FREE MARKET WELFARE

The case for a Negative Income Tax

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Executive summary

- Lower trade barriers, automation and cheaper transport have brought millions of extra low- and un-skilled workers onto the world market. While this has raised living standards and productivity overall, it has also created a group of people whose relative position has weakened considerably: lower skilled workers in developed countries. Globalisation has lowered the market value of many workers' skills to the point that the clearing price for some labour cannot provide a growing proportion of the UK population with an income that meets the popular definition of minimum living standards—even though it has also contributed to cheaper consumption bundles.
- This has been partially masked by government welfare policies but the current stopgap solutions to this are costly, ineffective and overly complex leaving many people stuck in poverty traps and financial insecurity. Recent proposed changes to the tax credit and minimum wage systems will only exacerbate the problems facing low-productivity workers.
- This paper will make the case that if any type of poverty spending is necessary, it should be the one which can provide the simplest, clearest system which places an emphasis on incentives, freedom and choice: A Negative Income Tax.

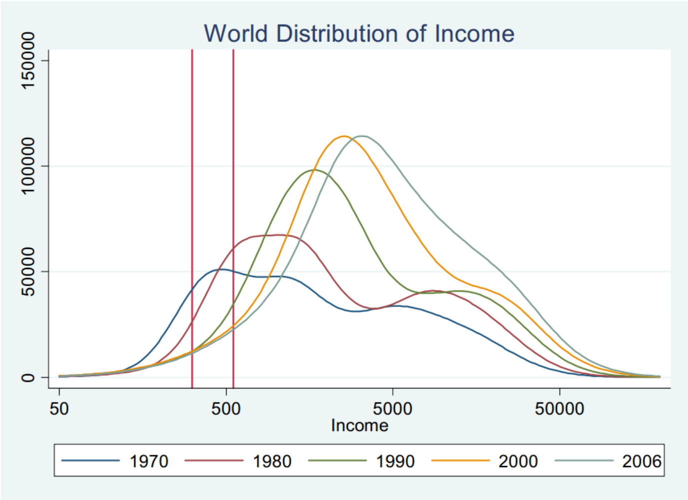
1. What is happening in the UK labour market?

The changes to the UK Labour market in the last 30 years should be examined in the context of changes to the global labour market caused by three major trends:

- Globalisation of and liberalisation of labour markets
- Technological and logistical improvements
- Automation

All three factors have contributed to a pronounced trend in the global income distribution: the merging of what was formerly many local labour markets bounded by borders, regulations and geography into one global labour market.

For UK workers in possession of highly valued skills or innovators seeking investment this broadening of markets has brought large increases in income and investment opportunities; for lower skilled workers in developing countries the opportunity to sell their labour to the world has brought huge welfare gains and massively reduced the incidence of absolute poverty.



This graph (from Pinkovskiy, Maxim, and Xavier Sala-i-Martin. Parametric estimations of the world distribution of income. No. w15433. National Bureau of Economic Research, 2009) shows changing global distribution of income as protections have dwindled and markets opened. What was once an artificially bimodal distribution of income, cleaved by geography and politics into separate clumps, has become unimodal over the decades as global labour markets have converged.

However for lower skilled workers formerly occupying protected labour markets in developed countries, this opening up of markets has brought considerable challenges. Despite gains in overall productivity and increases in consumption (particularly the affordability of consumer electronics- workers are after all also consumers), the relative welfare of these workers is jeopardised by their increasingly precarious economic bargaining position. Workers must now compete with outsourcing made simpler by technology, logistics, lowered trade barriers and even just labour force size, as the number of workers able to acquire skills and sell to the global marketplace has risen.

Competition overseas has been matched by competition at home- the reduced regulatory burden and cost of transportation and communication which makes outsourcing possible also makes the importation of foreign workers easier; there is also competition from non-human labour in the form of automated work processes which grow ever more sophisticated and cheaper to utilise.

This is most visible among younger workers—youth labour markets have been undergoing structural change for some time; even pre-recession demand for inexperienced youth labour has been falling. This trend has only been exacerbated by recent economic events to the point that the UK's youth labour market has been described as 'vanishing' in government reports (Wolf) Even the de facto abolition of the minimum wage for apprenticeships has not totally reversed this situation.

Among adults, the most striking trend in UK and other rich-country poverty is in-work poverty among working adults; that is, a rising number of people, however willing they are to work hard, are unable to sell their labour for enough income to sustain what a majority of the population agrees is a reasonable minimum standard.

While it's true that many government interventions lower employee pay packets (whether directly, like income tax or employee national insurance contributions, or indirectly, like corporation tax or employer national insurance contributions), other policies push in the other direction (e.g. working tax credits, minimum wages, in-work cash benefits). This means that the proportion of the population who would fail to meet this minimum reasonable standard in a 'natural' free market. is higher than many imagine.

In summary, the UK labour market is shifting in the direction of rising income inequality.

Without government intervention or reform of our existing interventions the UK faces considerable challenges from this development. What will happen to those who are not only missing out, but seeing their income decline from these changes?

2. What problems are emerging and for whom?

Lower skilled workers face the loss of their previously privileged position as preferred suppliers of labour within tightly controlled borders, bounded by relatively impassable geography. The group is a mixture of younger workers with few qualifications and limited experience, and older manual or clerical workers without transferable skills. This fall in protectionism is being exacerbated by technological change which renders a large number of traditional policy responses redundant. Autor, Katz and Goldin, have documented the role of technology: lowered demand for simpler jobs which can be automated, coupled with wage premia for those able to deploy this technology productively.

CONSIDERING THE MINIMUM WAGE

The minimum wage (and incoming National Living Wage) is illustrative of the problem. The goal of the policy is to attempt to capture some of the worker's surplus from the employer and divert it to the worker, but according to Neumark and Wascher's landmark 2006 review of the minimum wage literature, a majority of all studies, and a larger majority of the best studies found that beneficial wage effects were mirrored by a disemployment effect. What's more, according to MaCurdy (2015), even when costs are passed on to consumers, and few or no jobs are lost, the badly-off do not necessarily win out; the minimum wage is a blunt tool. While many low-wage workers are not in low-income families, all low-income families buy the goods and services produced with low-wage labour.

The minority that do find disemployment effects, which includes the famous Card and Krueger papers , have focused on the role of the minimum wage in industries with relatively inelastic demand for low-skilled labour such as fast food service or supermarket checkouts. Small (exogenous) rises in the minimum cost of labour in these industries have not historically resulted in much reduced employment (though there is evidence that minimum wage rises shift employment towards adults and away from teenagers). McDonald's will not respond to small increases by suddenly developing effective burger serving robots, nor can it easily economise on labour—higher skilled labourers cannot necessarily do the job any better.

Other sectors, such as manufacturing, in which capital is mobile and businesses can outsource ever more easily, can very quickly relocate production in the face of higher labour costs. As these types of businesses have migrated to countries or regions with lower labour costs, former manufacturing labour has moved into service provision such as fast food or supermarket labour, where labour demand is more inelastic and geographically constrained.

What is new is that even the industries which formerly were characterised by relatively inelastic, localised demand are being changed by automation and robotics. Card and Krueger and subsequent similar studies were conducted at a time when service-sector firms had little choice but to pay higher wage prices if mandated by law, but recent developments may be changing this. A number of fast-food restaurants such as McDonalds have already begun introducing automated order points in their premises and supermarkets are experimenting with reducing checkout staff in favour of automated machines. This mirrors the trend in high street retail banking following the ATM/ online revolution, with a growing proportion of transactions dealt with largely by machines, keeping humans on hand only to supervise and deal with complex cases.

It is important to note that while some labour may be already outcompeted by machines, the complexity of simple activities may be underestimated; anyone who has tried to use a checkout self scanner will know that they require supervision and oversight from a human employee and cannot perform even some very basic tasks which even the least capable human worker might manage: recognising different types of fruit, preventing theft, and sometimes even identifying money. Nonetheless, what the robots currently lack in capability they make up for in price—and on both margins they are improving.

Critics of concerns about service sector automation argue that the relative difficulty with which engineers can create machines to replace service workers means that concerns over automation may be misplaced. However, the opposite may equally be true: if we are already seeing technological unemployment from relatively simple mechanics then what greater effects will we see as automation technology improves?

All of these factors are lowering the market-clearing price of low-skilled labour which has been partly concealed by redistributive tax policies like Working Tax Credits. WTCs are largely unobserved cash top-ups, introduced along the lines of the United States' Earned Income tax credit. Provided the worker in question earns a sufficient income (with the price already increased by the minimum wage) the government will provide additional cash income in the form of a refundable tax allowance. The claimant receives this money as a tax cut, or if it overwhelms their entire income tax bill, they can claim the surplus as cash income.

