Policy Studies.

Their findings are summarised below.

1) Thinking about your finances, which of the following best applies to you?

| Answer  | %  |
|---|----|
| I am very comfortable financially   | 6  |
| I am relatively comfortable financially   | 35 |
| I do not often have money for luxuries, but can normally comfortably cover the essentials | 34 |
| I can only just afford my costs and often struggle to make ends meet                      | 17 |
| I cannot afford my costs, and often have to go without essentials like food and heating   | 3  |
| Not sure  | 4  |

2) How clear, if at all, are you about how the current tax system works for you and people you know?

| Answer                 | %         |
|------------------------|-----------|
| Very clear             | 9         |
| Fairly clear           | 43        |
| <i>Total clear</i>     | <i>52</i> |
| Not very clear         | 28        |
| Not clear at all       | 13        |
| <i>Total not clear</i> | <i>41</i> |
| Don't know             | 7         |

3) Thinking of yourself and people in a similar financial situation, would you say that you pay too much tax, too little tax, or about the right amount?

| Answer                 | %  |
|------------------------|----|
| Too much               | 30 |
| About the right amount | 48 |
| Too little             | 3  |
| Don't know             | 19 |

4) And thinking of the country as a whole, do you think that people in the UK pay too much tax, too little tax, or about the right amount?

| Answer                 | %  |
|------------------------|----|
| Too much               | 28 |
| About the right amount | 35 |
| Too little             | 17 |
| Don't know             | 20 |

5) If you had to pick one option, which of the following do you think the Government should prioritise?

| Answer                                     | %  |
|--|----|
| Increasing public spending                 | 34 |
| Reducing the amount the government borrows | 29 |
| Reducing taxes                             | 18 |
| Not sure                                   | 18 |

6) In the past the Conservative Party was sometimes described as the party of low taxes. Which of the following best reflects your view?

| Answer   | %  |
|--|----|
| The Conservative Party used to be the party of low taxes, but isn't any more | 18 |
| The Conservative Party are still the party of low taxes                      | 19 |
| The Conservative Party didn't used to be the party of low taxes, but is now  | 1  |
| The Conservative Party has never been the party of low taxes                 | 23 |
| None of these  | 9  |
| Don't know   | 29 |

7) The personal allowance is the amount of money someone can earn before they have to pay income tax.

From what you have seen or heard, what do you think has happened to the personal allowance over the last ten years?

| Answer   | %  |
|--|----|
| It has increased by over £5,000                  | 9  |
| It has increased by between £2,000 and £5,000    | 30 |
| It has increased by under £2,000                 | 17 |
| <i>Total it has increased</i>                    | 56 |
| It has been kept the same                        | 3  |
| It has been reduced by under £2,000              | 2  |
| It has been reduced by between £2,000 and £5,000 | 1  |
| It has been reduced by more than £5,000          | 1  |
| <i>Total it has been reduced</i>                 | 4  |
| Don't know                                       | 36 |

8) And have you personally noticed the impact of the changes in the personal income tax allowance over the last ten years?

| Answer         | %  |
|----------------|----|
| Yes, I have    | 28 |
| No, I have not | 58 |
| Don't know     | 14 |

9) The rate of income tax for income over £150,000 is currently 45 percent in England and Wales. Do you think this is too high, too low, or about right?

| Answer      | %  |
|-------------|----|
| Too high    | 20 |
| About right | 44 |
| Too low     | 21 |
| Don't know  | 15 |

10) Between incomes of £100,000 and £123,000 people lose their personal allowance, meaning the effective tax rate on earnings in that band is 60 per cent. Do you think this is too high, too low, or about right?

| Answer      | %  |
|-------------|----|
| Too high    | 39 |
| About right | 36 |
| Too low     | 7  |
| Don't know  | 19 |

11) The Government are currently replacing many welfare benefits with a new scheme called Universal Credit. From what you have seen or heard about this, do you think that Universal Credit is too generous to benefit claimants, not generous enough, or gets the balance about right?

| Answer                       | %  |
|------------------------------|----|
| Too generous                 | 12 |
| Not generous enough          | 37 |
| Gets the balance about right | 15 |
| Don't know                   | 36 |

12) Leaving aside the level that Universal Credit is set or how well or badly the Government are currently handling it, in principle do you think it is a good or bad idea to try and combine many existing different benefits into one single benefit?

| Answer         | %  |
|----------------|----|
| Is a good idea | 50 |
| Is a bad idea  | 29 |
| Don't know     | 22 |

