



ABOLISH THE POOR

How raising the Income Tax and National Insurance thresholds could give everyone a living wage

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BRIEFING PAPER

EXECUTIVE SUMMARY

- It isn't greedy employers, but greedy government, that is keeping people in in-work poverty; without tax on low earnings even workers on the 2015 minimum wage would earn a living wage.
- The government should raise the national insurance contributions (NICs) threshold along with the income tax threshold to let workers keep more of what they earn—without tax 37.5h on the minimum wage would give workers just 32p/h (or £670/year) less than the living wage.
- Employer-side NICs fall partly on employment and partly on workers' wages—cutting them should also be a governmental priority.
- Unconditional benefits paid to those in work are *not* a subsidy to employers, in fact they may induce employers to offer higher wages; those such as tax credits go mostly through to higher wages. Rothstein (2010) estimated that in the United States 73% of the Earning Income Tax Credit went to the worker.¹
- Even if the minimum wage for the over-25s were increased to £9/hour under the current tax system, take home pay will be only 69p/hour above the untaxed level of the 2015 minimum wage. This difference will become even less significant considering planned increases in the minimum wage in the coming 5 years.
- Instead of imposing a mandatory National Living Wage, the Chancellor would have done better to remove taxes from the lowest paid, giving workers a similar level of post-tax income while forgoing the 60,000 higher unemployment and £1.5 billion lower GDP that the Office for Budget Responsibility predicts will accompany his plans.

INTRODUCTION

That the low paid in the UK receive too little in the way of income is becoming a commonplace observation. In this paper we suggest a simple manner of increasing those incomes, one that is entirely in the power of the government to deliver immediately: raise the income tax and national insurance allowances to the level of the full time, full year, minimum wage. (*NB: All figures in this report refer to the national minimum wage of £6.50/h as at 8th of July 2015*)

¹ Rothstein, Jesse. 2010. "Is the EITC as Good as an NIT? Conditional Cash Transfers and Tax Incidence." *American Economic Journal: Economic Policy*, 2(1): 177-208.

This would, as the IMF has recently noted, increase the GDP growth rate and would, in part, pay for itself.

Further, this would immediately convert the current minimum wage into the net income provided by the Living Wage that many are demanding.

We think that it is simply immoral to be charging high taxes on incomes to those with low incomes and thus support such a measure on that ground alone. The additional benefit of being able to entirely abolish, by the standards currently used, in-work poverty by the same measure is to us simply a bonus.

What follows is a discussion of the details. Our basic point is that if we want to increase the incomes of the working poor, which we do and many others say they do, then we should start by not taxing them so damn much.

THE LIVING WAGE IS THE MINIMUM WAGE WITHOUT TAX

There's a growing movement calling for a "Living Wage" for the UK. This is substantially higher than the current minimum wage. The argument appears to be that anyone who is working full time should be paid enough to not be living in poverty after that full time work. That's not how wages are determined, but for the purposes of this paper let's leave that to one side.

It is then further said that employers who do not pay such a living wage, and whose employees then get in work benefits, are being subsidised by the taxpayer. We should thus push the minimum wage up to that living wage, the argument goes, in order to remove said subsidy from taxpayer to those employers.

There's at least one major problem with this idea, which is that we do not in fact have low wage poverty in the UK. This is entirely apart from the unemployment effects that would come from any such rise in the minimum wage. For the truth is that we have tax poverty, not low wage poverty.

This tax poverty exists because the income tax and national income systems kick in at very low incomes in this country. People who work part time on the minimum wage are paying income-based taxation on their incomes. At first appearance, this is ridiculous. We insist that this is the minimal moral amount that anyone can be paid for their time – and then we tax it?

We at the Adam Smith Institute have been making this point for a number of years now, ever since the Joseph Rowntree Foundation first sponsored the calculation of what that living wage is. We are now making the point that national insurance and income tax are both simply taxes upon income. What is true of income tax is therefore also true of national insurance: we shouldn't be charging either to those on very low incomes.

The end effect of this would be to transform the current minimum wage into that living wage that is being campaigned for, without any of the ill-effects that raising the minimum wage would risk. Tax poverty is something that government has in its hands the power to solve. So why not do so?

We should point out that we're just fine with the way that the JRF define poverty, as something that changes according to the society we're talking about. It's akin to what Adam Smith said about a linen shirt. Such linen is not a necessity in any form. But if you live in a society where being unable to afford a linen shirt means that you are regarded as poor then, if you cannot afford a linen shirt in that society, you are poor.

The JRF defined poverty in a similar manner – consulting a number of focus groups they asked what people should be able to purchase in order not to be regarded as poor in modern Britain. The full list can be found elsewhere² but it included things like being able to go out for a couple of pints once a week, a simple meal out once a month and so on. And while not being able to afford these things obviously isn't absolute poverty in any global or historical sense, we're perfectly happy with the idea that this is what today's Britons think you should be able to do if you are not poor. If you cannot do them in today's Britain then you are to be regarded as, by the standards of this time and place, poor.

From that they reach the number for the living wage, which is £7.85 outside London. We will leave aside the higher rate for London itself as we cannot really determine income taxation upon regional areas, although that could be an interesting idea to contemplate. This is to be compared with the current minimum wage of £6.50 an hour. Obviously there is a gap there.

However, we now need to consider the impact of taxation of incomes on those numbers. The current standard personal allowance is £10,600 a year for income tax. This is substantially higher in very recent years, partially as a result of our continual pointing to these following calculations. Income above this is taxed at 20% (higher rates of personal taxation do not affect the sorts of incomes we are talking about here).

Then there is also national insurance to pay. This comes in two flavours: employee's NI, which is charged at a rate of 12% on incomes above £155.01 a week (as with income tax, it is a marginal rate, only on what exceeds the allowance). Then there is employers' NI, which starts at £156 a week and is charged at 13.8%. Although most, likely all, of the incidence of the employers' NI is probably on the worker's wages, it isn't quite true to say that we can just add these two amounts together to reach a rate of 25.8%, for employees' NI is charged on the amount after employers' has been deducted.³ But a rate of 25% over that threshold will not be far off and added

² C. Goulden and C. D'Arcy, *A definition of poverty* (2014), Joseph Rowntree Foundation (<http://www.jrf.org.uk/publications/a-definition-of-poverty>)

³ J. Gruber, "The Incidence of Payroll Taxation: Evidence from Chile", *Journal of Labour Economics* (15-3, 1997), p. S72.

to the income tax rate that's 45% or so of marginal income vanishing in income related taxes.

This is a substantial amount when we are talking about the minimal sums that are regarded as the just and righteous amount that any- and every-one should be receiving for their labour. And substantial amounts being charged to those who we do regard as being poor. We would go so far as to argue that these rates of tax are immoral on such low earnings. When we then combine this with the rates of benefit withdrawal that also happen at about these income levels we reach "taxation" rates well up into the 60% and above at times (even, for some, 90 and 100%) and just as we've long said about such rates on the rich these are entirely counter-productive. There really is a Laffer Curve and while all can argue about what the peak rate is cumulative rates of over 70% are regarded by most as being over that peak.

Here are two numerical examples. We look at a full year working week of 40 hours and one of 37.5 for both the minimum wage and the living wage:

TABLE 1: INCOME AND TAXATION AT MINIMUM AND LIVING WAGES

| | MINIMUM WAGE | | LIVING WAGE | |
|-----------------|-------------------|---------------------|-------------------|---------------------|
| | 40 HOURS/ WEEK | 37.5 HOURS/ WEEK | 40 HOURS/ WEEK | 37.5 HOURS/ WEEK |
| Annual pay (£) | 13,520 | 12,675 | 16,328 | 15,307.5 |
| Income Tax (£) | 584 | 415 | 1,145.6 | 941.5 |
| Employee NI (£) | 655.2 | 553.8 | 992.2 | 869.7 |
| Net income (£) | 12,280.8 | 11,706.2 | 14,190.2 | 13,496.3 |

Note the outcome of this. Using that 40 hour working week, the living wage under the current taxation system provides an annual income only very marginally above what the current minimum wage would provide if it were untaxed. The difference is indeed small: £670 a year. Or, if we go back to taking about wages per hour, the difference is some 32 pence an hour.

The difference between the gross living wage and the current gross minimum wage is £1.35 an hour. The difference between an untaxed minimum wage and the living wage is 32 pence per hour. We really are correct in our identification of this as tax poverty, not low wage poverty, as the difference is indeed the heinous amount of income related taxation that is charged to the working poor. The solution is to reduce or eliminate that taxation.

This is before we've even begun to talk about employers' national insurance. It's a very odd tax to have in the first place, given that we think that people employing others is a good idea. So quite why we're taxing something that we want to happen

is uncertain. Unless it's just that most voters don't really see it, which would make it attractive to politicians if no one else.

It is actually employees who pay Employers' NI, through lower wages. Employers have a certain amount that a job is worth to them and that's what they'll pay. Whether some of that goes in income tax, wages, employees' or employers' NI is of little importance to them. The burden of such social security taxation is indeed upon the wages of the workers. Thus, over the medium to longer term at least, we would expect abolition of employers' national insurance upon low wages to lead to a rise in said low wages. We've not included it in that table on the grounds that it would not be an immediate change. There would be some adaptation of the labour market to these lower charges.

What would happen if employers' NI was cut or scrapped altogether? Initially, labour would become cheaper to hire for employers, while incomes for the workers would not change. This would increase employment: it's a standard that if you tax something you get less of it so if we stop taxing employment then we'll get more of it. More employment will of course bid up wages to some extent: that is how markets work, demand curves really do slope downwards even for labour. So: make labour cheaper to employ and more people will be willing to purchase it. At which point we would see that reduction in employers' NI charges being competed away in said labour market. Over time we would expect wages to rise to cover that reduction in taxation.

Note that if we want to say that wages wouldn't rise to fill that reduction then that is equivalent to stating that employers are currently really bearing the burden of employers' NI. They are the same statement. And given that no one really does think that they are then we would indeed expect wages to rise.

At which point it should be clear: reducing the taxation to zero of the current minimum wage, including employers' NI, would make that minimum wage higher than the current post-tax living wage. At which point, if we are to believe the campaigners of course, we have just entirely solved the problem of in-work poverty.

It's worth making one other point here. The calculations of that living wage do take this into account. As the income tax personal allowance has risen in recent years the living wage has been appropriately reduced (other factors have meant that the amount itself has risen, but the effect of the tax changes alone has been to reduce it). The campaigners themselves are quite clear on this point.

As long as they stay consistent to their own methods then they will agree: a zero income tax and zero national insurance minimum wage at the current rate would indeed mean all were receiving what they say is the living wage. And thus we would indeed have solved what they call the problem of in-work poverty.

It's rare that government has the ability to solve poverty entirely within its own power in such a simple fashion. So, we should do this. After all, if we want to working poor to have more money let's just stop taxing them so damn much.

A common trope at present is that the payment of in work benefits acts as a subsidy to those employers that hire low wage labour. This may indeed be true to some extent but not to the extent that is believed. For the trope is that all benefits paid to those in work are subsidies to those employers. This is not so.

Benefits that are paid upon the basis of low incomes, but not a work requirement, act as an anti-subsidy to such employers for they raise the reservation wage (the wage an unemployed worker requires to accept a job). Subsidies that are paid to those on low wages but only upon fulfilment of a work requirement are indeed, in part at least, a subsidy to those employers of the low wage labour, in the sense that they reduce would-be workers' reservation wages.

It is thus not possible to look at the total for in-work benefits and declare that to be subsidy to employers. For example, housing benefit would be paid whether someone was in work or not. It's conditional on not having sufficient income to purchase appropriate housing in that area. There is no work requirement and thus this acts to push up the wages that employers must pay. For as the household income rises the amount that is on offer in housing benefit declines. The employer must be offering wages sufficient to overcome this heavy marginal tax rate: wages are higher as a result of this benefit. The subsidy flows to the household receiving the benefit, not to their putative employer.

The situation is the other way around with working tax credits. These are conditional upon certain work requirements. These will therefore, in part at least, act as a subsidy to low wage employers.

As an example of this, from Arindrajit Dube. This references the American system but is equally applicable here. And we should note that Dube is by no means on the right: he is one of those arguing for a substantially higher minimum wage in the US. We might not agree with him on that but his analysis of who benefits from such subsidies is correct:

A final line of argument is that these public assistance programs have become de-facto subsidies for low-wage employers. For a program to be a subsidy for an employer, it needs to lower wages. Is this plausible for the public assistance programs considered? I think it is for the EITC, but not for other programs. Depending on where one is on the EITC schedule, that policy can increase work incentives. And there is a lot of empirical evidence showing EITC encourages labor force participation. An unintended consequence of that labor supply response, however, is that employers capture some of the tax subsidies. This can happen in a simple supply and demand framework, where an increased labor supply to the market drive wages down. This can also happen in a bargaining context where the size of the bilateral surplus expands from lower taxes, and employers capture some of this increased surplus. Work by UC Berkeley's Jesse Rothstein suggests that for every \$1 of transfer to workers using the EITC, post-tax income rises only by \$0.73 because of employer capture.

But what about other programs like food stamps or housing assistance? These means tested public assistance programs are not tied to work, and we should not expect them to lower wages. Let's take food stamps, which are available to eligible families whether or not a family member works or not. Indeed, when people are not working, they are more likely to be eligible for food stamps since their family incomes will be lower. Therefore, SNAP is likely to raise, and not lower a worker's reservation wages—the fallback position if she loses her job. This will tend to contract labor supply (or improve a worker's bargaining position), putting an upward pressure on the wage. Whether or not wages are increased is an empirical matter: there is evidence that the initial roll-out of the food stamps program across counties in the 1970s lowered work hours, consistent with an increase in the reservation wage. The key point is that it is difficult to imagine how food stamps would lower wages. And if they don't lower wages, they can't be thought of as subsidies to low wage employers. The same logic applies to other means tested programs like energy or housing assistance. Moreover, these conclusions hold in a wide array of models of the labor market, including ones that emphasize bargaining or efficiency wage concerns.⁴

The EITC maps over onto the UK's working tax credits (indeed, the UK's system is derived from the US one) and housing assistance is obviously the similar to housing benefit, even though in the US it is normally paid as a voucher. We have no direct equivalent of SNAP (food stamps) but the general point still holds.

Those welfare payments which are conditional upon work requirements will at least in part reduce average wages paid by employers, by increasing the supply of labour available. Those welfare payments which are conditional only upon unemployment or other non-work requirements will raise the reservation wage and thus are better considered as “anti-subsidies”.

Given that the payments in the UK welfare system are heavier on those that do not have a work requirement than those that do, the net position of the welfare system will be to push up wages, not act as a subsidy to low wage employers.

There is very little research in the UK about the incidence of working tax credits. The Resolution Foundation has acknowledged Rothstein's findings about the EITC, cited by Dube above, but argued that evidence from the UK does not seem to show a significant depressive effect of tax credits on wages.⁵ Looking at the growth in hourly wages relative to the median between 1999 and 2008, “there appears to be no evidence of slippage in the part of the distribution where tax credits were biting.”⁶

It is important to stress that the natural consequence of bringing more people into work will be for wages for similarly skilled workers to fall. Overall, this might well

⁴ <http://arindube.com/2015/04/19/public-assistance-private-subsidies-and-low-wage-jobs/>

⁵ P. Gregg, A. Hurrell, M. Whittaker, *Creditworthy: Assessing the impact of tax credits in the last decade and considering what this means for Universal Credit* (2012, Resolution Foundation), p. 25.

⁶ *Ibid*, p. 27.

be a good thing – joblessness is worse than lower pay, and with the Working Tax Credit the net effect on the workers will still be positive.

This employment effect is generally taken to outweigh the wage depression effect – the Resolution Foundation cites Leigh (2010) as finding that in the United States “the employment and wage effects in combination boost total incomes among single mothers by more than \$1 for every dollar spent”. Enticing more people into work was one of the stated aims behind the Working Tax Credit (as it is for the Universal Credit now), and attacking it for doing achieving this end is somewhat perverse.

THE LAFFER CURVE EFFECT OF REDUCING TAXATION OF THE POOR

As noted elsewhere here the combination of benefit withdrawal rates and the income and national insurance systems produces high marginal “tax” rates for those struggling up out of poverty. The exact rates depend upon income levels and household composition and can vary wildly. But there are at least 3 million households that labour under such marginal rates of over 60% and even some unfortunates who face rates above 100%. That is, if they earn marginal extra income they lose more in taxation and benefits withdrawal than they have just made. This is not, to put it mildly, conducive to people trying to work their way out of such poverty.

This is, of course exactly the same as the much and oft derided idea of the Laffer Curve. That there is some level of taxation (usually ascribed to incomes, but it is true of any form of taxation) where reducing the rate will lead to an increase in the amount collected. It is not true that the theory says that all tax cuts increase revenue. Only that there are levels at which higher rates will increase revenue and other levels at which lower levels will increase revenue. In its original form the idea ascribes this to lower rates increasing general growth in the economy, meaning that at later periods more revenue will indeed be gathered from that larger economy. It is also usually thought of as something that only applies to high incomes.

That last is not so: it applies to incomes at all levels as and when those high marginal rates start to bind. And we are quite sure that if, say, 60% is too high a rate for high earners (it is indeed above most estimations of the peak of the top income tax rate Laffer Curve for the UK economy) then it is also too high as a tax and benefit withdrawal rate for the low paid. The combinations of the income and substitution effects which go to make up the curve apply across income levels, not just to those with already high incomes. We would therefore expect to see some Laffer effects from lowering the marginal tax rate on the working poor. Effects meaning that we’re not claiming that such tax cuts would “pay for themselves”, rather that we would expect to see more GDP growth than we would without them, so that such cuts would partially, but only partially, pay for themselves.

Fortunately, we have a recent IMF report which states the same thing⁷. The finding is that a 1% increase (a 1% of GDP increase that is) in the incomes of the bottom 20% of the income distribution leads to a 0.38% rise in GDP in following years. Given that 0.3, 0.4% of GDP is what we currently look to as our quarterly increase in GDP this is an amount not to be sniffed at. And of course the one method of changing the income distribution that is entirely in the government's hands is that very government's handling of the taxation of the low paid.

Not taxing these incomes of the low paid would have a substantial effect upon that income distribution.

TABLE 2: SUMMARY OF THE EFFECTS OF TAXES AND BENEFITS ON ALL HOUSEHOLDS 2012/13⁸

| INCOME PER HOUSEHOLD PER YEAR (£) | QUINTILE GROUPS | | | | | |
|-----------------------------------|-----------------|--------|----------|----------|---------|--------|
| | BOTTOM | 2ND | 3RD | 4TH | TOP | ALL |
| Cash benefits | 7,154 | 8,817 | 6,622 | 4,691 | 2,666 | 5,990 |
| Benefits in kind | 7,646 | 7,617 | 7,026 | 6,193 | 5,403 | 6,777 |
| Direct taxes | -1,256 | -2,257 | 992.2 | 869.7 | -20,322 | -7,418 |
| Indirect taxes | -3,488 | -3,986 | 14,190.2 | 13,496.3 | -9,140 | -5,623 |
| Net position | 10,056 | 10,191 | 4,000 | -4,225 | -21,394 | -274 |

Table 2 there tells us that the bottom quintile, the bottom 20% of UK households, have incomes of around £15,000 a year and pay, on average, £1500 or so in income tax and NI. (This does not include employers' NI). There's 26 million odd households meaning that we've 5.2 million households paying that sum each for a cumulative amount of £7.8 billion. That's half a percent of GDP that we are ceasing to remove from the pockets of the poor: as the IMF states, we would expect to see some Laffer effect on GDP growth in the future reducing the revenue loss from doing this.

Or, of course, we might conclude that the benefits bill will be lowered by exactly the same amount of the reduction in tax collected. For at these income levels it really is a merry go round of taking money off someone with one hand in tax only for the State to give it back with the other was welfare payments. With, of course, the handling losses of having to pump that money through the bureaucracy. Either there is no net difference to the working poor, in that welfare reduces by the same amount taxation does (disregarding those frictional losses) or the incomes of the working poor rise and GDP does as well, mitigating the revenue losses.

⁷ <http://www.imf.org/external/pubs/cat/longres.aspx?sk=42986.0>

⁸ Source: ONS, The Effects of Taxes and Benefits on Household Income, 2013/141 - Reference Tables

As a rough rule of thumb, 50% of an increase in GDP turns up as an increase in tax revenues, so we would expect a 0.2%, or £3 billion, increase in future revenues from that Laffer effect if welfare payments were not reduced but taxation rates were. Not something that fully offsets the revenue loss but the idea is nowhere near as costly to tax revenues as a static analysis would suggest.

NATIONAL INSURANCE PAYMENTS AS A QUALIFICATION FOR CERTAIN BENEFITS

One potential problem with reducing national insurance payments to nothing for the low paid is that there are some benefits and future payments that are “earned” by having paid certain amounts of national insurance in the past. Thus if swathes of people are excused paying NI then they will not be able to accumulate rights to such benefits in the future. This is easily dealt with by extending a scheme already in existence. For the very low paid (roughly, £115 to £155 a week) we do not charge national insurance to wages but we deem that they have been paid. Thus the very low paid are able to accumulate future rights without having their current very low incomes charged income related taxes.

The obvious answer is simply to extend this scheme.

CONCLUSION

The UK does not currently suffer from low pay poverty. It suffers instead from tax poverty. The solution therefore is to reduce the amount of tax charged on low incomes, something that is entirely within the government’s power. Given the current structure of the tax system upon low incomes simply raising the income tax and national insurance allowances to the full year, full time, minimum wage will at a stroke abolish in work poverty as the calculations of the Living Wage show.

It is rare that politics offers such easy solutions: when it does we should take them. Let us increase the incomes of the low paid just by lifting less of their earnings in taxation.