A worker employed at the lowest level of the legal wage economy in the UK is subsidised by a combination of minimum wages, and in-work welfare payments in the form of tax credits, as well as means-tested housing benefit. This is before the large number of other smaller benefits to which they may be entitled, such as council tax relief, are even considered.

The proportion of families receiving in-work welfare in the form of tax credits has grown in the last decade to nearly 17% of working age households (HMRC), and the proportion receiving housing benefit or other wage top-ups has similarly expanded.

These measures, both introduced without great fanfare by the previous Labour government, have gone some way to propping up incomes for the lower skilled. What would the current clearing price be for low and un-skilled labour in the absence of such redistributive policies as currently proposed?

There is a school of thought that argues that the market-clearing price of labour ought to be sacrosanct, and that minimum wage and government wage subsidies are unnecessary distortions to a functioning market. Undoubtedly, were one prioritising only the raising of world income, this may be a sensible policy response, as demonstrated in the introduction. Higher wages in the developed world come at the expense of trade and much greater absolute welfare gains to the poor of developing countries. However, British politicians are not utilitarian universalists and their actions will be constrained by public opinion and the considerable perceived costs to within-, rather than between-country inequality.

WITHIN-COUNTRY INEQUALITY AND POVERTY REQUIRES A POLICY RESPONSE

While the social and political consequences of inequality are contested, there is consensus among economists that some combination measure of relative and absolute poverty is needed to address the long-term social and political consequences of low incomes.

Apart from other considerations, UK policymakers operate under pressure of public opinion, which favours such a mixed measure, as well as concerns about political stability, investment and innovation.

PUBLIC OPINION FAVOURS A MINIMUM (BUT RISING) LIVING STANDARD

A number of measures of public opinion show that a majority of British public opinion is firmly in favour of establishing a welfare safety net which at the very least sets a minimum 'floor'—a living standard below which no citizen may fall. The Breadline Britain survey , among others, demonstrates that the popular perception of poverty is relative, changes with social standards and based on social participation- the ability for a citizen to earn enough to enable a living standard similar enough to the mainstream of society to enable meaningful interaction.

This model of poverty is best exemplified by the Adam Smith's example of the linen shirt:

> *"By necessaries I understand, not only the commodities which are indispensably necessary for the support of life, but whatever the*

> *custom of the country renders it indecent for creditable people, even of the lowest order, to be without. A linen shirt, for example, is, strictly speaking, not a necessary of life. …But in the present times, through the greater part of Europe, a creditable day-labourer would be ashamed to appear in public without a linen shirt"*

Here Smith acknowledges that the social role of goods has an impact on what may be considered basic needs. Though it's important to remember that a focus on relative poverty without reference to absolute welfare can only tell part of the story, there are significant problems with ignoring relative poverty and its effect on excluding the poor from social participation.

INNOVATION DENTED BY SOCIAL EXCLUSION

If one's concern is the future of the national economy, a socially participatory model of poverty is important; particularly with regard to the future productivity of children (whose poverty is always regarded as less acceptable) one must consider the innovation that drives economic growth.

Only a tiny part of the rewards from such innovation is captured by the innovator , leaving a massive social surplus. Future innovation, along with its socially beneficially effects, may depend on children's access to education and social participation without which their talents go unexploited. This may explain why Breadline Britain's survey found that internet access for children is marked as a necessity by two thirds of adult respondents. In a future ever-more technologically developed economy increasingly dependent on the collaborations of the highly able few for large impact innovations, it is correspondingly important to ensure that all children have access to make the best of their talents.

POLITICAL STABILITY AND INWARD FOREIGN INVESTMENT

Perhaps the most immediate risk that a glut of relative poverty poses is to political stability. A large component of Britain's appeal to international investors and institutions is the confidence inspired by a long history of political stability and respect for property rights. The relationship between poverty and inequality, political instability and reduced foreign investment has long been empirically established (Alesina and Perotti).

So given that democratic opinion and national interest can be said to favour a welfare system which provides for a minimum floor of income at a level which allows basic participation in society (and thanks to technological and market innovations, participation by means of information technology has never been cheaper), we need to consider the scale of the problem- what is the big picture of UK incomes and what are the trends that a welfare policy will need to tackle?

The present situation presents many challenges, and the future hold many more, mostly unacknowledged by policymakers.

We need a welfare policy which is flexible, rooted in the current labour market and able to last into the future.

3. What are we doing about it?

The clearing price of lower skilled labour is simply not high enough to provide what electoral willpower, political stability and innovation would require: some form of welfare income policy is necessary. The response to this problem has been obfuscation, denial and a piecemeal provision of schemes and services that do not tackle the problem at its root.

BRITAIN'S WELFARE SYSTEM IS BASED ON ASSUMPTIONS THAT NO LONGER APPLY

The most salient problem with Britain's welfare system is the path dependency of descent from a system based on a very different (and historically anomalous) labour market. The labour market for which Britains's welfare policies were designed was underpinned by three assumptions:

- Male breadwinners: (with the implications for family policy and gendered division of labour which this implies)
- Stable employment: often in large, state owned industries with full employment as a government target

- Welfare as Insurance: Policies were designed to cover for the shorter periods when these other institutions would not provide a standard of living to an average member of society.

The expectation was that an average citizen would, if male, be employed in a job which had long term prospects and provided a reasonable standard of living; if female, be married to a male breadwinner whose salary would be sufficient to keep them and any children. Periods of brief unemployment, ill health or old age infirmity would be covered by temporary recourse to the benefits system.

Such assumptions are a world away from today's labour market and policy contexts.

Instead of male breadwinners we have dual earner households struggling to make ends meet, unstable often temporary employment and most importantly, a growing dependence on benefits almost separate to employment status: "Off benefits and into work", a once laudable goal, is now almost a myth.

It is extremely unlikely that any person finding work after a period receiving unemployment or sickness benefits will be 'off benefits'. They will cease dependence on specific unemployment or medical incapacity benefit, but then immediately (unless their first job is a particularly high-paid one) be placed on in-work benefits such as Tax Credits and additional payments such as Housing or Child Benefit will continue.

So the original assumptions behind the 'Benefits as insurance' model have been usurped by almost permanent dependence on benefits for a large proportion of the workforce- out of work benefits when out of work, in work benefits when employed. It's also relevant to note that people in work and receiving working tax credits are also exempt from the benefits cap of £500 per week.

So how has Britain's policy attempted to adapt the system to the changes previously outlined?

Constrained by path dependency and powerful political pressures the policy responses to this situation have come to rest on five pillars, all of which are imperfect and in some cases, extremely costly ways to resolve the UK's current labour market problems.

a. Protectionism
b. Pay subsidy (via minumum wage and wage topups- either consumer or taxpayer subsidies)
c. Skills training
d. Support/compulsion to seek employment
e. Medicalising unproductive labour

PROTECTIONISM

Though EU regulations prevent Britain from pursuing too much of a protectionist policy with regard to continental migration (especially now having relaxed restrictions on Bulgarian and Romanian migration) there are very high barriers to lower-skilled workers from the developing world coming to Britain for employment. Modelling by Lisenkova and Mérette (NIESR) has shown that while EU migration is likely to have a positive impact on net incomes for average workers (since mostly young and more highly qualified workers are the most mobile), this is not the case for lower-skilled migrants from the developing world. British policy has reflected this through blanket restrictions with exceptions for the highly skilled, through the High Skilled Migrant programme (whose presence has either a positive or negligible effect on native low-skilled labour) and growing income and savings requirements for family reunification visas. These measures are imperfect and have been widely criticised for excluding high-ability young workers from the UK; but they do some job of maintaining higher incomes for the low-skilled, albeit at a very high cost.

PAY SUBSIDIES (TAX CREDITS)

Tax credits are the most relevant recent development, based on the US Earned Income Tax credit. This was first introduced under the Republican administration of Gerald Ford as a policy with an explicitly redistributive goal. Provided they work a sufficient number of hours, the less a person earns, the more money they receive from the government in the form of a 'refund' (actually a direct transfer from the US federal tax budget) which is gradually withdrawn at $50 income increments as the person earns a higher annual income.

The UK's Tax Credit system operates on similar lines and is one of the larger benefits paid to people in work (along with Housing Benefit). Like its American forebear it gradually tapers off, with the goal that (absent interference from other benefits, more of which later), a recipient will always be better off in work that out of it.

This pay subsidy is one policy tool which has relatively high support from economists: it focuses on incomes; is directly targeted at those in poverty; and it somewhat avoids the moral hazard of more intrusively means-tested programmes.

SKILLS TRAINING

Starting with the New Deal under the previous Labour Government and continuing under the present coalition as the 'Work Programme', alongside many similar but smaller locally and centrally funded schemes, skills training has become a central plank in increasing the labour supply and is designed as something of a carrot to complement the stick of benefit sanctions and work compulsions.

Such schemes are often highly costly and are yet to prove themselves adequate to the task of changing the underlying problems with low to bottom end of the labour market, partly due to such policies being built on faulty assumptions. Retraining progammes do not have a strong track record, and vocational qualifications aimed at low-ability school leavers have actually been found to have a negative effect on employment rates, wage levels and likelihoods of being invited for interview. This bears repeating: government spending on skills programmes for those who have struggled at school resulted in some cases in employers viewing that candidate less favourably than one who has completed no such training.

From the Wolf Report on vocational education:

> *Low-level vocational qualifications, notably NVQs, have, on average, absolutely no significant economic value to their holders unless they are gained as part of a completed apprenticeship. This is especially true if they were gained on a government-financed scheme.*

Work-readiness training has also shown to be ineffective; the UK is not suffering from a lower-skilled labour shortage and such programmes are extremely expensive. Though they may reassure some voters anxious about benefits claimants free riding (explored by Petersen et al), and are politically popular, they do not address the underlying problem. In the case of the long-term unemployed, agencies placing benefits recipients with charities for volunteering purposes were told by the voluntary organisations that the presence of this free labour actually had a negative effect on marginal productivity: the charities were worse off for the presence of the volunteers than if they had been able to get on with their work alone.

COMPULSION TO SEEK EMPLOYMENT

Compulsion is especially ineffective. Compelling workers to seek employment increases the supply of the labour least demanded by the market. Workers whose motivation is so lacking that they are unwilling to find employment without coercion are unlikely to be attractive to employers.

Much of the evidence on the impact of benefits, conditionality and labour supply suggests conditionality (workfare) has little effect on the labour supply of working adults without children, and only a small negative effect on the labour supply of those caring for children.

MEDICALISATION

In the same period as the labour market changes described above have occurred, we have seen on both sides of the Atlantic the practise of dumping unproductive workers onto disability programmes to remove them from the labour pool and thus unemployment statistics. The rise in medical exclusion from the workforce has been especially steep for those workers whose health precludes them from manual labour but whose skill level excludes them from clerical work.

Citizens who end up on disability related benefits are faced with a difficult choice—if they feel able to work a few hours, to 'dip their toe in the water' of employment and test themselves, they risk being found able to work, compelled to do so and sanctioned if they fail—and so are incentivised to do as little as possible lest they risk benefit cuts. Trapping people in such poverty binds has proved to be a common finding of those examining flaws with Britain's benefits regime. Current efforts to encourage this population to return to the workforce have had mixed results; early reports of many thousands rflowing back in advance of health testing were revised on further investigation.

The problems at the policy level are matched by administrative level difficulties: as is already clear, the response is not coordinated and is based on often conflicting assumptions; problems partly of design, partly of implementation.

Design level problems: Moral hazards and social incentives, work incentives, and marginal withdrawal rate problems.

DESIGN LEVEL PROBLEMS

MORAL HAZARDS AND PERVERSE SOCIAL INCENTIVES

The existence of so called 'couples penalties' in the current system is a contested area of research – the IFS has found evidence that many couples are worse off due to benefit changes than if they were to live separately but this does depend on assumptions made about the degree to which couples may live more cheaply together than apart. In a system such as the UK's, which attempts to subsidise the freedom to form and dissolve relationships (mainly due to justified concerns about domestic violence resulting from economic dependence), it is inevitable that there is some risk of this. However, recent developments in Universal Credit, which will be paid only to one account per household, will actually make this worse without solving the underlying problem (see Universal Credit, below).

FREE RIDER PROBLEMS

Psychological research (Petersen et al among others) suggests that the moral injury experienced by those who see a person who is not contributing effort, yet is subsisting on public provision, is much greater than if the same sum if it had been wasted by a mistaken government action. One-hundred pounds given to a neighbour who lays about and doesn't work when capable rankles much more than £100 given to even the most inaccessible public art project.

Concerns about free riders have a far greater impact on voter opinion that the simple cost of providing the benefits; these values are rooted in norms which stigmatise free-rider behaviour more than a desire for fiscal prudence. This is why policies which involve recipients of public welfare working or making some effort remain popular with the public, despite evidence that this work may often cost more to the public purse than simply giving recipients the money.

Many scholars of welfare have been very critical of such norms, deriding them as out of date and unnecessarily stigmatising, but they are unlikely to disappear, nor should we necessarily want them to. A society in which help is gladly given to those in need but not to those who are (seen as) gaming the system is probably better than the alternatives.

A mistake of welfare policy has been to go against the grain of these norms, rather than work with them. Working tax credits, benefits paid to people who work hard but whose labour is of insufficient value to the market, are much more popular than benefits paid to those out of work. Any replacement or reform of Britain's benefits system must take this into account to have a chance of political success.

DISINCENTIVES TO WORK DUE TO HIGH AND

OPAQUE MARGINAL WITHDRAWAL RATES

Even post Universal Credit (and the dust has yet to settle there) there are considerable problems with marginal withdrawal rates (sometimes referred to as Effective Marginal Taxation Rates): the rate at which net income rises for low-earning workers as more hours are worked, wage income rises, and benefit income falls. Universal Credit has been partially designed so that rates never fall below the target of a 65% marginal tax/benefit withdrawal rate. While this is higher than the originally proposed cap of a 55% rate, it is substantially lower than the rates which many working people face under the current system. However, analysis by the IFS has suggested that the likely withdrawal rate will be closer to 76% once other benefit changes are taken into account and may even end up higher due to council tax relief localisation, eliminating a key plank of the Universal Credit policy.

IMPLEMENTATION PROBLEMS

One of the biggest problems with the existing system is the cost of delivery, costs borne by both claimant in terms of red tape and form filling and in government in processing and filing the claims. The Department for Work and Pensions employs 34,000 full-time equivalent employees, and spent £5.3bn on administration in 2011-12, or £6.1bn in today's money. (Interestingly, this is very close to size of the savings that will be made if the government goes ahead with its planned cuts to Working Tax Credits.)

What is key to this is the way that the changing labour market, with greater insecurity of employment, is driving these costs ever higher. The growing pattern of short-term contracts and higher labour market churn means that claims must be made and adjusted more frequently, resulting in a greater administrative burden and ever-increasing time commitments and risks of bureaucratic fumbles for claimants.

These costs are compounded by complex interactions between different benefits; one indicator of the burden of this system is that 17% of Citizen's Advice caseload (mostly funded by the taxpayer) is taken up dealing with means testing disputes (National Audit Office).

These visible financial costs are compounded by the psychological costs and burdens to claimants which undermine flexibility in the labour market. Anxieties about misunderstanding their entitlements, and the risk of being lost in bureaucracy should their circumstances change, can lead to a kind of employment paralysis once a particular claim has been successfully achieved (Dean).

UNIVERSAL CREDIT

Although designed to relieve some of the problems with the existing system outlined above, Universal Credit risks leaving many of the difficulties in place due to a mixture of its own design and implementation problems.

DESIGN:

As discussed above, Universal Credit retains a relatively high withdrawal rate though it will partially smooth the current jagged step decreases in support. The biggest potential pitfalls with UC's design is how it will be paid, as a single monthly payment to the highest earner in a household: this comes with a number of concerns unrelated to the overall budget amount with considerable implications for childcare and relationships.

MONTHLY BUDGETING AND MEANS TESTING

One potentially difficult aspect of UC is the monthly administration of the payment. Although it is somewhat easier administratively, it will make budgeting more difficult for claimants, especially given the expected fluctuations in benefit levels with which UC is designed to cope. An inability to budget ahead risks trapping recipients of the credit in the same psychologically dependent trap as the current system, which disincentivises work or any change that might result in the loss of funds, whether by design or bureaucratic problems.

PURSE/WALLET PROBLEMS

One of the risks from making a single monthly payment to one member of the household, while potentially easier administratively, is that in households with children it places the benefit in the hands of the household member who is earning the most, and therefore likely spending the least time caring for the child. Known as the purse/wallet dilemma, there is a significant risk that additional money placed into the household will not reach the child, the target of greatest concern to policymakers. Universal Credit's pilot data is not yet available, but past studies such as Ward-Batts (2008) and Lundberg, Pollak, and Wales (1997) have indicated that budgetary control in the hands of mothers (least likely to be the recipient of UC within a household) resulted in higher spending on children's clothes.

DOMESTIC VIOLENCE

An extension of the gender imbalance inherent in the single payment/highest earner model is a small but significant risk of domestic violence. