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UNEMPLOYMENT AND INCENTIVES - THE MORAL HAZARDS OF SOCIAL BENEFITS RESEARCH MONOGRAPH 37 (IEA) BY HERMIONE PARKER*

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This study by Hermione Parker, formerly Research Assistant to Ralph Howell and now an Adviser to the Treasury and Civil Service Sub-Committee, is directly relevant to the discussion on measures to promote employment. The analysis and the results are virtually the same as the Minford/Smith Study. Both emphasise that the issue must be examined at the margin. Both studies work through particular cases to show the disincentive effects.

This marginal approach is essential in order to discover the disincentive process. As I have argued ad nauseum, the use of average calculations as done by the DHSS and to a large extent pursued by the CPRS study, obscure the scissors effect of taxation on the one hand and benefits on the other. Parker, like Minford, is scrupulous in including all benefits, including the passported benefits, in calculation. This makes sense.

The Parker Study, although reaching the same conclusions as Minford/Smith, develops a different set of policy proposals. Parker is primarily concerned with a root and branch change in the system. She wishes to see a complete integration of the welfare and taxation system. So do we all. This would avoid many of the anomalies, disincentives and plain idiocies of the present arrangements. But Minford/Smith recognise that this is indeed a long run business. Their proposals, therefore, were primarily confined to an interim programme which could be enacted within our existing administrative arrangements. Another difference in the recommendations arises from the fact that Minford/Smith took considerable account of experience in Europe, where the Parker Study is confined largely to British experience.

In short, the Parker and the Minford/Smith Studies tend to on the one hand confirm one another, and on the other hand complement one another.

AW

22 September 1982

ALAN WALTERS

*The attached is a Galley Proof and does not incorporate the figures.

THE MORAL HAZARD OF SOCIAL BENEFITS - IEA RESEARCH MONOGRAPH

Flag A	-	Balance of Tax v. Benefit
B	-	Poverty Trap
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(Galley Proofs)

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PRIME MINISTER

THE MORAL HAZARDS OF SOCIAL BENEFIT

RESEARCH MONOGRAPH 37——9/11 UNI 689/696

Introduction

Hermione PARKER

Economic Effects of Moral Hazard

by LORD HARRIS OF HIGH CROSS

In the world of commercial insurance it is understood that if a person is completely covered against all risk of loss—whether from fire and burglary, or even from accidents and illness—he is likely to behave less carefully in minimising costs. Thus comprehensive cover against the cost of car repairs and medical care will incline at least some motorists to take more risks. It is to minimise such perverse effects that car and health insurance policies require claimants to pay a proportion of the cost, just as theft insurance may require the householder to fit effective locks and other safety devices.

Students of insurance use the term 'moral hazard' to describe this danger that policy-holders will take less care to reduce any costs against which they can insure. By insulating the individual from loss, the effect of such insurance is not simply to transfer the cost from the individual to the insurance company, but to increase the total costs, borne in varying proportions by the company in lower profits and by the insurer in a higher premium.

A precisely similar dilemma confronts all public or private philanthropy aimed to protect people from poverty. Wherever relief is conditional on evidence of 'need', it inevitably weakens the general impulse of self-help for all but the most independently-minded who still feel a stigma about 'charity', or the most severely handicapped who cannot anyway help themselves. Thus if a means test takes account of an individual's capital, it must tend to discourage thrift or encourage the dissipation of savings. ?

It is an economic merit of private charity that the donor can discriminate arbitrarily in favour of the 'deserving' poor and impose limits or conditions to contain costs. It is the political disadvantage of public 'compassion' (at taxpayers' expense) that it more often operates progressively to raise benefits, extend their coverage and remove or weaken such conditions as the now largely defunct test for unemployment benefit of 'genuinely seeking work'.[1] Even Keynes before the war acknowledged that the availability of a 'dole' that was modest by today's standards contributed to 'voluntary unemployment', especially for people who would have been able to earn only a low income by taking a job. In *The Moral Hazard of Social Benefits*, Hermione Parker reveals with detailed examples how this disincentive effect of benefits has been multiplied by the dampening effect of taxation in reducing the take-home pay from unskilled work to little more, or even less, than the income in cash and kind from an almost bewildering variety of social programmes that since Beveridge have 'growed like Topsy'.

The author is not chiefly concerned here with the moral and social consequences for independence, self-reliance, tax avoision, the underground economy and the weakening of family life and mutual aid. Her concern is rather with the economic damage of depressing incentives for millions of able-bodied people to work and save and so distorting the employment and application of human resources.

Mrs Parker does not extend her analysis to the ramifications of heavy taxation throughout the economy or its distortionary and depressing effects on high enterprise and investment. Her concern is rather with ordinary families, and with the combined effects of high taxes on low incomes and of the welter of mostly tax-free benefits available from the state in place of income from employment.

The spread of such costly, ill-devised welfare policies throughout Europe and North America must help explain the difficulties so many governments now have in extricating their economies from the unholy combination of high inflation and rising unemployment. The familiar complaint of excessive labour costs has many causes, including over-powerful trade unions and minimum wage laws. But there can be little doubt that costs of production have been inflated by a growing element of various forms of taxation made necessary by the rising bill for social benefits. At the same time, the indexation of benefits must make them more attractive compared with net incomes from work which are now commonly rising more slowly than the price index. Finally, the pressure to raise wage costs, especially for the lower paid, has plainly been intensified, on the one hand, by higher social benefits and, on the other, by the inroads on low earnings by the voracious taxation necessary to finance the mounting bill for social benefits.

? Mrs Parker's central finding is that generous social policies have had perverse economic effects by weakening or destroying incentives to work for heavily-taxed take-home pay. A clear result is to encourage, extend and prolong dependence on social benefits which are themselves an increasing cause of higher taxation. It is difficult to see how vigorous economic progress will be fully resumed until the baneful effect of what I call the 'tax-benefit mangle' is progressively diminished.

All the more dismaying is it that an earlier version of this *Monograph* prepared for *Social Trends* failed to get departmental clearance on the ground that it was against government policy to acknowledge the seriousness of this problem. One measure of the scale of the Government's dilemma is that to raise all personal tax allowances and thresholds by no more than 25 per cent would reduce government revenue by over £4 billion.

Yet until the economic cost of moral hazard is tackled by cutting direct taxes and containing the cost of social benefits the prospect for rapidly declining unemployment must remain remote.

August 1982

RALPH HARRIS

[1] Official surveys have regularly found that 10 to 20 per cent of the registered unemployed are not 'actively looking for work'.

? baneful or baleful

The Nature of the Problem

v.b(?)

1. THE BALANCE OF TAX v. BENEFIT

By their nature all income support programmes must jeopardise the incentive to work, because they narrow the gap between incomes in and out of a job. Yet it is both economically and morally desirable that work should always remain financially attractive, not least for the lower paid, and that extra effort and special skills should be rewarded. If even small minorities of the workforce are encouraged to draw sickness, unemployment or supplementary benefit when they could be working, when they could earn more by their own efforts, or when they could be training to improve their marketable skills, then social security gradually becomes an engine of impoverishment instead of a means to prevent poverty.

That every increase in the social security budget has to be paid for out of higher taxes is obvious; it is less obvious that every rise in income tax and national insurance contributions (NIC) can reduce still further the advantage of working. Moreover, unless the lower paid are completely exempt from income tax, the gap between incomes in and out of work can be eliminated altogether at the bottom of the earnings scale. But although income maintenance programmes jeopardise the incentive to work, it by no means follows that every erosion of incentive is necessarily the result of benefits being too high. In addition to excessive taxation, high work expenses or income policies or combinations of these and other factors can also eliminate the net financial advantage of working.

A

Even with low benefits the incentive to work may still be weak if the rewards (after tax) for paid work are also low. The dilemma is best grasped in terms of a pair of scales with, on one side, living standards from idleness (a function of benefit levels), and on the other, living standards from work (a function primarily of wages, direct taxation and work expenses). To preserve work incentives the second scale must always be heavier than the first. The balance will tilt in favour of not working if benefits are raised, or taxes are increased, and markedly so if both occur together. The damaging effects on the labour market are similar whether larger spending on benefits results from higher *rates* of benefit or from *more claimants*, or whether higher taxes are levied to pay for increased social security or other programmes.

The balance upset

The danger is that once the balance is upset the process becomes cumulative. Thus the stronger the relative attraction of benefits, the larger the number of claimants, the more the cost and the higher the tax falling on the smaller numbers in employment. The consequences may barely be noticeable at first but gradually the rate of economic growth falls and the tax base is reduced. As workers try to recoup their tax 'losses', there is pressure for increased wages which in turn leads to more unemployment, more spending on benefits and still higher taxes. Resources available for those in genuine need are diminished, and there is a real possibility of generally falling living standards with those least able to protect themselves the worst affected. In the long run nearly everybody suffers.

This study is concerned with the impact of Britain's tax structure and welfare system on incentives. It starts from the premise that men and women work primarily for financial reward. It accuses nobody of being 'workshy' or of 'scrounging'. It does not question the desirability of a generous system of social security. It aims only to demonstrate how the piecemeal growth of the existing system has come to undermine the natural instincts of self-reliance and self-advancement, instead of harnessing them to the common good.

? - L

The study is based on the proposition that labour, like all economic goods and services, is not immune from the laws of supply and demand. In the absence of social security, the floor for wages would be the 'minimum living wage', and because of competition from single people it could be less than the 'minimum' appropriate for family men, thereby threatening hardship and poverty. But once government introduces income maintenance for the unemployed, the wages floor is set by social security benefits *plus* a margin to offset the 'disutility' of work. The preservation of that margin is essential if the labour market is to function efficiently.

Vacancies for the skilled

If the *net* reward for lower-paid work compares unfavourably with the total package of benefits during unemployment (or if the margin is too small), then job vacancies at the lower end of the earnings scale will be hard to fill and harder still to keep filled.[1] The official unemployment statistics will increase, reflecting partly migration to the black economy, partly the lengthening period of search as workers try to find jobs which are financially more worthwhile,[2] and partly the response by employers to the resulting upward pressures on pay. Inevitably there will be a switch away from labour-intensive towards capital-intensive production. The consequent unemployment is worse for the lower paid and unskilled, while demand for skilled labour remains buoyant. ~~But~~ if, as in Britain, the net rewards for skilled and semi-skilled work are only marginally higher than the net rewards for unskilled work, then vacancies for skilled labour will be difficult to fill.[3] Labour shortages will then co-exist alongside apparently high unemployment.

The situation is complex, but the principle involved is simple. Governments which disregard the basic laws of demand and supply imperil the smooth-running of the whole economy. It is true that people have differing preferences and expectations, even to the extent that some are prepared to work for little or even no extra reward. That does not alter the fundamental truth that every narrowing of the margin between living standards in and out of work further diminishes the effective demand for paid work, and *vice-versa*. Similarly, a narrowing of the differences in net pay from widely different levels of gross earnings reduces the supply of skilled labour, whereas an increase in net differentials would encourage people to acquire fresh skills.

Where it can be shown that the tax/benefit structure is likely to have any of these results, it would surely be better to change the system quickly rather than (as at present) to waste time arguing about the exact number of people affected, or about their likely reactions. The alternatives are either to risk a continuing increase in the 'natural' rate of unemployment[1] to unprecedented dimensions or to make benefits conditional on accepting work available or to move openly to introduce direction of labour.[2]

Whitehall out of touch

At grass roots level, the anomalies which will be discussed—and their gravity—are not generally disputed. Anecdotal evidence is freely given and is overwhelming. Men and women from all walks of life, including DHSS staff administering the scheme, are exasperated because Whitehall and Westminster are so clearly out of touch. Mrs Thatcher's Government came to power pledged to provide a remedy, but instead matters have become worse. Politics is about priorities. Priority is rightly given to the control of inflation, but the erosion of incentives is a root cause making for wage inflation, of which excessive monetary growth is no more than the *mechanism*. Thus wage inflation, which in the past caused price inflation when monetary policy was permissive, has led to increased unemployment since monetary policy has been tightened up. So long as the pre-disposing causes of inflation/unemployment remain unattended, the remedy will be more costly than it need be. Present high unemployment may drive some of the symptoms temporarily underground, but they will re-emerge if economic expansion resumes.

2. SPENDING POWER IN WORK AND OUT OF WORK

The way in which Britain's tax/benefit system undermines work incentives has been criticised for many years. Income tax, national insurance contribution and local authority rates, all increasing faster than the rate of inflation, are charged on earnings below the entitlement levels for supplementary benefit and a host of other means-tested benefits, to produce a structure which narrows differences in living standards not just between incomes in and out of work ('unemployment trap'), but also between workers at different levels of gross earnings ('poverty trap').

[1] 'No takers', a Manpower Services Commission study of hard-to-fill vacancies, *Department of Employment Gazette*, September 1979.

[2] W. W. Daniel, 'Why is high unemployment somehow acceptable?', *New Society* 19 March 1981; also, 'Measuring unemployment and vacancy flow', *D of E Gazette*, June 1980.

[3] *The employment paradox in smaller firms*, Association of Independent Businesses, October 1979.

+ / [1] Defined as the rate of unemployment consistent with a stable rate of inflation.

[2] Moves towards the direction of labour have already been mooted, c.f. Ralph Howell's 'Right to work' in *Why Work?* [2], and various proposals for youth conscription.

Does he advocate it?

+/ Is this really right?

Lopsided

To analyse this process, new jargon and new analytical techniques have emerged, relying heavily on computer models. Since November 1975, for instance, and in response to ~~persistent~~ parliamentary questions by Ralph Howell, MP [2], the DHSS eventually produced a regular series of Tables[1] comparing *net weekly spending power** for different types of families, in work and out of work, and at different levels of earnings. Net spending power is defined as gross earnings, or unemployment benefit, *less* income tax, national insurance contribution, local authority rates, rent or mortgage costs and work expenses, *plus* child benefits, tax refunds (where appropriate) and any means-tested benefits to which there may be entitlement. It is therefore a much wider and more useful concept for measuring work incentives than net incomes which take into account only income tax, national insurance contribution and child benefit.

The Tables from the DHSS Tax/Benefit Model for November each year between 1975 and 1981, and for April 1982, provide the statistical basis for the main analysis in this *Monograph*. Benefits are uprated annually in November, and in April of each year there are usually changes in income tax and national insurance contribution, and also in local authority rents and rates. In theory work incentives are at their best in April, after increases in the personal tax allowances. But in 1981 there was no such increase. And in 1982 the value of the 14 per cent increase in tax allowances was more than offset by the 1 per cent increase in national insurance contribution, and by hefty increases in rent/and rates. Improvements in benefits of 11 per cent due in November 1982, in contrast to a forecast increase in gross earnings during 1982-83 of only 7½ per cent, will narrow still further the gap between incomes in and out of work, unless there are big offsetting tax cuts in the 1983 Budget or increases in child benefit. The situation reflects the lack of clear understanding amongst Ministers of the poverty and unemployment traps.

Net spending power

To compare individual living standards, the 'net spending power' concept has some advantages, but it also has limitations which make it dangerous if misused. Spending power figures have to rest on certain common assumptions, which limit their validity. In real life every person's circumstances differ from all others. Differences in housing costs and in the expenses of going to work can make all the difference to whether employment is or is not worthwhile.[1]

Generally speaking, the DHSS model [1] projects an over-optimistic image of the real world, because it assumes (*a*) low housing costs based on average rents and rates in local authority housing (but excluding water rates[2]), (*b*) low work expenses (only £4·40 was allowed in November 1981), and (*c*) a 100 per cent take-up of means-tested benefits. On the other hand, the model also assumes married couples sharing one wage, whereas about 50 per cent of married women are in paid work.

For all these reasons, and no matter how tempting it may be to generalise from the DHSS figures to try to show, for example, how many people are better off not working, any such estimates are totally misleading. All that the DHSS figures can do is to show whether or not the tax/benefit structure maintains work incentives. They can give a general indication of the level of earnings below which incentives are weakened. They can be used, therefore, to show the direction of change (Graphs 3 and 5). But they cannot be used to estimate even the approximate number of people for whom work is not worthwhile. Nor can they be used to quantify the effects of the tax/benefit structure on the supply and distribution of labour. Both depend on individual circumstances and on each individual's reaction to those circumstances.

Replacement ratios

Time and again the DHSS has emphasised the dangers of generalising the spending power figures of hypothetical families. But many commentators ignore the warning, and use *replacement ratios* derived from spending power figures in order to estimate the number of people for whom paid work is not worthwhile.

A *replacement ratio* in this context is defined as income received when out of work as a proportion of income from employment (either previous, present or prospective). So long as the figures fed into the calculation relate only to net incomes (i.e. earnings, former earnings or prospective earnings, *less* income tax and national insurance contribution, *plus* child benefit and other non-means-tested benefits), replacement ratios can safely be generalised because the only variables are earnings and family size, which are relatively straightforward to handle. But the comparison of replacement ratios based only on net incomes is meaningless, since it is precisely the variables (unknown but assumed) fed into the net spending power figures which can tilt the balance for or against paid work.

Faced with this dilemma the reaction of many analysts has been to produce *spending power replacement ratios* by feeding in either the DHSS assumptions on housing costs, work expenses and so forth, or their own. In next to no time the reader can be presented with spending power replacement ratios for the entire population, analysed according to duration of unemployment and family characteristics, and followed by detailed estimates of the number of people better off not working than working, and so on.[1]

Macro-calculations of this sort are misleading. Unemployment in Britain, especially long-term unemployment, is disproportionately concentrated on those sections of the population with high spending-power replacement ratios, such as the unskilled, the chronic sick and disabled, people with large families, or those with high fares to work or above-average housing costs. The idea of an 'average replacement ratio' for the whole population, as put forward by Kay, Morris and Warren [5] for the Institute for Fiscal Studies,[2] is either meaningless, being based on average net incomes, or a contradiction in terms because based on 'average' net spending power.

[1] DHSS *Tax/Benefit Model Tables* [1].

*Glossary, p. 00.

[1] So can redundancy payments.

[2] An estimated £1·30 for water rates was included for the first time in the April 1982 Tax Benefit/Model Tables.

[1] For instance: A. B. Atkinson and J. S. Flemming [3]; Louie Burghes, Child Poverty Action Group [4].

[2] Also J. A. Kay and C. N. Morris [6].

PART TWO

How the Traps are Baited

3. THE FOUR TRAPS

1. THE POVERTY TRAP AND THE POVERTY PLATEAU

For a significant part of the community, especially families with children and, most of all, lone mothers, pay differentials have become largely meaningless. Out of each extra pound of earnings the wage earner has to pay income tax and national insurance contribution, and *at the same time* entitlement to means-tested benefits is either reduced or withdrawn (rent and rate rebates immediately and the main family benefits within one year). Because of the level of deductions for income tax, national insurance contribution and local authority rates on the one hand, and of means-tested benefits on the other, living standards at the bottom of the earnings scale no longer vary with gross earnings.

EXAMPLE: A family with two children living in cheap local authority housing enjoys spending power of about £75 per week[1] if the father earns £120. Another family of similar size and living in similar accommodation, where the father earns just £45 for part-time work, is only £10 per week worse off.

It is important to distinguish between the *poverty trap*, with its high implied marginal 'tax' on each extra pound of earnings, and the *poverty plateau*,[2] meaning the levelling of differences in spending power over a wide range of gross earnings.

(a) The poverty trap

The poverty trap exists because earnings from work, *even earnings below the entitlement levels for means-tested benefits*, are subject to income tax, national insurance contributions and local authority rates. For some reason never divulged, the discussion in Whitehall too easily overlooks deductions resulting from the poverty trap which come to less than 50 pence in the pound. But for the purposes of this *Monograph* the poverty trap exists *wherever income tax and national insurance contribution are charged on incomes below the entitlement levels for means-tested benefits*, regardless of what marginal tax rate is implied. By the end of 1979, nearly 1 million adults in full-time work were in this position.[1]

The mechanism of the poverty trap is shown in Table 1. Rent and rate rebates are withdrawn at between 23 and 33 pence in the pound, and are in theory adjustable as soon as earnings change. The figures refer to April 1982.

B

More nearly means less

Graph 1 (*a*) illustrates the high 'implied' marginal 'tax' rates to which single-wage married couples drawing housing rebates are liable as a result of this system. On earnings between £55 and £70 they lose about 71 pence out of each extra pound earned, and on earnings between £71 and £105 they lose about 61 pence from each extra pound. Because of the poverty trap the loss of spending power is proportionately more severe than for people paying marginal tax on annual incomes over £30,000.

Children and the poverty trap

Families with children may be entitled to Family Income Supplement (FIS) as well as housing benefits. In November 1981, the FIS prescribed amount for a two-child family was £82 or about 65 per cent of average male manual earnings. FIS is phased out by 50 pence for each extra pound earned, and loss of entitlement to FIS also means loss of statutory entitlement to free school meals (FSM). Theoretically, any family in receipt of FIS stands to lose more than 100 per cent of each extra pound earned. Each additional child raises by £8 the earnings ceiling (or prescribed amount) below which there is entitlement to FIS, and consequently the earnings level at which the family can escape the poverty trap.

Table 1:

How the Poverty Trap works, October 1982

		Deduction from each Extra £ Earned %
1. *Income tax:* from each £ earned above £30·10 for single people and £47·02 for single-wage married couples—		30·00
2. *National insurance contribution:* on earnings between £29·50 and £220 a week, employed earner's rate (not contracted out) charged on total earnings up to £220 upper earnings limit—		8·75
3. *Rent and rate rebates:*		
(*a*) From each extra £ of income below the need allowance:	rent rebate	25·00
	rate rebate	8·00
TOTAL DEDUCTIONS (items 1, 2 & 3 (a))		71·75
(*b*) From each extra £ of income above the needs allowance:	rent rebate	17·00
	rate rebate	6·00
TOTAL DEDUCTIONS (items 1, 2 & 3 (*b*))		61·75
All the above Deductions occur pari passu *with Increases in Earnings*		
4. *Family income supplement* (FIS)—		50·00
		£
5. *Free school meals* (FSM), estimated weekly value—		2·25
6. *Free welfare milk* (FWM), estimated weekly value—		1·40

Note: FIS is awarded for a year at a time, and carries automatic entitlement to free school meals and free welfare milk. Under the Education Act 1980 the statutory requirement for local education authorities to provide free school meals for children from low-income families was limited to children in families receiving FIS or supplementary benefit. LEA's have discretionary powers to extend this provision to other children and in October 1981 about 73% of LEA's in England were doing so. But the parent cannot claim it as of right. Free welfare milk is phased out with FIS or at £2·50 above SB level, except for handicapped children or under-fives at approved nursery schools, play groups and so forth.

[1] Unless otherwise stated, *all* income figures are weekly. This chapter refers throughout to people at work.

[2] The term 'poverty plateau' was first used by Professor Jonathan Bradshaw in *New Society*, 9 October 1980 [7].

1 COPY TO FOLLOW

/ l. c.

GRAPH 1 (a), (b), (c)

Because FIS is awarded for a year at a time, the worst effects of the poverty trap are generally avoided in practice. The chances are that the ceiling for FIS will have been lifted before a family's FIS award comes up for renewal, so that many families escape without loss of FIS. Graph 1(*b*) shows the theoretical position for a family with two children aged 4 and 6. The fact remains that there is nothing in law to prevent people from being worse off by earning more, and sometimes they are.

Graph 1(*c*) illustrates the position for a three-child family if there is no immediate adjustment of FIS, free welfare milk or free school meals. It may be argued that this is misleading because only a minority of families have three or more children. But about one-third of all children live in families with three or more, and it is wrong to overlook the effects of the system on so large a minority.

Families caught in the poverty trap must either break or bend the law if they want to raise their living standards. Hence to their children disrespect for the law becomes a normal part of life. How can we expect young people brought up in such circumstances to be law-abiding if during their childhood such qualities are penalised by marginal tax rates of 60 to 70 per cent on incomes ranging from as little as £50 up to £125?

The figures in Graph 1(*c*) show the marginal net income retained from each extra pound earned, assuming continued payment of FIS at the rate applicable to earnings £1 lower in every case. Housing benefits are adjusted immediately, and because FIS counts as part of weekly income for the assessment of housing benefits, the latter are withdrawn twice as fast as in Graph 1(*b*). The net effect is to produce marginal net incomes similar to those for single-wage couples without children (Graph 1(*a*)), but where there are children the poverty trap is much wider. For the three-child family it stretches up to £130 a week, even assuming low housing costs.

In real life it is probable that earnings would increase by more than £1 at a time, perhaps by £5 or even £10. Despite the continued payment of FIS at the higher rate applicable to the lower earnings, marginal net incomes remain extremely low, because of higher taxes and lower social benefits. And if the effects of higher rents, rates and work expenses are also taken into account the gain is even smaller. Sometimes it is a net loss.

EXAMPLE: *Because of the poverty trap* a married man with non-earning wife and three children, whose earnings increased from £80 to £85 between November 1981 and the present time, has *less* spending power now than last November, *before* taking account of price inflation, and even assuming that FIS continues to be paid at the rate applicable to earnings of £80. Increases in national insurance contribution, in rent, rates and fares to work, have more than offset the increased wage and the 14 per cent increase in tax allowances last April:

Spending power from £80 in November 1981:	**£78·08**[1]
Spending power from £85 in October 1982:	**£75·83** (FIS adjusted)
	£77·76 (no adjustment of FIS)[1]

EXAMPLE: Because of the poverty trap a married man with non-earning wife and two children, whose earnings increased from £105 to £115 during the same period had an increase in spending power of only £1·36, after taking account of taxation, housing and fares to work. The implied marginal tax rate is 86 per cent.

Spending power from £105 in November 1981:	**£71·70**[1]
Spending power from £115 in October 1982:	**£73·06**[1]

EXAMPLE: Because of the poverty trap an agricultural worker (with a non-earning wife and two small children) and who earned the median wage for agricultural workers throughout 1980 and 1981, had only £2 more to spend out of an additional £5 in November 1981. After taking into account inflation at 12 per cent, he was worse off by 9 per cent in real terms, as shown in Table 2.

Table 2:

Net Weekly Spending Power of an agricultural worker, November 1980 and November 1981

	November 1980 £	*November 1981* £
Median earnings of agricultural workers	83	88
Net weekly spending power, married man with two children aged 4 and 6	65	67

[1] DHSS Tax/Benefit Model Tables [1], November 1981 and April 1982.

All the above examples are derived from the DHSS Tax/Benefit Model Tables [1], and use the same assumptions regarding housing costs and fares to work.

Politicians play down the reality of the poverty trap. It is said that the concept rests on a faulty 'snapshot' analysis which allegedly disregards the effects of pay awards, benefit upratings and increases in tax allowances. But this view is not substantiated by the facts.

(b) The poverty plateau

The virtual disappearance of differences in spending power over a wide range of earnings is not seriously disputed. Within that range people find themselves on the poverty 'plateau': extra effort and extra skills are no longer rewarded. For people with low earnings potential it often pays to work part-time locally and claim maximum housing rebates rather than travel to full-time work.

C

EXAMPLE: A single woman may be better off working part-time in a local pub or restaurant than in a full-time job: working 20 hours a week at £1·75 an hour, her net spending power is over £33, compared with £00 for for the full-time job, as shown in Table 3.

Table 3:

Part-time versus Full-time Working, October 1982

Part-time earnings	£35·00	*Full-time earnings*	£70·00[1]
PLUS		*PLUS*	
rent rebate	11·90		4·54
rate rebate	3·95		1·48
free lunches	5·00		—
LESS		*LESS*	
income tax	1·47		11·97
NIC	3·06		6·13
rent	12·50		12·50
rates	5·50		5·50
work expenses	—		10·00
NET WEEKLY SPENDING POWER	**33·32**		**29·92**

[1] Cf. estimated average female manual earnings in April 82: £78·35.

Source: DHSS [1], April 1982.

As income increase the wage-earner loses much more in income tax and national insurance contribution, and gains less from means-tested benefits. The flattening effect of this pincer operation on living standards is illustrated in Graph 2.

GRAPH 2

The theoretical 'escape points'

The theoretical 'escape points' from the poverty plateau and the poverty trap (i.e. where this pincer movement no longer operates) is often above average manual earnings. Using the DHSS Tax/Benefit Model assumptions and defining the escape point as that level of earnings at which there is no further entitlement to means-tested benefits (and at which net spending power increases by 62 pence in the pound, i.e. the 'standard rate' including national insurance contribution), the picture is as shown in Table 4.

Table 4:

Escape points from the poverty trap and the poverty plateau, April 1982

	£ per week	*% average male manual earnings*[1]
Single man	97	75
Married couple	115	89
Married couple + 1 child	126	98
Married couple + 2 children	133	130
Married couple + 3 children	138	107
Married couple + 4 children	143	111
	£ per week	*% average female manual earnings*[2]
Single woman	97	124
Lone mother + 1 child	123	158
Lone mother + 2 children	130	167

[1] Estimated at £129 in April 1982.

[2] Estimated at £78 in April 1982.

Source: DHSS [1], April 1982.

Since 1979 the position has been deteriorating.

Following the Labour Government's tax cuts in 1978, the escape points from the poverty trap and poverty plateau fell to a lower percentage of average manual earnings than at any time since 1975 (when the DHSS Tax/Benefit Model Tables were first produced). In the last three years this improvement has been lost.

GRAPH 3

These examples indicate only 'theoretical' escape points. In real life they will be higher for some people and lower for others, e.g. they will be higher if housing costs exceed those assumed in the DHSS Model Tables.[1] They will also be higher for families with student children who are likely to be affected by the 14 per cent withdrawal rate of mandatory student awards.

For all these reasons it is wrong to suppose that the so-called poverty trap affects only the lower paid. The nomenclature is misleading. It would be more appropriate to describe it as a general *anti-effort trap*, because it discourages people who by normal standards are not regarded as poor.

2. THE UNEMPLOYMENT TRAP

If people are encouraged to stay out of work for longer than is strictly necessary, to work intermittently or not at all because a return to work would either reduce their spending power or bring *a net gain of less* than £10 a week, they fallen into the unemployment trap. A net reward of £10 for a full week's work is surely the absolute minimum necessary to offset what economists call the disutilities (disadvantages) of work. A few people might be satisfied with less, but most would expect more, especially those who can supplement social benefits with cash earned in the underground economy.

Throughout most of the European Community, but especially in Britain, the relative gains from working have become too small. The wage earner is often only marginally better off by working, particularly when absence from work can be ascribed to sickness. In Britain there is no guiding principle in the provision of benefits to ensure that people are better off when they are in paid work than when they are sick or unemployed. There is no national minimum wage, and the supplementary benefit minimum income guarantee scheme specifically *excludes* anybody in full-time work, even though, for many, net wages may be less than benefits.[1]

D

Income maintenance in training

But that is not all. Anyone on a training or re-training course outside the Training Opportunities Scheme is automatically ineligible for social security, because he or she is not 'available for work'. With the exception of a minority generally below the age of 21, who are allowed to draw supplementary benefit provided they study for *less* than 21 hours a week, any effort at organised self-help is penalised by loss of entitlement to benefit. And even this concession was in danger of being withdrawn early in 1982. Other unemployed people, offered jobs in industry subject to an initial unpaid training period, also forfeit the right to social security and sometimes therefore turn down job offers.

British income maintenance schemes during training contrast bleakly with arrangements elsewhere. In Germany, every adult has a statutory right to paid training and re-training, and the training allowance is more valuable than unemployment benefit. Unemployment is regarded as a situation of last resort. Every young person has the right to a guaranteed minimum income during further education or vocational training, but not to the dole. In France, there is a system of continuous training, with maintenance of income, financed partly by the state and partly by employers.

As with the poverty trap, the extent to which any person may be caught in the unemployment trap in Britain depends on earnings potential, family size/characteristics, housing costs and tenure, and work expenses. Families with many children are generally the worst affected, especially if they depend on the single wage of a lone mother. And for the very poor, the borderlines between the unemployment trap, the poverty trap and plain fraud have become so nebulous that it is hard to know when to blame the system and when to blame its victims. Many people are unable to extricate themselves from debt, let alone raise their living standards, except by resort to the black economy.

Recent changes

The unemployment trap has changed significantly since the present Government took office, but a lasting solution is still nowhere in sight. Earnings-related supplement has been abolished, the real value of the standard rate of unemployment benefit has been cut by 5 per cent, the real value of the unemployment benefit child additions has been cut by even more, unemployed people aged 60 or over are now excluded from unemployment benefit if they have more than a minimal occupational pension, and since July 1982 benefits paid to the unemployed, including supplementary benefit but excluding all child additions, have been assessed for income tax.

Taxation of short-term benefits (e.g. sickness, maternity) is long overdue, and will immediately widen the gap in spending power between incomes in and out of work. Income tax refunds will remain[1] but will be smaller and will not be paid until either the end of the tax year or until the unemployed person has returned to work.

[1] There is no upper income ceiling to eligibility for housing rebates, nor any ceiling to reckonable housing costs, although the maximum rebates are limited to £30 for rent rebates (£35 in the GLC area), and £5·50 for rate rebates (£9·00 in the GLC area).

[1] It may be thought that restoration of the former 'Wage Stop' would remedy the situation, but this is not the case. The wage stop was designed to preserve equity in incentives. It did not require a man to get *less* when he was in work. It only ensured that an unemployed person's income was no larger than it would have been in full-time work. The wage stop rule was abolished in 1975. It had proved difficult to administer, involving a large element of local discretion. Those principally affected were families with children, especially large families, and by 1973 a disproportionate number of families from Northern Ireland. Writing in the 1975 Annual Report, the Supplementary Benefits Commission recorded the equity problem occasioned by the removal of the wage stop, but concluded that

> 'the real solution seems to lies not in reducing benefit to these families but in a generous level of family support, a raising of tax thresholds for low wage earners and higher levels of earnings'. (para. 33).

This conclusion remains valid.

Further reading on the Wage Stop:

Ministry of Social Security, *Administration of the Wage Stop*, HMSO, 1967 (reprinted 1972); Laurie Elks, *The Wage Stop*, Child Poverty Action Group, 1974; SBC *Annual Report 1975*, Cmnd. 6615, HMSO.

[1] Further discussion of the new tax refunds is in Part 4, pp. 00-00.

The long-term value of the other changes is much more doubtful, although the full effects are still hard to judge. One immediate result is to increase reliance on supplementary benefits, because national insurance unemployment benefit is now worth less than the supplementary benefit scale rates. Thus *the unemployment trap has been replaced by the supplementary benefit trap*. Short-term savings in public expenditure are likely to be more than offset in the long-term by the insidious effects on self-reliance and self-esteem from a system of social security for the unemployed based largely on means-tested supplementary benefit. The slightly 'abated' (i.e. reduced) value of NI unemployment benefit is derisory by international standards.

The social insurance principle lies in ruins. Entitlement to benefit during unemployment no longer bears any close relation to either the individual's contribution record or personal effort. The regular worker and the regular saver are penalised. The only people who do not lose are the feckless spenders and the chronic drones. Moreover, the value of the total supplementary benefit package is so well concealed and so variable that the full impact on incentives of income maintenance based on supplementary benefit will be extremely hard to monitor.

The supplementary benefit package

The supplementary benefit scale rates may appear to be low' especially for wives and children, and also for the long-term unemployed, who are restricted to the ordinary SB scale rates. Paradoxically, however, the *relative* value of the total supplementary benefit package compared to spending power from low wages is disproportionately high, and is increasing. *The supplementary benefits system has become Britain's main growth area.*

This is the result of a combination of factors:

(1) Until 5 July 1982, supplementary benefits were not taxed. Even now only the basic adult supplementary benefit rates for the unemployed are taxable.[1] Children's SB and other payments remain tax-free.

(2) Children's SB rates (available only to the unemployed) are age-related and much higher than child benefits available to parents at work.

(3) Housing costs are payable in full with SB (except mortgage capital repayments but including mortgage interest), and a 'non-householder housing addition' of £2·55 is payable to single non-householders on top of the scale rate.

(4) SB is a passport giving automatic entitlement to other benefits, for example, free school meals, free welfare milk, free optical and dental care, and free prescriptions.

(5) In calculating SB certain income is disregarded, e.g.:
- — any expenses in association with part-time work
- — net earnings up to £4 per week per spouse
- — dependent children's earnings without upper limit
- — fostering allowances in full, and two-thirds of earnings from child-minding and lodgers
- — tax refunds in most cases
- — capital, and income from capital, up to £2,000 (£2,500 from November 1982).

(6) Extra payments for additional requirements may be claimed, e.g.:
- — heating additions
- — laundry costs in certain cases
- — fares to hospital
- — hire purchase in certain cases.

(7) Extra single payments for exceptional needs may be claimed, e.g.:
- — furniture and household equipment
- — house and garden expenses
- — clothing and footwear.

Because of what is available under items (4) to (7) above it would be misleading to compare net spending power from work with the *basic* SB scale rates, or even with the basic scale rates plus heating addition for under-fives, free school meals and free welfare milk. It has often been noted that most supplementary benefit claimants live at a level somewhere between 120 and 140 per cent of the scale rates.[1] For this reason, living standards or spending power on supplementary benefit in this study are assumed to be *120 per cent of the SB scale rates* unless otherwise stated.

3. THE SUPPLEMENTARY BENEFIT TRAP

The supplementary benefit trap as it affects a two-child family dependent on the single wage of the father is illustrated by Graph 4. The DHSS prefers to concentrate on figures applicable to families with young children, on the ground that most children are under 11 years of age. Statistically this is doubtless correct. But children also grow up and, as they do so, the SB rates for them increase. Consequently, it becomes progressively more difficult for parents with low earnings potential to find work which provides more in spending power than they can obtain by remaining on SB.

E

GRAPH 4

[1] Only that part which is equal to the NI unemployment benefit is taxable, e.g. SB rate for a married couple is £37·75 of which £36·40 (N.I. unemployment benefit rate) is taxable.

[1] For example, Supplementary Benefits Commission [8], paras. 4-15.

As always the wage necessary for the recipient to be £10 a week better off by working depends on individual circumstances. The graphs assume average local authority housing costs throughout. They therefore underestimate the disincentive effect for many people, especially mortgagees with higher costs. Even so, and assuming weekly work expenses of £10 and two children of 11 and 13, gross earnings of nearly £150 a week are necessary in order to provide a living standard about £10 better than SB.

The most difficult decisions face a low-income family when the children reach 16. If the children remain in full-time education and the father is in work, child support is limited to child benefit at £5·25, unless the father earns less than £82, in which case he can draw family income supplement. But assuming one child of 16 and one of 18, both at school, the family's SB scale rate plus free school meals alone adds up to £75·15, and 120 per cent of the SB scale rate is £85.[1] If the children leave school and register for work, each is almost immediately entitled to SB in his or her own right, at £18·60 for the 18-year-old and £14·30 for the 16-year-old, plus the 'non-householder's housing addition' of £2·55.

E

It is not surprising that unemployment has reach 3 million, nor that it is disproportionately concentrated among the young. Tinkering with the situation by postponing a young person's entitlement to SB until the end of the first school holidays after leaving school, and then cutting off child benefit as well if work is commenced before the end of the holidays, causes much unnecessary hardship[2] and invites abuse. Jobs today are seldom lasting. How is the mother expected to judge whether or not a given job is likely to prove casual or regular? The system requires radical reform. All we are doing at the moment it driving people into the black economy.

Table 5 shows the approximate levels of gross weekly earnings necessary in October 1982 to produce a £10 gap between spending power in work and 120 per cent of the SB scale rates for all the main family types, including young single people. The weekly earnings necessary to make work financially attractive would have to be even higher if the claimants were owner-occupiers in the early stages of a mortgage, since interest payments could well be £40 or £50 a week. In Table 5 housing costs are derived from

Table 5:

The Supplementary Benefit Trap, October 1982

Family type	*120% SB*	*Approximate levels of gross weekly earnings necessary to produce a gap of £10 between spending power in work and on SB*		*£ per week* *Tax refund*[1]
	£	£		£
1. *Single householder*	27·90			2·06
work expenses £5 (£10)		78	(91)	
2. *Single non-householder*				
(*a*) *Aged 18 or over*	22·32			3·45
work expenses £5 (£10)		47	(55)	
(*b*) *Aged 16-17*	17·16			4·74
work expenses £5 (£10)		38	(46)	
3. *Married couple*	45·30			2·78
work expenses £5 (£10)		99	(112)	
4. *Married couple + 2 children aged 4 and 6*	74·26			2·78
work expenses £5 (£10)		118	(£32)	
5. *Married couple + 4 children aged 3, 8, 11 and 16*	95·70			2·78
work expenses £5 (£10)		158	(166)	

[1] Refundable on return to work or at end of the tax year (Part 4, pp. 00-00).

Source: DHSS Tax/Benefit Model Tables, April 1982, and own calculations.

Assumptions: as in DHSS Tax/Benefit Model Tables for housing, otherwise as shown.

Note: Estimated average manual earnings in April 1982:
men about £129 per week.
women about £78 per week.

the DHSS Tax/Benefit Model Tables. The £10 assumption for weekly work expenses is reckoned to be much more realistic than the DHSS estimate of £5, which takes no account of expenses other than fares, e.g. trade union dues, meals away from home, extra clothing and superannuation. The following examples are derived from Table 5:

EXAMPLE 1: A school leaver needs earnings of £46 in order to be £10 per week better off by working:

	£		£
Earnings	46·00	*Supplementary Benefit*	14·30
PLUS		*PLUS*	
	—	estimated 20% additions	2·86
LESS		*LESS*	
income tax	4·77		—
NIC	4·02		—
work expenses	10·00		—
NET WEEKLY SPENDING POWER	**27·21**		**17·16**

EXAMPLE 2: A single householder needs earnings of £91 (with work expenses of £10 per week), *and £78* (with work expenses of £5) in order to be £10 per week better off by working:

	£		£
Earnings	91·00	*Supplementary Benefit*	23·25
PLUS		*PLUS*	
rent rebate	0·97	rent rebate	12·50
rate rebate	0·22	rate rebate	5·50
		estimated 20% additions	4·65
LESS		*LESS*	
income tax	18·27		—
NIC	7·96		—
rent	12·50	rent	12·50
rates	5·50	rates	5·50
work expenses (say)	10·00		—
NET WEEKLY SPENDING POWER	**37·96**		**27·90**

[1] Additionally, the children can take Saturday jobs without affecting the parents' SB entitlement.

[2] Because it affects the family's entitlement to housing rebates.

EXAMPLE 3: A married man with non-earning wife and two small children needs earnings of £132 (*with work* expenses of £10) *and £118* (with work expenses of £5) in order to be £10 per week better off by working:

	£		£
Earnings	132·00	Supplementary Benefit	43·05
PLUS		*PLUS*	
child benefit	10·50	child benefit	10·50
		rent rebate	14·60
		rate rebate	6·40
		estimated 20% additions	10·71
LESS		*LESS*	
income tax	24·59		—
NIC	11·55		—
rent	14·60	rent	14·60
rates	6·40	rates	6·40
work expenses (say)	10·00		—
NET WEEKLY SPENDING POWER	**74·46**		64·26

The earnings levels necessary to make work financially attractive are close to *average* manual earnings, estimated at £129 for men and £78 for women in April 1982. At three-quarters of average manual earnings the gap between incomes in and out of work quickly fades away except for single men. *Table 6 shows that, for most people, a wage at three-quarters average manual earnings is hardly worth working for* when supplementary benefit would provide 80 to 90 per cent as much spending power, and in some cases more.

Table 6:
Spending power gap between low pay and supplementary benefit, April 1982

	Spending power gap between 120% of the SB scale rates and net spending power at three-quarters average manual earnings	
	£ Work expenses	*£ Work expenses*
	£5	*£10*
Single male householder	17	12
Single female householder	3	–2
Married couple	10	5
Married couple + 2 children	–6	–11
Married couple + 4 children	–8	–13

Source: Derived from DHSS Tax/Benefit Model, April 1982.

The gap between living standards on supplementary benefit and living standards on low pay has been decreasing steadily since 1979. The curves in Graph 5 show a deterioration in the supplementary benefit trap since 1979 similar to the worsening of the poverty trap depicted in Graph 3. All the figures are taken straight from the DHSS Tax/Benefit Model Tables for each November since 1975, which allow only low estimates for work expenses.

GRAPH 5

4. THE LONE PARENT TRAP

In 1979 there were about 860,000 one-parent families in Britain, 100,000 lone fathers and 760,000 lone mothers. Of the latter, 110,000 were widows. Altogether one-parent families accounted for about 10 per cent of the nation's children.

The lot of most lone parents other than widows is a complex blend of the unemployment and poverty traps, which I shall call the *lone parent trap*. National insurance benefits for widows are not means-tested, so widowed mothers can add to their benefits by going out to work, even if most earn wages well below the poverty trap 'escape points'. But for lone parents who are not widows, non-means-tested provision is limited to child benefit and one-parent benefit, at £5·25 per child and £3·30 per family respectively in November 1981, and £5·85 and £3·65 respectively from November 1982.

Lone mothers and their children are among the most vulnerable members of society. The women have lower earnings potential than men; many have to pay child-minding costs in addition to travel and the other expenses normally associated with earning a living. For these families the effects of the unemployment and poverty traps are so interwoven that it is hard to distinguish the one from the other. But the net result is indisputably to encourage long-term dependence on supplementary benefit and to discourage self-reliance, because the reward mechanism no longer operates. The only way for most of these mothers to escape the lone parent trap is by working in the black economy.

A lone parent is not required to register for work in order to get supplementary benefit, and can choose whether to work full-time and (probably) qualify for family income supplement, or to work less than 30 hours and receive supplementary benefit. Since November 1980 the first £4 of net weekly earnings plus half of any net earnings between £4 and £20 is entirely disregarded when calculating SB entitlement (this regulation replaced the previous £6 disregard). Additionally, lone parents are now eligible for the long-term rates of supplementary benefit after one year instead of two.

GRAPH 6

F

The effect on the work incentive is dramatic, and is illustrated in Graph 6. Assuming work expenses of £20 a week (a figure which takes into account child-minding costs[1]), cheap local authority housing and no entitlement to free school meals above the FIS ceilings, it makes virtually no difference in terms of spending power whether a lone mother with two small children eventually earns £120 for a full week's work or £20 working part-time. And gross earnings of about £140 a week are necessary to make her £10 a week better off by working full-time. With older children, with more children, or with housing costs higher than those assumed, the position would be worse. But even £140 is 170 per cent of estimated female manual average earnings in April 1982.

The figures are tabulated in Table 7. Net spending power on supplementary benefit is almost certainly underestimated because no account is taken of other 'disregards' or of payments for additional requirements referred to in the previous section (p. 00).

Certainly there is a strong case for making it possible for lone parents to stay at home and look after their children, especially those below school age. But it is hard to justify a system which actively discourages self-help until the child is 16, and which gives the mother little choice except between poverty or the black economy. As soon as the child or children leave school, the mother is suddenly left with no income support at all, and is required to make a difficult re-adjustment. By that time, after so many years away from the labour market, it is harder for her to find and keep a steady job.

Table 7:
The lone parent trap, October 1982
Lone mother with 2 children aged 4 and 6. Rent £14·60, rates £6·40, work expenses £20·00, child benefit £10·50, one-parent benefit £3·30.

(1) *WORKING FULL-TIME*

Gross weekly earnings	*Tax*	*NIC*	*FIS*	*Rent rebate*	*Rate rebate*	*FSM*	*FWM*	*Net weekly Spending Power (NWSP)*
£	£	£	£	£	£	£	£	£
40	—	3·50	20·00	13·20	4·48	2·25	1·40	50·63
50	0·89	4·38	16·00	11·70	4·00	2·25	1·40	52·88
60	3·89	5·25	11·00	10·45	3·60	2·25	1·40	52·36
70	6·89	6·13	6·00	9·20	3·20	2·25	1·40	51·83
80	9·89	7·00	1·00	8·21	2·86	2·25	1·40	51·63
90	12·89	7·87	—	6·68	2·32	—	—	51·04
100	15·89	8·75	—	4·98	1·72	—	—	54·85
110	18·89	9·63	—	3·28	1·12	—	—	58·68
120	21·89	10·50	—	1·58	0·52	—	—	62·51
130	24·89	11·38	—	—	—	—	—	66·53
140	27·89	12·25	—	—	—	—	—	72·66

(2) *WORKING PART-TIME: Rent and rates paid in full**

Net earnings	*SA ordinary rate*	*SA long-term rate*	*FSM*	*FWM*	*NWSP ordinary SA*	*NWSP long-term SA*
4	43·45	49·80	2·25	1·40	48·35	54·70
6	42·45	48·80	2·25	1·40	49·35	55·70
8	41·45	47·80	2·25	1·40	50·35	56·70
10	40·45	46·80	2·25	1·40	51·35	57·70
12	39·45	45·80	2·25	1·40	52·35	58·70
14	38·45	44·80	2·25	1·40	53·35	59·70
16	37·45	43·80	2·25	1·40	54·35	60·70
18	36·45	42·80	2·25	1·40	55·35	61·70
20	35·45	41·80	2·25	1·40	56·35	62·70
25	30·45	36·80	2·25	1·40	56·25	62·70

*The calculation is as follows: net earnings + child benefit + one-parent benefit + supplementary allowance + free school meals + free welfare milk less rent and rates = net weekly spending power. For part-time work with SA, work expenses are taken fully into account to reach reckonable net earnings.

Assumption: No free school meals (FSM) above FIS levels.

Note: Estimated average female manual earnings in April 1982 were £78·00.

Sources: DHSS Tax/Benefit Model Tables, April 1982.
Hansard, 15 January 1981, col. 619-22, updated.

[1] The National Council for One Parent Families estimated child-minding costs to be between £15 and £20 a week in London in Autumn 1981.

TABLE 7

Lone mother with 2 children aged 4 and 6. Rent £14·60, rates £6·40, work expenses £20·00, child benefit £10·50, one-parent benefit £3·30.

PART THREE

Scale of the Problem and Priority for Change

4. THE EFFECTS OF WORK DISINCENTIVES

It is relatively easy to show that the British tax/benefit structure reduces the incentive to work, and that for people caught in the poverty trap or the supplementary benefit trap the situation is getting worse, not better. But it is difficult to estimate the number of people affected, and the practical effects of disincentives on the labour market.

These are distinct aspects of the problem and it is important not to confuse them. Even if one knew how many people were better off not working than working, for instance, it would be incorrect to assume that the same number of people actually 'choose' not to work.

The evidence suggests that in practice many people do work for very little financial gain, some because they do not realise how small the gain is, some because they value the longer-term benefits of remaining in the labour force, and some because they like to work. But this does not mean to say that they are not angry and frustrated. Often it is the unemployed with the highest replacement ratios who most actively seek work.[1] Many are offended by the idea that their labour is worth less than social security, so they go on locking in the hope that a better offer may be made next week. But it can be months before they find a job at a wage rate they consider acceptable. And the unemployment statistics reflect this delay.

G

Growth of black economy and low pay

The growth of the black economy and the increased prevalence of moonlighting are clear indicators of grass-roots reaction against the system. Estimates of the size of the black economy now range between 4 and 15 per cent of Gross Domestic Product, and even the 'official' Inland Revenue estimate[1] of between 6 and 8 per cent amounts to around £15 billion a year.

There is no official estimate of the number of people better off or only marginally worse off by not working than when in paid work. The Government view is, while not exactly denying the existence of a problem, nevertheless to insist that the numbers affected are statistically insignificant—in other words, to give the problem low priority for change. Thus in its evidence to the Treasury and Civil Service Committee Sub-Committee 'Enquiry into the structure of personal income taxation and income support' [1], the Government did not attempt to estimate the numbers involved in the unemployment trap, saying only that 'the vast majority of people are better off in work than out of work'. Better off by how much? In a recent letter to the *Financial Times*, Mr Frank Field estimated that 'millions of workers have a net income from work which is not much above what they could claim on social security.'[2]

The Institute for Fiscal Studies (IFS) has estimated that in November 1981 about 9 per cent of the working population had replacement ratios on supplementary benefit which were 80 per cent or more of their in-work incomes, and that about 20 per cent of the working population had replacement ratios on SB of 70 per cent or more.[3] These estimates bring up to date a simulation carried out by the IFS in 1980 whereby the incomes of the working population (as reported in the 1978 Family Expenditure Survey) were compared with entitlement to benefit when unemployed. Unfortunately neither the details of the original tax/benefit model nor of the updating have been published. But it is fairly certain that living standards on SB were underestimated, being based on the SB scale rates only; and that no account was taken of work expenses,[1] so that the study is not helpful.

As for numbers of people affected by the poverty trap, the latest DHSS estimate (based on analysis of the 1979 Family Expenditure Survey) of 470,000 families in Great Britain who stood to gain less than 60 pence out of each extra pound earned[2] as opposed to their usual definition of 50 pence or 25 pence, is ludicrously low, being less even than the number of lone mothers in the country, most of whom are inextricably caught up in both the unemployment and poverty traps.

The Government's estimates are low partly because of low take-up of means-tested benefits (only 50 per cent for FIS), partly because of problems and disagreements about definition,[3] and partly because of confusion between the poverty and unemployment traps. These are closely interwoven, and without a doubt a high proportion of the unemployed would be caught in the poverty trap if they were in paid work. The same DHSS analysis of the 1979 Family Expenditure Survey shows that 800,000 adults of working age in Great Britain (i.e. approaching 1 million if Northern Ireland is also taken into account) were dependent on incomes with implied marginal tax rates of over 40 per cent. By now (August 1982) the figures must be higher still.

[1] DHSS Cohort Study [10].

[1] Sir Lawrence Airey in evidence to the Treasury and Civil Service Committee II, November 1981.

[2] *Financial Times*, 20 May 1982.

[3] J. A. Kay and C. N. Morris [6].

[1] Kay, Morris and Warren [5].

[2] Letter to Sir Brandon Rhys Williams, Bt., MP, from the DHSS dated 29 June 1982.

[3] For instance: (*i*) Disagreement about the implied marginal tax rates which constitute the poverty trap. Some estimates take 50 per cent or more, some 75 per cent and some 100 per cent. Implied marginal tax rates for lower wage earners of between 40 per cent and 50 per cent are generally regarded as harmless (too low to matter), although they produce a tax structure which is regressive. (*ii*) References to families instead of adults affected by the poverty and unemployment traps, based on the outdated notion that wives do not participate in the labour market.

Taking a broad definition of the unemployment and poverty traps, but still relying largely on data from the Family Expenditure Survey, it is possible to make a rough 'snapshot' estimate of the number of adults likely to be discouraged from helping themselves, simply by adding together the number of adults of working age dependent on supplementary benefit and the number of adults dependent on incomes either below SB levels or not more than 140 per cent of SB levels during the period of the survey. All SB claimants except lone parents (who have a tapered 'disregard') face 100 per cent implied marginal tax rates if they reurn to work, and a substantial proportion would be low paid if they were at work. Additionally, most of those earning below SB levels or within 140 per cent of SB levels would be entitled to means-tested benefits either directly or through their spouses. Indeed, since means-tested benefits usually cut out at above 140 per cent of SB levels, an estimate of this sort must exclude some working people who are technically within range of the poverty trap as defined in this study. Even so, *the total estimated number of adults at risk from the poverty and/or unemployment traps in 1979 comes to over 4½ million or about 17 per cent of the workforce at that time* (Table 8).

By now, of course, these figures are out of date. Unemployment in 1979 was 1·3 million compared with over 3 million in July 1982. And the escape points from the poverty trap are higher today in relation to average earnings. *The 1982 figure is unlikely to be less than 5½ million (i.e. over 20 per cent of the workforce) at risk from the poverty and/or unemployment traps.*

Limitations of sample surveys

In the discussion on the incidence and impact on the labour market of the poverty and unemployment traps, increasing importance is attached to empirical evidence based on survey data.

Table 8:
Number of Adults at risk from the Poverty and Unemployment Traps, 1979

Total estimated number of adults under pensionable age dependent either on supplementary benefit or on incomes which were (a) below SB levels, or (b) not more than 40 per cent above SB levels.

(Thousands)

	Adults affected 000's
(1) Excluding people who had been sick or unemployed for less than 13 weeks at the time of the Family Expenditure Survey:	
Incomes below SB	690
SB claimants	1,110
Incomes at or above SB, but less than 40% above	1,510
Total	3,310
(2) Estimated number of adults dependent on low incomes for less than 13 weeks at the time of survey:	
Dependent on SB for less than 13 weeks	260
Dependent on NI unemployment benefit for less than 13 weeks	430
Dependent on NI sickness benefit for less than 13 weeks	510
Total	1,250
TOTAL OF (1) + (2)	4,560

Sources: (1) DHSS, *Low income families 1979*, June 1982. (2) *My own* calculations.

Note: The DHSS estimates of low-income families are derived from Family Expenditure Survey data, but the computer programme has been written to exclude families where the head is off work for less than 13 weeks. The figures therefore underestimate the total number of people dependent on low incomes at the time of the survey, and also the number of people at risk from the unemployment and poverty traps. Thus the figures in (1) above are the figures published by the DHSS. The figures in (2) are an attempt to fill in the gap, and are necessarily very approximate. They are based on the average number of claimants in receipt of the benefits listed for less than 13 weeks during 1979. Some duplication is therefore possible, but also some omissions.

One of the disadvantages of such evidence is the long delay before the results are published. For instance, the offical poverty trap figures based on analysis of the 1979 Family Expenditure Survey did not become available until June 1982. Such delays are especially to be deplored when dealing with a disease which feeds on itself. Trying to estimate the number of people at risk from the unemployment and/or poverty traps, and hence the priority for change, is like trying to estimate the 'natural' or 'minimum sustainable' rate of unemployment[1] from old data. It is not feasible. Each increase in the number of registered unemployed requires higher taxation of those at work, which reduces still further the margin of incentive between incomes in and out of work, further extends the period of job search necessary to find a financially acceptable job, and thus pushes up the 'natural' rate of unemployment a further notch.

Evidence from sample surveys provides useful information on the characteristics of the unemployed, and on work attitudes. But it has limitations. People constrained by the system to bend or break the rules are unlikely to say so officially. A truly random sample of the unemployed is therefore unattainable. And yet those potential respondents who turn out to be unavailable, or who prefer not to co-operate, almost certainly include the people most at risk.

Despite both of these difficulties the available survey data shows a clear correlation between the pattern of unemployment in Britain and the nature of our tax/benefit system. Amongst its worst features are a high rate of taxation at low levels of pay, no tax relief against work expenses, no proper system of either training or income support for the 16-19 age group, dependency additions for non-earning wives and a fragmented system of child support, with much higher benefits payable for the children of parents who are not working than for the children of parents in paid employment. All of these factors are reflected in the findings.

[1] Total interviews as a proportion of the names originally selected for the MSC 1979 study of the long-term unemployed came to only 38 per cent. Of the original sample, 41 per cent declined or refused to take part, and 18 per cent could not be traced (though presumably drawing benefit).

TABLE 8

Total estimated number of adults under pensionable age dependent either on supplementary benefit or on incomes which were (a) below SB levels, or (b) not more than 40% above SB levels.

W. W. Daniel's second survey of unemployed people, *Where are they now?* [13], showed below-average 'activity rates' among the wives of unemployed men, and a high incidence of short-term and recurrent unemployment among young people. The correlation between high incidence of unemployment and low earnings was emphasised by Layard, Piachaud and Stewart, using data from the 1975 General Household Survey, in their evidence to the Royal Commission on the Distribution of Income and Wealth [14]. The DHSS *Cohort Study of the Unemployed* [10] (a nationally representative sample of men who became unemployed in 1978) showed that 25 per cent had incomes out of work equal to at least 82 per cent of their previous net in work incomes, and confirmed that a disproportionate percentage of the unemployed are young, unmarried and unskilled or only semi-skilled. People interviewed had earnings far below the national average—about half in the bottom fifth of the earnings distribution. Only one-third of the wives were earning compared with over half for the population as a whole. And a high proportion had recent experience of unemployment, half in the previous year and three-quarters during the previous five years.[1]

Figures quoted in the Supplementary Benefits Commission final annual report[2] demonstrate the higher incidence of long-term unemployment in Britain compared with the rest of the European Community, and an above-average incidence of unemployment experienced by family men. A recent comparative study by a French government agency notes Britain's relatively low short-term replacement ratios for the unemployed and relatively high long-term replacement ratios compared with France, Germany, Sweden and Canada; also the disincentive impact of our dependency additions for wives and children.[3] The *1980 Family Expenditure Survey* shows 38 per cent more children in the families of unemployed manual workers than in those of employed manual workers, whereas for non-manual workers the unemployed families had fewer children than those in paid work.[1]

Evidence of survey of long-term unemployed

In 1979 the Manpower Services Commission carried out a survey amongst nearly 2,000 long-term unemployed people[2] [12]. At that time there were about 337,000 long-term unemployed, just over one-quarter of all the registered unemployed. By January 1982 there were 905,000 long-term unemployed, nearly 30 per cent of the total, and over half of the registered unemployed at that time had been out of work for more than 26 weeks. Not surprisingly, the MSC figures showed a disproportionate number of older workers and disabled people. They also showed that nearly three-quarters of the sample had been in semi-skilled or unskilled jobs. Only a minority had any formal educational or vocational qualifications, and 77 per cent had no formal qualifications whatsoever. Even among the 16-24 age-group, 73 per cent had no qualifications. Inadequate pay, travelling distances and heavy work were quoted as the main reasons for not taking up job vacancies. Almost one-quarter of those questioned regarded low pay as the dominant factor. Many compared their benefits with the likely pay from available jobs and

> 'felt the extra was inadequate compensation for the rigours of a job and the expenses incurred by travel and extra food'.[1]

Despite the formal evidence, despite the crescendo of anecdotal evidence at local level, despite recognition by the former SBC Chairman, Professor David Donnison, that 'large numbers [of people] get little more when working than if unemployed and public concern about incentives is acute',[2] the official Whitehall view is to recognise the existence of a theoretical problem but to minimise its relevance and its effects in practice. This is the advice regularly passed on to Cabinet Minister.

Every possible device is used to play down the gravity of the situation by those who oppose change. The poverty trap is said to be an illusion based on faulty 'snapshot' analysis which does not take into account that (some) benefits are granted for a year at a time.[1] The poverty trap is repeatedly said to be the unavoidable consequence of attempts by caring governments to relieve poverty.[2] The level of unemployment benefit is said to have no significant effect on the duration of unemployment. And reports from the grass roots are brushed aside as mere 'anecdotal evidence'. Half an hour at any pub should be long enough to discover what really goes on, yet it seems from his 1982 Budget speech that the Chancellor still accepts the official line. Speaking about unemployment he said:

> 'The key point is this. Somewhere in *the gap* between the levels of income which we pay to those out of work and the earnings enjoyed by those who have a job are rates of pay which those now out of work would be glad to take if they had a chance. But convention and narrowness of vision prevent those bargains being struck.'* (Italics added.)

For the lower paid, for family men earning much more, and for almost anyone with a mortgage, the question must be: 'What gap?'.

[1] D of E *Gazette*, August 1980, January 1981 and June 1982.

[2] Cmnd. 8035 [15], Table 5.1.

[3] 'Note sur l'indemnisation du chomage en France et à l'étranger', CERC, July 1982.

[1] *Family Expenditure Survey*, 1980, Table 26c.

[2] Defined as unemployed for more than one year.

[1] MSC [12], para. 5.6.

[2] David Donnison, 'A Radical Strategy to Help the Poor', *New Society*, 29 October 1981.

[1] Only FIS and its passport benefits are awarded for a year at a time. In theory a person drawing housing rebates can be prosecuted under the Theft Act if he or she fails to notify increased income immediately. In most cases the means-tested benefits would not be necessary if tax were less, i.e. the poverty is 'tax induced'. (Part 4, pp. 00-00.)

[2] COPY TO FOLLOW

[3] *Hansard*, 9 March 1982, col. 73.

PART FOUR

Causes of the Problem

5. HAPHAZARD POLICY ON INCOME REDISTRIBUTION

It is wrong to assume that the progressive erosion of work incentives since 1948 is due simply to increases in benefit rates, and that the obvious remedy therefore is to cut benefits. The situation is more complex. Benefit rates have risen substantially, even after allowing for inflation. But so have earnings. For work incentives what matters is, *first*, those changes which alter the ratios between net incomes from benefits and net incomes from work, and, *secondly*, those which alter the ratios in spending power (a whole complex of factors including travel to work and means-tested benefits) that together determine relative living standards.

There is no single explanation for all that has occurred. Five factors, taken together, show *how it came about*, but there is only *one underlying reason*. The former may be summarised as follows.

(i) A social insurance system based on flat-rate benefits with additions for dependents; and a minimum income guarantee through the supplementary benefits system which does not apply to those who are in paid work.

(ii) Greatly increased direct taxation of earned incomes, especially the earnings of the lower paid of families with children, due to failure to up-rate the personal tax allowances in line with benefits, to the abolition of earned income relief and the reduced rates of tax, and to increases in NIC.

(iii) The exemption from taxation of unemployment benefit (until recently), sickness benefit and supplementary benefit, and the cumulative nature of PAYE.

(iv) An inadequate and fragmented system of child support.

(v) Increased and increasing reliance on means-tested benefits.

For an explanation of the reason why we must examine the curiously haphazard and subjective approach to income redistribution which characterises British society, and which is reflected at Westminster and in Whitehall. Without a more objective and consistent or comprehensive approach, policy-making will remain incoherent and will often produce results opposite to those intended.

H

6. THE BENEFIT SYSTEM

The traditional British system of social insurance based on flat-rate benefits with additions for dependents is altogether different to the Bismarck-inspired earnings-related systems which dominate social insurance elsewhere in the European Community.[1] The continental style earnings-related benefit is not a supplement paid in addition to flat-rate benefit, but a fixed proportion of previous or normal earnings, with no variation according to family size. So long as the proportion is not set too high and is related to earnings net of tax, or is itself taxable, it is relatively easy to preserve the necessary incentive to work.

The disadvantage of earnings-related social insurance is that for the lower paid the benefit can be insufficient to prevent poverty. Hence the trend towards supplementing social insurance by some sort of minimum income guarantee: 'social assistance' in Germany and the Netherlands, 'public assistance' in Denmark, the 'minimex' in Belgium, the 'revenu minimum garanti' and the 'vieillesse minimum' in France.

Disadvantage of flat-rate benefits

The disadvantage of Britain's flat-rate benefit system is that the more effective protection provided at the bottom of the earnings scale is possible only at the expense of the majority of wage and salary earners. This is because it is impossible to pay *flat-rate* benefits to the majority in amounts which are worthwhile without damaging incentives amongst the lower paid. Flat-rate benefits by their nature represent a much higher percentage of former earnings for low wage earners than for those on the average wage. And the British dependency additions inevitably represent a larger percentage of previous earnings for family men than for single people. In November 1981, for instance, the standard rate of unemployment benefit represented only 19 per cent of previous gross earnings for a single person who had been earning £120 a week, but 38 per cent if he had previously earned £60. For a married man with two children the two cases represented $31\frac{1}{2}$ per cent and 63 per cent respectively.

Graph 7 shows that the unemployment trap has not widened because of increases in either flat-rate unemployment benefit or supplementary benefit since 1948, both of which bear approximately the same relationship to average earnings today as then, having actually *fallen* since 1965.

GRAPH 7

[1] Except in Ireland.

But the introduction in 1967 of earnings-related supplement, superimposed on flat-rate insurance benefits, compounded all the difficulties inherent in our system. By continental standards the ratio, even at its high point in 1971, was never generous to the better-off wage-earner. But for low-wage families with children it used to have to be 'extinguished' by the 85 per cent ceiling rule, which prevented flat-rate benefit plus Earnings Related Supplement from exceeding 85 per cent of previous reckonable earnings.

Earnings-related supplement was abolished in 1981, but the difficulties associated with flat-rate insurance benefit and with the supplementary benefits system remain. These difficulties are made far worse because people who are in full-time work are excluded from supplementary benefit. *For each unemployed person, but* not *for people in work, therefore, the supplementary benefits system acts as a* de facto *minimum wage*, all the more unpredictable and damaging because it varies with the number and age of the claimant's dependents. The result is a constant upward pressure on wages. At the same time the unemployment statistics are inflated by the longer periods of job search.

The British supplementary benefits system is virtually unique. Elsewhere it is usual for a minimum income guarantee to be operated on the basis of proof of need alone, although some countries tilt the mechanism in favour of the *working* poor. In Germany, for instance, self-help is encouraged by adding between 30 and 50 per cent to the social aid entitlement of anybody in paid work. And in France the '*revenu minimum garanti*' (introduced in 1981 for families with children) is reduced to a nominal or basic rate for families whose incomes are less than the national minimum wage, in other words where neither parent is working. In the Netherlands the criterion for social assistance is need, and social assistance rates are set at a given percentage of the national minimum wage, although the gap is too small to preserve incentives.

7. INCOME TAX AND NATIONAL INSURANCE CONTRIBUTION

It was shown in the previous section that the ratio between flat-rate unemployment benefit/supplementary benefit and *gross* male manual average earnings has not altered significantly since 1948. But when we examine the ratio between flat-rate unemployment benefit/supplementary benefit and *net* earnings the picture is transformed. The difference is due to income tax reaching further down the income scale, and to increased national insurance contribution on earned income.

Graph 8 shows how tax on earnings has grown since 1950, and how the impact has shifted at the expense of single people at the bottom of the earnings scale and family men earning slightly more. The figures refer to male manual earnings and take account of family allowance and child benefit as well as income tax and NIC. Between 1948 and 1961 the NIC was charged at a flat rate, which is the reason for the strange-looking curves for families with children (Graph 8 (3) and (4)).

EXAMPLE 1: In 1981 a single person earning half the national average paid 25 per cent of his earnings in income tax and national insurance contribution. That was more than a single person with earnings *twice* the national average would have paid in 1950.

EXAMPLE 2: The tax burden for married men earning three-quarters of the national average increased from 6·5 per cent in 1950 to 25 per cent in 1981.

EXAMPLE 3: The typical two-child family on average earnings paid just under 4 per cent of total income (earnings plus family allowance) in national insurance contribution and income tax in 1950 and 26 per cent in 1981.

GRAPH 8

EXAMPLE 4: A family with four children on average earnings paid 3 per cent of its income in national insurance contribution in 1950 but *no* income tax. By 1981 total tax liability amounted to 24 per cent of earnings plus child benefit—an eight-fold increase.

The impact of these sharp increases in the tax burden on the incentive margin between net incomes in and out of work is demonstrated in Table 9, which shows *net income 'replacement ratios'*, i.e. they compare the supplementary benefit scale rates with gross earnings less income tax and NIC, plus family allowance/child benefit where appropriate. The trend is indisputable and the figures can safely be generalised because they do not involve hypothetical assumptions regarding work expenses or housing costs for individual families. For the same reason, the picture presented is also incomplete. Table 15 (p. 95) shows the estimated change in *spending power 'replacement ratios'* over the same period.

Table 9:
Net Income Replacement Ratios, 1948-1981

National assistance/supplementary benefit scale rates as percentages of average earnings less income tax and national insurance contribution, plus family allowance/child benefit as appropriate.

Year	Single person	Married couple	Married couple + 2 children*	Married couple + 4 children **
(1) Average Male Manual Earnings				
	%	%	%	%
1948	21	32	41	55
1956	20	32	40	53
1964	22	35	42	56
1972	24	38	48	64
1980	27	41	54	72
1981	27	42	54	73
(2) Two-Thirds Average Male Manual Earnings				
1948	29	46	62	80
1956	29	45	60	76
1964	32	49	62	82
1972	35	53	66	84
1980	38	57	72	94
	39	58	73	95

* Two children aged 4 and 6.
**Four children aged 4, 6, 12 and 16.
Notes: The SB scale rates are for November each year, and include the post-November 1980 heating addition for children under five.
Earnings figures are for October in each year. The 1981 figures are provisional.
Sources: *Social Security Statistics*, 1981.
The Taxes Acts, Vol. I, 1980.
DHSS Abstract of Statistics for index of retail prices, average earnings, social security benefits and contributions.

Heavier taxation of people on low incomes is the single most important reason for the erosion of work incentives since 1948. It is attributable to a variety of causes which may be summarised as follows:

(i) Falling tax thresholds in relation to average earnings.
(ii) Much higher starting *rate* of income tax and abolition of reduced rates of tax,
(iii) Abolition of earned-income relief.
(iv) Steady increase in the cost to the worker of earnings-related national insurance contribution since 1961.

(i) Tax thresholds

The tax threshold has been defined by the Inland Revenue[1] as the level of earnings which may be received before liability to tax arises. For single people and married couples, therefore, the tax threshold is currently equal to the single person's and married man's tax allowance;[1] until 1973 the tax threshold was more ample because of earned income relief.

Tax allowances and the incentive margin

It is generally supposed that as long as tax allowances are moved up in line with inflation (the Rooker-Wise amendment)[2] the incentive margin between incomes in and out of work will remain constant. But this is not necessarily the case. From the point of view of incentive, what matters is that tax allowances should be moved up in line with benefits. Any government which increases tax allowances by less than it improves social security benefits for the unemployed puts work incentives at risk, and invites wage demands. In order to make good the extra tax, and to maintain the gap between incomes in and out of work, wages must increase disproportionately. In Britain earnings have increased faster than prices throughout most of the post-war period. And *benefits* have kept up with earnings. Tax allowances have kept ahead of prices most of the time, but have lagged far behind earnings. That is the cause of the trouble.

The choice for policy is either to link benefits *and* tax allowances to earnings, or index both to prices. The first option is very expensive. The second would gradually reduce the relative living standards of the unemployed, and would probably be thought politically unacceptable in the long-term. No wonder that governments prefer to fudge the issue. The effect has been a dramatic fall in the relative living standards of the lower-paid, as can be judged from Graph 9.

EXAMPLE 1: In 1950-51 the tax threshold for a single person was 37 per cent of average male manual earnings. By 1981-82 it had fallen to 21 per cent.
The single person's tax allowance in November 1981 was £26·44 a week. In order to restore the 1950-51 ratio with average earnings it would have had to be raised to nearly £47.

EXAMPLE 2: In 1950-51 the tax threshold for a married man with a wife who did not work was 60 per cent of average male manual earnings. By November 1981 the married man's tax allowance of £41·25 was worth only 33 per cent of estimated average male manual earnings and would have had to be raised to nearly £76 in order to restore the earlier position.

GRAPH 9

The distinction between tax thresholds and tax break-even points in Graph 9 is an important one. The *tax break-even point* is defined by the Inland Revenue [17] as the earnings level at which *net* liability to tax arises. The main complication in constructing a comparable statistical series of the sort illustrated in Graph 9 concerns families with children, because of the replacement of taxable family allowance and child tax allowances by tax-free child benefit. Although a family with children now starts to pay income tax at a relatively lower level of income than in earlier years, it is not necessarily worse off. Thus, assuming basic-rate tax of 30 per cent, a tax allowance of £100 would be equivalent to a child benefit of £30, but the tax threshold is reduced by £70. The concept of the break-even point is intended to overcome this difficulty.

[1] *Inland Revenue Statistics*, [17], 1980, Section 2A.

[1] For two-wage-earning married couples, it is the married man's tax allowance plus the wife's earning income allowance, the latter being equal to a single person's tax allowance.

[2] COPY TO FOLLOW

EXAMPLE 3: In 1950-51 the tax break-even point for a married man with a non-earning wife and two children was 119 per cent of average male manual earnings. By November 1981 it had been cut to 57 per cent.
In order to restore the 1950-51 position, and assuming the married man's tax allowance of £76 (Example 2) and retention of tax free child benefit, the latter would have had to be increased to about £11 per child in November 1981, instead of £5·25.

It will be noted from Graph 9 that tax break-even points rose slightly after the transition to child benefit in 1977-79, but have since fallen. Tax thresholds for single people and married couples rose in 1972-73 and again in 1977-78, but have since fallen.

It is axiomatic that, to avoid either the unemployment trap or the poverty trap, tax thresholds must be pushed up well clear of poverty levels (defined as the income levels below which there is entitlement to supplementary or other means-tested benefits). The unemployment trap is an inevitable consequence of taxing incomes from work below or only marginally higher than SB levels. The poverty trap would fade away if tax thresholds were raised above entitlement levels for family income supplement and housing rebates.

It was not always so. The increasing value of the supplementary benefit scale rates in relation to tax thresholds is shown in Table 10. The small improvement in the figures for 1982 is due to last April's 14 per cent increase in tax allowances compared with the 11 per cent increase in supplementary benefit which will take effect in November 1982. Once again the SB figures in the Table exclude housing allowance and other additions, and therefore overestimate the gap between supplementary benefit and tax thresholds. And once again it is necessary to use the tax break-even point for families with children, in order to keep the figures on a comparable basis.

In practice, of course, families are not aware of tax break-even points. What concerns them is what is called their *tax-free income* [17], namely earnings plus child support, which may be received before liability to tax arises. Unlike tax thresholds for single people and married couples, tax-free incomes for families with children are below the supplementary benefit scale rates. Unfortunately it is not possible to show tax-free incomes on a comparable statistical basis before and after the transition to child benefit in 1977-79.

Table 10:
Tax Thresholds and Supplementary Benefit levels, 1950-82

National assistance/supplementary benefit scale rates as percentages of:

	Tax thresholds		*Tax break-even points*		*Tax-free Incomes*	
	Single person	*Married couple*	*Married couples with: 2 children**	*4 children***	*Married couples with: 2 children**	*4 children***
	%	%	%	%	%	%
1950	46	49	37	32	—	—
1965	70	75	54	46	—	—
1980	81	84	73	76	102	128
1981	88	92	74	76	108	133
1982	85	89	73	75	105	131

* Two children aged 4 and 8.
**Four children aged 3, 4, 12 and 16.
Note: SB rates for November of each year.
Tax figures for the whole of each financial year divided by 52.
Sources: Social Security Statistics, 1980, Table 34·01, and *Hansard*, 10 March 1982, col. 862.
Inland Revenue Statistics, 1980, 2A, 1981 Appendix C, and *Hansard*, 30 March 1982, col. 100.

The menace of lower tax thresholds is in part the result of a system of income tax relief based on tax allowances, and of a child support system based on tax-free child benefits. The Chancellor is boxed in. He cannot lift the lower paid out of tax, or increase child benefit, without helping every income taxpayer and every parent in the country. Whereas the age allowance is confined to benefits for retired people on relatively low incomes, being phased out on incomes above £6,700, all the other allowances represent tax-free income the whole way up the income scale, as does tax relief on mortgage interest and other secondary reliefs. Moreover, each £100 by which the Chancellor increases a tax allowance costs the Exchequer twice as much for taxpayers with marginal rates of 60 per cent than for taxpayers paying tax at the standard rate.

(ii) Tax rates

At the same time as tax thresholds have been falling, the starting rate of tax has been nudging inexorably upwards. Throughout most of the 1950s and until 1963 there were three reduced rates of income tax—stepping stones before the standard rate was reached—and these sub-standard starting rates varied between 9, 12½ and 15 per cent of taxable income. Between 1963-64 and 1969-70 there were two reduced rates. Since then, with the exception of a 25 per cent band on the first £750 of taxable income during 1978-79 and 1979-80, the British taxpayer has been subject to a starting rate (which is also the basic or standard rate) of between 30 and 41 per cent. Britain's wide range of reserves subject to basic rate tax is unique in the European Community, and the 30 per cent starting rate is one of the highest in the world.

High marginal rates of tax are another price we have to pay for our system of income tax reliefs which produces (by international standards) comparatively low average rates. In 1980-81 the income tax base was reduced by over 50 per cent on account of the various tax allowances, reliefs and exemptions relevant to the household sector.[1] The *average* rate of income tax on the total income of all households was only 13 per cent. In such circumstances it is not surprising that high *marginal* tax rates are necessary. It seems unlikely that a solution will be found to the unemployment and poverty traps without radical reform of the tax system.

(iii) Earned-income relief and work expenses

Although in Britain the expense of travelling to work has never been deductible for tax, earned-income relief at two-ninths of taxable income continued until 1973. Britain is now the only member state of the European Community where there is no tax relief for the costs regularly associated with paid employment. Most countries allow earned income relief *and* some sort of allowance for work expenses. In Denmark and Germany there is no upper limit to the costs of travel to work which may be set against tax. In Belgium and the Netherlands it is commonplace for employers to pay the costs of their employees' journey to work.

The escalation of travel costs since the oil price explosion in the mid-1970s has become a further significant factor, tilting the balance against paid work. Every fare increase, every increase in petrol price or duty, narrows still further the incentive margin between incomes in and out of work. For the lower-paid the situation is especially serious because of changing travelling habits. People are having to travel further to find jobs. The local jobs which were once available no longer exist, and public transport has shrunk. Some young people have to turn down job vacancies because public transport is either non-existent or too expensive and they do not have their own means of transport.

[1] Parliamentary Written Answer, *Hansard*, 17 February 1982, col. 150.

(iv) National Insurance contribution

Originally charged at a flat rate of 25 pence per week, national insurance contribution became partially earnings-related in 1961, and wholly so in 1975. At 25 pence the original contribution was regressive but it represented only 3·7 per cent of average male manual earnings. Today the non-contracted-out rate is 8·75 per cent, having increased by over two percentage points since the present Conservative Government took office. Further regular increases in NIC will be necessary if only to pay for the 1975 additional pension scheme.

There is a danger that increases in the NIC will take the place of increases in the rate of income tax, even though it has a bigger disincentive effect than income tax. This is because, firstly, the NIC is restricted to earned incomes. Secondly, it is more regressive than income tax because of the contribution ceiling or upper earnings limit, which means that people earning less than £220 a week pay a higher combined rate of income tax plus NIC on each extra pound earned than people immediately above the upper earnings limit.

8. TAX-FREE BENEFITS AND CUMULATIVE PAYE

The distortions produced under PAYE by the tax refund procedure are well documented and not seriously disputed. In November 1981 tax refunds could add about £8 to the weekly spending power of an unemployed single person, and about £12 per week to the spending power of a married couple.

Under the National Insurance Act of 1946 all national insurance benefits were intended to be taxable, but it quickly became evident that the cumulative nature of PAYE made it difficult to tax short-term benefits and the Finance Act of 1949 made them exempt. The cumulative nature of PAYE has meant that anybody who became sick or unemployed was entitled not only to tax-free benefits, but also to refunds of tax paid on incomes earned earlier in the same tax year since earnings turned out to be lower for the whole year than the tax system had anticipated. The weekly value of the refund was about equal to 1/52 of each beneficiary's annual tax allowance, i.e. 30 per cent of £41·25 (£12·38) for married couples with one wage-earner in November 1981, and 30 per cent of £26·44 (£7·93) for single people, assuming there was no liability to a higher-rate tax.

These refunds were payable until all tax previously paid in the same financial year had been paid back. But from the recipient's point of view, the potential advantages of the system, were not limited to those who became sick or unemployed during the latter half of the tax year. A tax-free social security income at the start of the financial year also meant reduced tax liability when work was eventually resumed.

In sickness, the position has been especially anomalous, due to the large and growing number of people whose sick pay was made up to the amount of their usual earnings. Since the part of sick pay equal to sickness benefit was free of tax, tax refunds became payable, creating a double bonus effect. For people earning above £8,000 a year the financial gain from sickness could easily exceed £100 a month.[1]

It is important to emphasise that the *cumulative nature* of PAYE is responsible both for the administrative difficulties associated with taxing benefits and for the tax refunds anomaly. Britain is by no means the only country where benefits are tax-free, although several have recently started to tax benefits. But elsewhere tax-free benefits do not pose quite the same problem, because the tax adjustments are not made until the *end* of each financial year.

It is Mrs Thatcher's Government's intention to bring most welfare benefits into tax. Benefits to the unemployed and to people on strike have counted as part of taxable income from 5 July 1982. Payments for short-term sickness (up to eight weeks) will be taxed from 6 April 1983 under the proposed statutory sick pay scheme. The date on which other short-term benefits (sickness benefit, maternity allowance, injury benefit and unemployability supplement) and invalidity benefit will be taxed is not yet known. Child benefit and the child additions payable with supplementary benefit and national insurance benefits will remain tax-free. So will the additions payable with supplementary benefit (the heating addition and the non-householder's housing addition, for example) and various other national insurance benefits (war pensions, mobility allowance and invalidity allowance).

The proposed changes will substantially reduce the value of tax refunds. Nor will they be payable on the same regular basis as in the past. They will be repayable either when the taxpayer returns to work or at the end of the tax year.

[1] *Hansard*, 11 February 1980, col. 504.

It would nevertheless be wrong to assume that the problem of tax refunds has been solved. *Tax refunds will have to continue so long as PAYE remains cumulative.* The initial amounts will be small, but only for so long as tax thresholds continue at their present historically low levels. For basic-rate taxpayers the new refund will be 30 per cent of the difference between the rate of taxable benefit and the weekly tax allowance. If tax thresholds were raised above supplementary benefit levels including housing costs, which is a necessary precondition for the restoration of work incentives, it follows that the new tax refunds could then become quite large. The figures in column (c) of Table 11 assume tax thresholds which approximately restore the 1950-51 ratios to average male manual earnings. The figures are hypothetical but they show little real change has so far been made.

Table 11:
Value of Tax Refunds

	Approximate weekly value of tax refunds		
	(a) *Nov. 81*	*(b)* *July 82*	*(c)* *Assuming 1950-51 tax thresholds**
	£	£	£
Single householder	7·93	2·06	7·13
Single non-householder aged:			
over 18	7·93	3·45	8·62
16-17	7·93	4·74	9·81
Married couple with or without children	12·38	2·78	11·48

*Assuming that tax thresholds were restored to the 1950-51 ratios to average male manual earnings, i.e. £47 for a single person and £76 for a single-wage married couple. (See page 9.)

As long as PAYE remains cumulative, it is much more difficult to operate reduced rates of tax, or to introduce gently progressive tax rates, as is normal practice outside Britain. And yet abolition of Britain's exceptionally wide band of tax incomes subject to the standard-rate tax, and a change to gently progressive tax rates starting as perhaps 5 or 10 per cent would help greatly to restore work incentives at the bottom of the earnings scale. The cost to the Exchequer would depend on the width of each 'band' as well as on the tax rates.

Cumulative PAYE systems exist in Britain and Ireland only. When introduced during the Second World War the advantages may well have outweighed the disadvantages. But today taxpayers in many countries pay their tax on a regular weekly or monthly basis without having to endure the complexities of cumulative PAYE, and without any undue upheavals at the end of the tax year. Published tax tables enables each taxpayer to check his or her own tax liability. Minor adjustments due to unemployment, sickness or high work expenses are made at the end of the tax year.

By increasing the number of benefits subject to tax (and many will remain tax-free), the scale of the tax refund problem will be reduced. But the central issue remains. A lasting solution to the unemployment and poverty traps is unlikely as long as cumulative PAYE continues and some benefit payments remain tax-free. The only logical exception to the latter rule is child benefit which is paid at the same rate whether or not the parent is in paid work, and which replaces former child tax allowances as well as former family allowance.

9. CHILD SUPPORT

Judged by its impact on incentives to work, Britain's child support system is, for several reasons, fatally flawed.

First, the level of support varies according to the employment circumstances of the parents and is worth less for the children of working parents than for the children of parents who are unemployed or sick. This narrows the gap between incomes in and out of work and is only partially offset by family income supplement.

Secondly, the value of child benefit is so small that it has to be supplemented by means-tested benefits, if only to offset the unemployment-trap effects mentioned above. This, in turn, produces a poverty-trap effect.

Thirdly, for young people between full-time compulsory school and regular, full-time employment, there is no properly integrated system of income maintenance at all. But there is a clear financial advantage in registering for work as soon as possible, no matter how unqualified.

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Graph 10 shows how the levels of child support vary according to parental circumstance. Child benefit is a tax-free, universal benefit paid to all parents regardless of their income and whether or not they are in work. From the incentive aspect it is an ideal benefit. *National insurance child additions* are paid for the children of parents who are sick or unemployed (short-term additions), and for the children of widows, retirement and invalidity pensioners (long-term additions), subject to all the usual NI provisos.

GRAPH 10

Supplementary benefit (formerly National Assistance) was scheduled to be the minimum income guarantee for people who through no fault of their own could not be self-supporting. It is means-tested. But because the children's SB rates are so much more generous than child benefit and the short-term NI child additions, supplementary benefit is increasingly the main benefit for unemployed families. Free school meals, free welfare milk and a heating 'addition' for families with children under five are automatically available under SB, but not with NI benefit, nor for families in paid work.

A fragmented system

Britain's fragmented child support system is virtually unique, a hangover from the social security system which existed before World War II. Writing in 1942 Sir William Beveridge warned against it:

> 'The gap between income during earning and during interruption of earnings should be as large as possible for every man. It cannot be kept large for men with families, except either by making benefit in unemployment and disability inadequate, or by giving allowances for children in time of earning and non-earning alike.'[1]

Beveridge recommended age-related, taxable family allowances averaging (in those days) 40 pence per week, payable for each child after the first in working families and also the first child of parents receiving social security. The exclusion from entitlement to family allowance of the first child in working families was from the start much criticised, and was finally changed by the Child Benefit Act of 1975. The chief continuing difficulty has arisen because the war-time Coalition Government legislated in 1944 for family allowance at 25 pence instead of 40 pence, which made necessary the continued payment of additions for children under the new 1948 national insurance benefits, and of children's rates with the new national assistance scheme. In other words, despite the Beveridge Report, a fault which bedevilled the pre-war social security system was carried over into the post-war welfare state.

Moreover, instead of gradually closing the gap between child support for parents in and parents out of work, the gap became wider. Whereas child support for unemployed families has maintained its 1948 parity with average earnings, child support for working families has fallen sharply, as is shown in Graph 11. By the questionable device of holding down the real value of national insurance child additions, the gap between child benefit and child support on short-term unemployment and sickness benefit will soon be closed. But the gap between child benefit and children's supplementary benefit rates continues to widen. For unemployed families supplementary benefit is the benefit of the future, due to the abolition of earnings-related supplement and the November 1980 5 per cent abatement in the indexed value of insurance benefits.

Effect of FIS in extending the poverty plateau

Family income supplement was introduced in 1971 to raise the net incomes of lower-paid families. But despite recent increases, the prescribed amounts below which FIS is payable are so low[1] that only a tiny minority of two-parent families has ever been eligible. For large families and for families with older children, family income supplement is in any case worth less than supplementary benefit. The main effect of FIS is to reduce net differentials and to extend the poverty plateau—and, occasionally, when entitlement runs out soon after a pay incresae, to produce marginal tax rates of over 100 per cent.

GRAPH 11

[1] *Social Insurance and Allied Services*, Cmd. 6404, 1942, para. 412.

[1] £82 for a two-child family in November 1981, or about 65 per cent of estimated average male manual earnings at that time.

Since April 1979 child benefit has been the only form of non-means-tested support available to working families. But the *rate* of child benefit was based on a consolidation of former family allowance and child tax allowances at a time when both were at an all-time low (Graph 9). A cash injection during 1978 produced a temporary but short-lived improvement. Today, in return for child benefit of £5·25 a week (£5·85 from November 1982), which is less than the cost to most families of sending their child to a state school, parents are taxed on the same basis as childless couples. And because they require larger accommodation, they generally contribute rather more in local authority rates. Consequently, families dependent on the single wage of the father often pay more in *net* tax (after taking into account child benefit) than two-wage couples without children but with the same joint earnings. And they also pay more in tax than pensioner couples with the same gross incomes, as shown in Table 12.

Table 12:
Net Incomes with and without Children, 1981-82

£ per week

Gross weekly incomes	*Net weekly incomes*		
Earnings or state pension + occupational pension	*Two-wage childless married couple**	*Single-wage married couple + 2 children***	*Pensioner couple*
£	£	£	£
80	62	72	73
100	75	84	87
120	87	97	99
130	100	109	110
160	112	121	124

* Assumes that three-quarters of the earnings are earned by the husband.
**Including child benefit.

Illogical support 'system' for 16-19 age group

When children reach 16 years of age their welfare status depends on whether or not they remain in full-time education and on whether their further education is academically- or vocationally-orientated.

Sixteen-year-olds staying on at school remain the financial responsibility of their parents who continue to receive child benefit. But a young person who registers for work counts as a separate 'family' unit for welfare purpose and becomes the financial responsibility of the community.

Many of these young people have little or no hope of finding regular employment, being at best semi-literate and semi-numerate. In 1979/80, out of a total of 751,000 school-leavers in England, only 275,000 had GCE 'O' level/GSE Grade I passes in English and only 197,000 had similar qualifications in mathematics. Over 91,000 children (about 12·2 per cent left school in 1979/80 without having passed any examinations at all, and a further 269,000 (about 36 per cent left school having obtained only lower grades in miscellaneous subjects.[1]

These youngsters are in desperate need of further education and/or vocational training. If they do not get it they are likely to remain on the periphery of the labour market throughout the whole of their working lives. Yet often they choose unemployment and supplementary benefit precisely because they come from families who need, or think they need, the extra cash.

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Although various grants, benefits and allowances other than supplementary benefit exist for the 16-19 age group, the regulations are bewildering in their complexity and constantly changing. Responsibility is divided between at least three central government departments (the Department of Health and Social Security, the Department of Education and Science, and the Department of Employment) and the local authorities. In most areas educational maintenance allowances are cut off at such low income levels and are worth so little that they do not compete with supplementary benefit. In practice 16-year-olds are able to stay on at school or go into further education only if their parents are able and willing to support them.

Britain lags far behind France and West Germany in her attitude towards training and further education. And the Government's *New Training Initiative*[1] tackles only part of the problem. A great deal of public expenditure will be wasted unless the provision of training places is combined with rationalisation and reform of *all* income support schemes for the whole 16-19 age group.

Training and income maintenance in West Germany

Recent figures show that only 56 per cent of British school-leavers were engaged in full-time general education, vocational education or apprenticeships, compared with 90 per cent in West Germany and 81 per cent in France. In West Germany there is a unified system of income maintenance for students and first-time trainees which is probably the most advanced of its kind anywhere in the world.[2] On reaching a certain level in school (usually at about 16), every young person is entitled to a minimum income, part loan and partly contributed either by the parents or out of public funds, provided that he or she is pursuing a recognised course of study. The sum guaranteed varies according to age, type of course, and whether or not the student is living at home. The aim is to ensure that every young person has an equal opportunity to reach his or her full potential. Training courses are readily available and young people who prefer not to take the opportunities provided are generally not able to draw social security.

1 Dept. of Education and Science, *Statistics of School Leavers CSE and GCE —England*, HMSO, 1980.

1 Cmnd. 8455, HMSO, 1982.

2 *Bundesausbildungsforderungsgesetz* (BAföG), or law for the promotion of education and training. The West German social security system is outlined in Rolf Neuhaus [19].

In Britain there is a long-standing prejudice against vocational training, which is regarded as in some way inferior to academic learning. Yet the economy needs technicians and craftsmen as well as graduates. There is no economic justification for an income maintenance system which favours those who are academically inclined. Nothing is to be gained by using public funds to encourage young people to go to university who lack academic ability, or who would be able to contribute much more by learning a trade or getting a technical qualification. Yet this is precisely how the system operates. Academic courses qualify for mandatory awards whereas vocational courses qualify only for discretionary awards. When funds are limited, the latter tend to fade away. Students at colleges of further education generally come from families where there is less money available than in the families of university undergraduates. Yet most college students receive no grant or very little. In addition they are expected to pay fees and supply their own equipment. Not surprisingly, they end up with less spending power than if they stayed at home and relied on the dole.

EXAMPLE: One sister, aged 21 and unemployed, has spending power from supplementary benefit of £21·15 a week, and can earn a further £4 a week without loss of benefit entitlement.

The other sister, aged 18, who is training to be a hairdresser, earns £31 but has net spending power of £19 after deducting tax, NIC, fares and college fees. How this happens is shown in Table 13.

Table 13:
Spending Power as Trainee Hairdresser compared with Supplementary Benefit

Second-year hairdressing apprentice + day release	£	*Unemployed on SB*	£
Wage	31·00	Unemployed 18-year-old SB scale rate	18·60
		PLUS	
		Non-householder's housing addition	2·55
		Disregarded earnings	4·00
LESS			
Income tax	0·26		—
NIC	2·71		—
Fares to work	5·00		—
College fees, etc. weekly average	1·35		—
Fares to college + lunches	2·00		—
NEW WEEKLY SPENDING POWER	18·68		25·15

Note: how the £31 wage takes the second-year apprentice into the 'NIC trap'. Because her earnings are over £29·50 she must pay NIC at 8·75 per cent on the whole lot. She would be better off with a wage of £29. Her net pay after income tax and NIC is £28·03, only 53 pence more than the £27·50 rate for a first-year apprentice, which is below the thresholds for income tax and NIC.

10. Means-Tested Benefits

Instead of tackling the problem at its roots, the authorities' response to the unemployment trap has for many years been to increase reliance on means-tested benefits, by introducing new ones and by raising the entitlement levels for existing ones. Each time this happens there is an initial palliative effect which is quickly followed by new distortions. The main consequence has been the opening up of the poverty trap.

It is widely supposed that means-tested benefits are the most cost-effective way to tackle poverty. But means-tested benefits at best relieve poverty; they can never prevent it. And because the 'take-up' of benefits is low, they are never more than 75 or 80 per cent effective, often much less. Furthermore, because of the discouraging effects on incentive as they are withdrawn, it is arguable that means-tested benefits add to poverty by inhibiting the long-run productive process. This is more than ever likely when, as in Britain, means-tested benefits are paid to people who are also subject to tax.

Tax-induced poverty

During the last 30 years we have created a new sort of poverty: *tax-induced poverty* (Table 14). The DHSS figures show that in almost every case means-tested benefits payable to employed people are necessary only because gross earnings have been whittled away by income tax, national insurance contribution and local authority rates. If such taxes were levied according to ability to pay there would be little need for means-tested benefits. The official argument that the poverty trap is largely the result of measures taken to relieve poverty[1] does not withstand close examination.

EXAMPLE 1: Assuming average local authority rents and rates, a single person's means-tested housing benefits are less than his tax liability unless his earnings are below £44 a week.

EXAMPLE 2: Assuming average local authority rents and rates, means-tested housing rebates for a married couple are less than tax liability unless earnings are below £59 a week.

EXAMPLE 3: Again assuming average local authority rents and rates, the total means-tested benefits entitlement (including family income supplement and free school meals) for a married man with two children is less than his tax liability unless his earnings are below £74.

Table 14:
Tax induced poverty: Tax liability compared with Means-tested Benefit Entitlement, October 1982

Family type	*Gross weekly earnings*	*Total tax**	*£ per week* *Total means-tested benefit***
Single person	40	12	14
	50	16	11
	60	20	8
	70	24	6
Married couple	50	11	17
	60	15	14
	70	19	10
	80	22	8
Married couple + 2 children	60	16	34
	70	19	23
	80	23	16
	90	26	10

* PAYE, NIC and local authority rates.

** Rent and rate rebate, FIS, free school meals, free welfare milk.

Source: DHSS [1], April 1982.

[1] Joint memorandum by the Treasury, DHSS and Inland Revenue to the Treasury and Civil Service sub-committee Inquiry into the structure of personal income taxation and income support [11], pp. 00-00.

The incentive to work is further undermined by the unco-ordinated nature of means-tested benefits, due largely to the piecemeal fashion in which they have evolved. Lack of co-ordination between family income supplement and supplementary benefit means that child support is often higher on SB than when at work. The restriction of free school meals to families in receipt of FIS or SB creates further problems. Free school meals for a two-child family were worth £4·50 or more in November 1981, and to lose them has a major disincentive effect. Widows, who tend to earn just enough to take them above the FIS prescribed amounts, are frequently victims of this anomaly.

Housing benefits contradictions

Housing benefits provide another example. Instead of a single, unified system with all householders subject to the same ground-rules, entitlement depends on employment status and housing tenure. Consequently, people with the same income and the same housing costs get different treatment for altogether extraneous reasons. Housing costs, including mortgage interest, are payable in full to anybody in receipt of supplementary benefit (in other words, to those out of work), but working people, unless their wages are exceptionally low, get at best only part of a rent rise rebated, or some tax relief if they are mortgagees. The Government's new housing benefit scheme[1] is an important step in the right direction, but many anomalies will remain. For instance, no account is taken of owner-occupiers, yet an increasing number of people are buying their own homes, and an increasing proportion will in future be claiming supplementary benefit.

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Net spending power

By showing how income tax and national insurance contributions have eaten into earnings during the past 30 years, and by comparing the SB scale rates with gross and net earnings, it has been demonstrated that the unemployment trap is the result of higher taxation rather than increases in social security benefits. But net spending power, which takes account of means-tested benefits and work expenses as well as child benefits and tax, is a more useful indicator of the total effect of government policies on work incentives, because it gives a more complete picture.

Table 15 attempts to show how *spending power replacement ratios*, i.e. how much you have to spend in work or out of work, have altered since the introduction of national assistance (the forerunner of supplementary benefit) in 1948. The figures are hard to unravel, and must be subject to all the usual caveats. In particular, as already explained, the figures must not be generalised. Some people will have been better off, and some worse off, than the figures suggest. No account is taken of additions to supplementary benefit other than free school meals and the post-1980 heating allowance. Nor do the figures include any allowance for work expenses other than fares, nor for an incentive margin.

Housing costs are the average housing additions (rent and rebates) paid with national assistance/supplementary benefit in each year. For 1948 the figures were taken from the 1975 Annual Report of the Supplementary Benefits Commission. For all the other years the figures are taken from the DHSS *Abstract of Statistics*.

Free school meals are included only where there was a statutory entitlement, as with supplementary benefit and family income supplement in 1975, 1980 and 1981. There was no national scheme of free school meals until 1964.

Free welfare milk has been omitted from all the figures, because its value in 1948 is not known. But the regulations governing entitlement have not been altered significantly.

Fares to work for 1975, 1980 and 1981 are those used by the DHSS in their Tax Benefit Model [1], and are derived from Family Expenditure Surveys and the 1978-79 National Travel Survey, using the updated fares component of the retail prices index. For 1948 an estimated weekly expenditure of 10 pence has been used, this figure being derived from the *Report of an Enquiry into Household Expenditure 1953-54*, after allowing for an estimated 24 per cent increase in the prices of consumer goods and services between 1948 and 1953.[1]

This estimate of a 44-fold increase in the cost of travel to work between 1948 and 1981 is an indication of the enormous change which has taken place in travel to work patterns as well as in travel to work costs. People are having to travel further, and they are playing substantially more for each mile they travel. Lower-paid workers and women in particular, because they often do not have their own means of transport, are disproportionately affected. This is a subject important enough to warrant a study of its own. There must be a correlation between unemployment and the expenses of getting to work.

[1] The Social Security and Housing Benefits Act 1982.

[1] *Report of an Enquiry into Household Expenditure 1953-54*, Table 9

		Incomes: *£3 but under £6*	*£6 but under £8*	*£8 but under £10*
Travel to work by:	Rail/tube	0·01	0·025	0·03
	Bus/tram	0·075	0·12	0·125

as per cent of average male manual earnings in October 1953 (£9·46).

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Table 15:
Net Spending Power Replacement ratiosm
1948, 1975, 1980 and 1981
National assistance/supplementary benefit scale rates plus free school meals and heating addition as percentages of gross earnings less *income tax, NIC, rent, rates and fares to work,* plus *FAM/child benefit, FIS, rent and rate rebates and free school meals.*

Year	Single householder	Married couple	Married couple + 2 children*	Married couple + 4 children**
(1) AVERAGE MALE MANUAL EARNINGS				
	%	%	%	%
1948	23	36	46	61
1975	32	51	66	88
1980	32	49	68	92
1981	33	52	71	94
(2) TWO-THIRDS AVERAGE MALE MANUAL EARNINGS				
1948	34	55	73	93
1975	50	73	85	104
1980	50	70	88	97
1981	53	73	90	99

* Two children aged 4 and 6.
**Four children aged 4, 6, 12 and 16.

Note: SB entitlements are for November each year.
Earnings are for October each year, and provisional for 1981.

Sources: *Social Security Statistics*, 1981.
The Taxes Acts, Vol. I, 1980.
DHSS *Abstract of Statistics* for index of retail prices, average earnings, social security benefits and contributions.
Own calculations.

Although wages have increased more rapidly than prices, the gap between living standards in and out of work has narrowed appreciably since 1948, and continues to do so. What would have been the effect on incentives if the trade unions had exercised more restraint in pay bargining, or if incomes policy had been successful? Might it be that apparently irresponsible wage demands are a rational response to the consequences of the tax/benefit system on the relative living standards of families with children and of the lower paid? The sharp deterioration in the relative position of single people at two-thirds average earnings, and of families with children at average earnings, confirms the pattern already noted in Graph 8.

PART FIVE

The Necessity for Reform

11. AN INTEGRATED INCOME REDISTRIBUTION SYSTEM

A widespread erosion of work incentives has been brought about by the combination of factors described in the preceding Parts. There must clearly be something wrong with a system which permits such a fundamental fault to develop. Why did it happen? The quick answer is the lack of strategic policy-making and of co-ordination, both between and within government departments. But the underlying reason is more subtle. It lies rather in public attitudes, and in the peculiarly haphazard and subjective approach to income redistribution which is endemic in Britain.

Despite the vast sums of taxpayers' money involved,[1] Britain has no income redistribution programme as such and no government department with overall responsibility for income redistribution—not even a division within the Treasury. There is no definition of objectives, no single poverty standard, and not even an agreed definition of what is meant by poverty.

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Instead of charging tax according to taxable capacity and paying benefit either according to assumed basic needs or according to previous earnings, people are slotted into arbitrary catagories. Some are then treated more favourably than others, either because they are considered more deserving or because that just happens to be the way the system has evolved.

N

Net incomes, living standards and work incentives have come to depend on altogether extraneous factors, e.g. on whether a person is male or female, single or married, widowed or divorced, with or without children, an old-age pensioner or one of the long-term unemployed, a school leaver or sixth-former, disabled in war, at work, or from birth.

A rational system of income redistribution would rest on objective criteria such as assumed basic need and taxable capacity, which in turn could be calculated using scales derived from family budgets.[1] Such budgets, taking account of minimum nutritional and other needs as well as spending patterns, already form the basis of social aid scales in the United States, Germany and elsewhere. The same standards should apply to allowances against income tax. Alternatively, the tax system and the benefit system could be integrated, either through tax credits or through a negative income tax.[2] When benefit entitlement or tax liability is based on unstated criteria, subjective and political judgements take over and the door is open to government by pressure groups, vested interests and political expediency. Those with the loudest voices or most numerous votes benefit at the expense of those without and the system falls apart.

That is precisely the position in Britain today. Some people receive state benefits when they already have sufficient resources of their own, or pay less in tax than they might reasonably be expected to pay. Others go without. Almost everybody feels cheated. And because the system is so complex and inaccessible, constructive and effective criticism is difficult.

Surprisingly, Britain's muddled approach to income redistribution is seldom questioned. Nor is the widespread habit of making subjective judgements about other people's welfare requirements or the amount of tax they should pay. Politicians, civil servants, academics, research institutes, the media and countless pressure groups are all in the business of suggesting how much people should get and pay—all without any attempt at a coherent, consistent and costed strategy.

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Some areas have become sacrosanct, notably retirement pensions. Nobody dares to question their preferential treatment, although it means that pensioner couples pay no net tax (in other words, state retirement pension exceeds tax liability) until their incomes reach nearly £11,000 per annum, or £205 a week. In contrast, couples with one wage earner and two children start to pay tax on incomes below £75 a week. No account is taken of the extra costs of raising children, nor of the disutilities of work.

Table 16:
Tax/benefit treatment of pensioners compared with working families

Tax break-even points, October 1982, £ per week*

	Gross incomes		*Tax liability*	*Tax break-even points (rounded)*
	£		£	£
1. *Pensioner couple*				
State retirement pension	47·35	Income tax	47·40	157·65
Other income**	157·65	NIC	—	
TOTAL GROSS INCOME	205·00	TOTAL TAX	47·40	
2. *Married couple with 2 children*				
Gross earnings	64·00	Income tax	5·09	64·00
Child benefit	10·50	NIC	5·60	
TOTAL GROSS INCOME	74·50	TOTAL TAX	10·69	

* *Tax break-even point* defined for pensioners as the level of other income at which net liability to tax commences, and for working families as the gross earnings level at which net liability to tax commences. Note that state retirement pensions are taxable whereas child benefit is tax-free.

**Occupational pension, investment income, and so forth.

[1] About £69 billion in 1981-82 made up as follows: social security (including student maintenance awards, FSM and MSC benefits/allowances) £31·42 billion, housing expenditure (excluding capital expenditure) £4·46 billion, estimated cost of income tax allowances, relief and exemptions £33·3 billion.

[1] For a full discussion of family budgets, Margaret Wynn [21].

[2] Colin Clark and others [22].

A powerful lobby is at present recommending an increase in child benefits to be financed by the abolition of the married man's tax allowance and the wife's earned income allowance in favour of non-transferable adult tax allowances. Thus not only would all adults of working age be entitled to the same tax allowance (approximately equal to the present single person's tax allowance), but husbands and wives would be taxed independently, so that the new tax allowance would be worth nothing to a non-earning spouse. The savings from abolishing the married man's allowance and wife's earned-income allowance would be diverted to increasing child benefit.

Using 1981-82 tax allowance figures and November 1981 supplementary benefit figures, it can be shown that the effect would be to push the tax threshold for married couples without children on a single wage even further below SB level than it is at present. As shown in Table 17, the position for familes with children would improve at the expense of families whose children are grown up.

Table 17:
Tax Thresholds and Supplementary Benefit Levels in October 1982 and Under a System of Mandatory Independent Taxation

	£ per week		
	Tax thresholds		*SB levels including average rent addition November 1981*
	Existing system 1982-83	*Proposed system*	
Single person's tax allowance	30·10	—	35·39
Wife's earned income allowance	30·10	—	
Married man's tax allowance	47·02	—	
New adult tax allowance		30·10	
Two wage married couple	77·12	60·20	52·23
Single wage married couple	47·02	30·10	51·23

Reform of the existing system of tax relief is urgently required, but if separate taxation of husband and wife on these lines were put into effect, it would worsen the unemployment and poverty trap for childless married couples dependent on the low earnings of a single spouse. There are probably over a million families without dependent children where the wife is not in paid work, and many of them are low paid. Many more wives work ~~part-time~~ and would not be able to take full advantage of a non- tax allowance. No matter how strong the case for ~~increasing~~ child benefit, it would appear quite wrong to raise the living standards of families with children at the expense of any other hard-pressed group in the community.

Indeed, this would be just another patchwork change of the kind which has done so much damage in the past. Yet it is put forward as a serious option for reform in the Government's consultation paper, *The Taxation of Husband and Wife,*[1] by the Equal Opportunities Commission,[2] and by the Institute for Fiscal Studies,[3] among others. Its advocates presumably believe that anybody without dependents should take paid work or register for work, and that this value-judgement should take priority over the concept that taxable capacity varies with the number of dependents. They seem not to have considered the social and economic effects if more than one million non-working wives were suddenly to register for employment.

If we are to restore work incentives at the same time as preventing poverty and having an income redistribution system that people accept as fair, it will be necessary to avoid social and political prejudice, and to remodel the entire tax/benefit system on the basis of carefully defined, objective and consistent criteria. Having done this, all future benefit upratings and tax changes must be carefully synchronised. Insofar as means-tested benefits remain necessary, the same entitlement regulations must apply across the board, regardless of employment circumstances.

[1] Cmnd. 8093 [27].

[2] *The Taxation of Husband and Wife:* Response of the EOC to the Government's Green Paper [28].

Conclusions

1. The purpose of this study has been to examine the relationship between the tax system and social benefits to discover how work incentives have been eroded. Without doubt there has been a marked deterioration in the tax/benefit balance since 1950—and it continues. The effect of increased replacement ratios on the unemployment trap has been partially offset by the introduction of means-tested benefits for the lower paid. But a perverse by-product has been to reduce or remove differences in net incomes over a wide range of gross earnings. In other words, it has created the poverty trap and the poverty plateau.

2. The present contradiction is not due to increases in flat-rate unemployment or supplementary benefit rates, which bear approximately the same relation to gross earnings as in 1948. The chief cause is the attack on the living standards of the lower-paid from direct taxation (income tax and national insurance contribution).

Income maintenance today is no longer simply a matter of how much is paid out by the state in welfare benefits. What the state takes away in taxation is equally important. This is a development of the utmost significance. But government is still conducted as though there had been no such change.

3. Because of Britain's almost unique flat-rate benefit system with its dependency additions, the lower-paid and families with children receive disproportionately large benefits in relation to former earnings if they are out of work. And at the same time, because our tax system starts too low down the income scale, and because child support is inadequate and fragmented, their *net* incomes from *paid work* are disproportionately small. The cumulative nature of PAYE compounds the problem, and the tax refund anomaly will not be remedied by the simple expedient of making some benefits liable to tax. P

4. The predictable consequences of an irrational, faulty system of income redistribution are unemployment, inflation and low growth—except in the spreading cash economy. And it is surely no coincidence that Britain is experiencing just such effects. Nevertheless, it is not the main purpose of this study to examine those relationships, nor to try and show exactly how many people are exposed to the moral hazard of social benefits through the erosion of incentives to help themselves. In theory, survey evidence is the most reliable source of information. In practice it is out of date before it is published. It also tends to underestimate the scale of the problem, because people forced by the system to break or bend its rules are not likely to admit it.

5. The nearest we can get to quantifying the scale of the problem is a round estimate of $4\frac{1}{2}$ million adults in 1979 at risk from the unemployment and poverty traps, representing about 18 per cent of the work-force. But the figures are increasing and the total at risk in 1982 is unlikely to be less than $5\frac{1}{2}$ million or over 20 per cent of the welfare. The poverty and unemployment traps are closely interwoven, and many potential victims of the poverty trap are among Britain's 3 million unemployed.

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6. Attempts made by other writers to quantify the scale of the problem, using hypothetical standard rents, rates and work ex-

penses to establish so-called average replacement ratios, are extremely misleading because it is precisely those people with above-average housing costs and fares to work who are most at risk from the unemployment trap. It is necessary to distinguish between *net income replacement ratios*—which can be generalised to estimate numbers affected, but which are unhelpful because they take no account of individual circumstances—and *spending power replacement ratios,* which give the full picture for each indivudal but which cannot be generalised.

7. It is important to emphasise that the problems described in this study are by no means unique to Britain, nor to the present time. Similar problems have occurred before, and are now being experienced in most countries with highly-developed social security systems. Recognition and study of the difficulties inherent in income redistribution programmes, and of the micro-effects on the individuals concerned, is a necessary first step towards a more efficient system.

8. The argument about unemployment should be not about whether today's unemployed genuinely want to work, but about the price at which it is worth their while to sell their labour and the speed with which they set about and find new jobs. An incentive margin of £10 may be reckoned the minimum payment necessary to offset the disutilities of work. If, for whatever reason, each unemployed person now takes on average twice as long as before to find an acceptable job, the unemployment statistics will double. At the same time, if living standards for skilled and unskilled labout converge, a lack of skilled workers and a surplus of unskilled labour, must result, so that unemployment and labour shortages exist simultaneously. Again, if child support is inadequate, there will be continuous upward pressure on wages right across the board.

9. Where it can be shown that the existing tax/benefit structure is likely to have such effects, it would be better to change the structure quickly rather than waste time arguing about the exact number of people affected. The only logical alternatives are to accept a continuing increase in the so-called 'natural rate of unemployment' or introduce direction of labour.

10. The problems outlined in this *Monograph* will not be remedied by *ad hoc* or patchwork solutions. The system requires radical reform by the consistent application of objectively defined criteria. The twin problems of income redistribution and incentives to work should be the responsibility of a single government department.

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