13) Thinking about the overall system of taxes in Britain, what do you think should be the Government's aim when making decisions about taxation?

| Answer   | %  |
|--|----|
| To try to provide people with the strongest incentives to work | 35 |
| To try to redistribute wealth from the rich to the poor        | 25 |
| To try to bring in the most money they can for public services | 23 |
| None of these  | 4  |
| Don't know   | 12 |

14) Would you approve or disapprove of a policy that said "everyone should be allowed to earn £1,000 per month [£12,000 per year] completely free of income tax or National Insurance"?

| Answer                  | %  |
|-------------------------|----|
| Strongly approve        | 41 |
| Tend to approve         | 35 |
| <i>Total approve</i>    | 76 |
| Tend to disapprove      | 7  |
| Strongly disapprove     | 2  |
| <i>Total disapprove</i> | 9  |
| Don't know              | 14 |

15) Would you approve or disapprove of a policy that said “the Government should never take more than half of every extra pound someone earns in tax”?

| Answer                  | %         |
|-------------------------|-----------|
| Strongly approve        | 28        |
| Tend to approve         | 33        |
| <i>Total approve</i>    | <i>61</i> |
| Tend to disapprove      | 13        |
| Strongly disapprove     | 5         |
| <i>Total disapprove</i> | <i>18</i> |
| Don't know              | 22        |

16) Which of the following policy ideas would you most like to see the Government pursue?

a) A universal basic income – in which everyone receives a set payment from the state regardless of whether or not they work

b) A universal working income – in which everyone currently in work is guaranteed to keep a set amount of their earnings tax-free

| Answer                     | %  |
|----------------------------|----|
| A universal basic income   | 18 |
| A universal working income | 55 |
| Neither                    | 8  |
| Don't know                 | 19 |

# Notes

- 1 See, for example, NatCen Social Research, "A Backlash Against Austerity?" in *British Social Attitudes 34* (2017).
- 2 Centre for Policy Studies, "New Blue: Ideas for a New Generation" (2018), pp. 7–20.
- 3 Based on employment figures from Eurostat.
- 4 See Waddell and Burton, "Is Work Good for Your Health and Well-Being?" Department for Work and Pensions (2006), p. 9. Its review of the published research finds that "work meets important psychosocial needs in societies where employment is the norm" and suggests that "work is central to individual identity, social roles and social status".
- 5 NatCen Social Research, "Work and Welfare: The Changing Face of the UK Labour Market" in *British Social Attitudes 35* (2018), pp. 23–24.
- 6 See previous CPS reports: Martin, "Abolish NICs: Towards a More Honest, Fairer, and Simpler System" (2010); and Johnson, "Five Proposals to Simplify Savings" (2014).
- 7 One quirk of the National Insurance system is that it is actually based on weekly or monthly pay periods, rather than operating on an annual basis like income tax. Chapter 6 addresses this point in more detail.
- 8 For a good summary of effective marginal tax rates in the British tax system, see Bourne, "Taxing Problem: The UK's Incoherent Tax System", Institute of Economic Affairs (2014).
- 9 Davis et al., "A Minimum Income Standard for the UK 2008-2018: Continuity and Change", Joseph Rowntree Foundation (2018), p. 3.
- 10 Saatchi and Warburton, "Poor People! Stop Paying Tax!" Centre for Policy Studies (2001).
- 11 *Ibid.*, p. 19.
- 12 See Full Fact, "4 Million People Taken Out of Income Tax" (2017). This suggests that 4 million fewer people had to pay income tax in 2015/16 than did in 2010/11. Subsequent increases in the personal allowance that took effect in 2016/17 and 2017/18 were expected to take an additional 1.3 million people out of the income tax net.
- 13 Author calculations based on annual CPI inflation figures and Office for National Statistics, "Annual Survey of Hours and Earnings: 2017 Provisional and 2016 Revised Results" (2017a). From 2010/11 to 2017/18, average pre-tax earnings fell by 5.1 per cent, while take-home pay fell by 1.4 per cent. However, a significant change to National Insurance came into effect from 2011/12. Starting the comparison from that year therefore gives a clearer impression of the effect of the higher personal allowance.
- 14 For the purposes of this calculation, "part-time work" is 20 hours a week at the national living wage; "full-time work" is 40 hours a week at the national living wage.
- 15 National Insurance contributions would kick in at 21 hours per week on the national living wage.
- 16 Lawton and Pennycock, "Beyond the Bottom Line: The Challenges and Opportunities of a Living Wage", IPPR and Resolution Foundation (2013), p. 45.
- 17 See Office for Budget Responsibility, "The Effects of the National Living Wage" (2015), which estimated that unemployment would be 60,000 higher under the national living wage than it would have been otherwise.
- 18 Worstall, "Abolish the Poor: How Raising the Income Tax and National Insurance Thresholds Could Give Everyone a Living Wage", Adam Smith Institute (2015), p. 1.
- 19 Quoted in Smith, "IFS Attacks Chancellor Over 'Disingenuous' Personal Allowance Claim", Citywire (2016).
- 20 Dupont, "No Worker Left Behind", Policy Exchange (2015), p. 55.
- 21 One important detail to stress here is that the lower earnings limit – that is, the point at which earnings are considered high enough to be rewarded with National Insurance credits – should not rise in line with the primary threshold as the universal working income is established. This would ensure that people still built up a National Insurance contribution record even if they weren't earning quite enough to pay direct taxes on their income.
- 22 Based on the Treasury's "ready reckoner" and inflation forecasts from the Office for Budget Responsibility. See HMRC, "Direct Effects of Illustrative Tax Changes: April" (2018a).
- 23 These income figures represent taxpayers at the 5th, 25th, 50th, 75th, and 95th income percentile, respectively, based on 2015/16 figures from the Office for National Statistics.
- 24 See Chapter 5 for an analysis of how the government currently withdraws the personal allowance from those earning more than £100,000 per year.
- 25 Browne et al., "The (Changing) Effects of Universal Credit" in *The IFS Green Budget*, Institute of Fiscal Studies (2016), p. 249.
- 26 Centre for Social Justice, "Dynamic Benefits: Towards Welfare That Works" (2009), p. 19.
- 27 Kennedy and Keen, "Universal Credit Roll-Out: 2018–19", House of Commons Library (2018), p. 22.
- 28 See Department of Work and Pensions, "Benefit Cap: Number of Households Capped" (2018), Table 2; and Office for National Statistics, "Number and Percentage of Households Receiving More in Benefits Than Paid in Taxes, 1977 to Financial Year Ending 2016" (2017b), Table 1.
- 29 It is important to note that someone's real-world effective marginal tax rate may be affected by other benefits – council tax reduction or free school meals, for example – that are

- beyond the scope of this report. In the long run, as many of these other benefits as possible should be integrated with Universal Credit. However, any such integration will likely have to wait until the roll-out of Universal Credit in its current form is complete.
- 30 Browne et al. (2016).
- 31 Department for Work and Pensions, "Universal Credit Employment Impact Analysis: Update" (2017). Cited in Centre for Social Justice, "Universal Credit: Work and Pensions Select Committee Submission" (2017a).
- 32 If the "universal working income" outlined in the previous chapter were implemented, Jane's full-time participation tax rate would be 47 per cent rather than 48 per cent.
- 33 See Clarke and Bangham, "Counting the Hours", Resolution Foundation (2018).
- 34 This assumes that each 1p cut in the Universal Credit taper will cost around £385 million. In 2013, Mark Hoban MP, at that time Minister of State for Employment, told the House of Commons that a 5p cut to the Universal Credit taper would cost £1.5 billion, and that a 10p cut would cost £3.3 billion. These figures imply a cost of £300 million per 1p cut to the Universal Credit taper. However, subsequent reductions in work allowances mean that the taper now affects more people; this suggests that rate cuts may be somewhat costlier today. Indeed, according to the Office for Budget Responsibility's Policy Measures Database, the recent reduction in the taper rate from 65p to 63p is expected to cost £724 million in 2021/22 – implying a cost of £362 million per 1p reduction in the taper rate. Our estimate of the cost of lowering the Universal Credit taper to 50p is therefore a conservative one – it may end up costing slightly less than we suggest, even before any behavioural effects.
- 35 For example, parents claiming Universal Credit are expected to attend interviews with a work coach when their child reaches the age of one, to look for work when they turn five, and then to seek full-time employment when they reach the age of 13. Claimants who earn below a certain earnings threshold (set based on their individual circumstances) are expected to take steps to increase their hours or earnings. On top of this, there are strict obligations for updating the Department for Work and Pensions about changes in income or circumstances. Other reporting requirements include submitting evidence of childcare costs incurred each month in order to claim childcare support.
- 36 In fact, the marriage allowance is not the only thing causing trouble at the higher rate threshold. There is also an issue with the personal savings allowance, according to which basic rate taxpayers can earn up to £1,000 in savings interest (outside an ISA) without having to pay tax on it. For higher rate taxpayers, that allowance falls to £500. To see the problem, imagine that you earn £46,350 and have £1,000 of savings income. Because you are still – just – a basic rate taxpayer, that savings interest is tax free. But what if your earnings rise by £1, pushing you into the higher rate income tax bracket? Now your savings allowance falls to £500, which means you have to pay 40 per cent tax on the other half of your interest. Your overall income has only risen by a pound, but your tax bill has gone up by £200 – implying a 20,000 per cent effective marginal tax rate.
- 37 Adam, "Taxing Couples", Institute for Fiscal Studies (2018), p. 9.
- 38 Ibid.
- 39 See Joyce, "The New Tax Break for Some Married Couples", Institute of Fiscal Studies (2013a), which implies that perhaps a quarter of those eligible for the marriage allowance are pensioners.
- 40 Centre for Social Justice, "Centre for Social Justice Polling on Public Attitudes to Family in Policy: Summer" (2017b), p. 2.
- 41 Adam and Brewer, "Couple Penalties and Premiums in the UK Tax and Benefit System", Institute for Fiscal Studies (2010).
- 42 OECD, "Taxing Wages 2016–2017" (2018), p. 61.
- 43 Ibid., p. 55.
- 44 This addresses a common criticism of tax allowances in general: if you reduce by £1,000 the taxable income of someone paying 40 per cent tax, they are left £400 better off, whereas someone paying 20 per cent tax would only gain £200. Treating the proposed family responsibility allowance as a tax credit means that rather than reducing the higher-earning spouse's taxable income, it actually just reduces their final tax bill by 20 per cent of whatever unused personal allowance is transferred. This reflects the basic rate of income tax: if £1,000 of unused allowance is "transferred" the higher-earning spouse would end up £200 better off, regardless of his or her usual tax bracket.
- 45 Many of those who stand to lose out from the proposed shift to a family responsibility allowance – namely, those who currently qualify for the marriage allowance but do not have young children and are not eligible for the carer's allowance – would be more than compensated by the introduction of the universal working income proposed in Chapter 1. An obvious exception, however, are people over the state pension age, who do not currently pay National Insurance on any pension or employment income. To avoid hitting such people financially, the government may wish to "grandfather" their eligibility for the marriage allowance into the new system. This would slightly increase the cost of the proposed reform.
- 46 Joyce, "The New Tax Break for Some Married Couples," Institute for Fiscal Studies (2013b).
- 47 Adam (2018), p. 8.
- 48 The lower earnings limit for National Insurance contributions is £6,036 per year in 2018/19.
- 49 HMRC, "Child Benefit Statistics Geographical Analysis: August 2017", National Statistics (2018b).
- 50 Royal London, "New HMRC Figures Show Cause of Women's Pension Equality 'Set Back a Generation'" (2018).
- 51 That is,  $5000 / 100 = 50$ .
- 52 As things stand, however, there is no provision in legislation for this to be the case. The £50,000–60,000 income band upon which child benefit is based is fixed without reference to inflation or any other tax thresholds. It is possible, therefore, that if the higher rate threshold rises above £50,000, basic rate taxpayers could eventually be subject to the high income child benefit charge. With the effect of the charge spread across two income tax brackets, the structure of effective marginal tax rates would become even more complex. It seems likely, however, that once the higher rate threshold reaches £50,000, the high income child benefit charge will thereafter apply to the first £10,000 earned beyond the higher rate threshold.
- 53 Brewer and Joyce, "Withdrawing Child Benefit from Better-Off Families: Are There Better Options?" in *The IFS Green Budget*, Institute for Fiscal Studies (2012), pp. 234–236.
- 54 Brewer and Joyce actually focus in the main part of their text on integrating child benefit with child tax credit. However, they include an annex which restates the proposals in terms of Universal Credit. Given the changes to the welfare system since Brewer and Joyce wrote, it makes sense to focus here on their proposals as contained in that annex.
- 55 That is,  $(5,000 / 100) * 11.5 = 575$ .
- 56 Farthing, "Save Child Benefit", Child Poverty Action Group (2012), p. 8.
- 57 As noted above, this £50,000 figure should be replaced with



- the higher income tax rate threshold from 2020 onwards, so as to avoid basic rate taxpayers eventually becoming liable to pay the high income child benefit charge.
- 58 Withdrawal of the personal allowance isn't the only kink in the tax and benefits system that occurs when income hits £100,000. When a parent earns more than that, they also cease to be eligible for the government's tax-free childcare scheme. The upshot is that an extra £1 of income could theoretically cost a parent as much as £2,000 per child, per year – and more if the child happens to be disabled.
- 59 That is,  $(46,350 - 11,850) * 0.2 = 6,900$ .
- 60 Reducing the personal allowance automatically lowers the point at which you start paying the higher rate by a corresponding amount.
- 61 See Brewer and Browne, "Can More Revenue be Raised by Increasing Income Tax Rates for the Very Rich?" Institute for Fiscal Studies (2009), pp. 20–21. Based on a Treasury response to a freedom of information request, the authors suggest that taxable income elasticity for those earning £100,000–£150,000 is 0.17, while the taxable income elasticity for those earning over £150,000 is 0.35. The latter figure, for example, means that when the net-of-tax rate (i.e., one minus the effective marginal tax rate) falls by 1 per cent of its previous value, then taxable income will fall by 0.35 per cent.
- 62 Office for Budget Responsibility, "Economic and Fiscal Outlook: October" (2018a).
- 63 Ibid.
- 64 Office for Budget Responsibility, "Fiscal Sustainability Report: July" (2018b), pp. 8–9.
- 65 Ibid., pp. 12–15.
- 66 See Johnson (2018), as well as previous reports by the same author, all of which are available at [www.cps.org.uk/publications](http://www.cps.org.uk/publications).
- 67 The £47 billion figure consists of £30.7 billion from income tax relief and £16.2 billion of NICs relief on employer contributions. See Office for National Statistics, "Table PEN6: Cost of Registered Pension Scheme Tax Relief" (2018).
- 68 For the household savings rate, see Office for National Statistics, "Quarterly Sector Accounts, UK: October to December" (2017c). Figures on pension saving come from Financial Conduct Authority, "The Financial Lives of Consumers Across the UK" (2017), p. 53. It is possible that some respondents were enrolled in private pension schemes without knowing about it. The auto-enrolment programme has already made pension saving more widespread, and should continue to do so.
- 69 PwC, "Wider Pensions Reform Needed to Tackle Pension Savings Shortfall" (2015).
- 70 Delloit and Wallace-Stephens, "Venturing to Retire", Royal Society of Arts (2018), p. 8, Table 1.
- 71 Johnson (2018), p. 4.
- 72 PwC (2015).
- 73 There is some justification for savers being able to get up-front tax relief at one marginal rate, but then pay tax at a lower marginal rate when they draw their savings down. A progressive tax system tends to tax fluctuating incomes more heavily than steady ones, even when the total amount of lifetime income is the same. By facilitating the spreading of taxable income over time, tax relief can help to alleviate this injustice. For more, see Booth, "Why Equalising Tax Relief on Pensions Contributions Is a Bad Idea", ConservativeHome (2014).
- 74 There would, of course, be some overall cap on tax-advantaged savings. This might take the form of an annual allowance, combined with a rule that any unused allowance could be rolled forward for, say, up to ten years. Another option would be to introduce a *lifetime* limit on total contributions to tax-advantaged savings vehicles. This was recommended for ISAs in Association of Accounting Technicians, "Time for Change: A Review of the Individual Savings Account (ISA) Regime" (2018).
- 75 These withdrawal rules are very similar to those that apply to the existing Lifetime ISA. However, Johnson's proposed 20 per cent charge simply claws back the government's bonus. General withdrawals from the Lifetime ISA are, by contrast, subject to a 25 per cent charge. At that level, the charge also takes away part of the account holder's original savings.
- 76 Office of Tax Simplification, "The Closer Alignment of Income Tax and National Insurance" (2016).
- 77 Ibid., p.20, Table 2.B.
- 78 Ibid., p. 78.
- 79 HM Treasury, "Public Expenditure Statistical Analyses" (2018), p. 19.
- 80 See Warman, "Who Governs Britain?" Centre for Policy Studies (2018), p. 21–22, citing Ernst & Young, "Independent Analysis of Governance Scenarios and Public Service Reform in County Areas" (2016).

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The British tax system has become too complicated. It is time to reform it with one clear and simple ambition in mind: to Make Work Pay.

This should be done via two simple steps. First, let every worker keep the first £1,000 a month they earn completely free of tax – a universal working income.

Then, ensure that they get to keep at least 51p in every extra £1 they earn from that point on – a work guarantee that runs throughout the system.

The result would be a simpler, more effective tax and benefits system that promotes growth, is easily understood, and ensures that it always pays to work.

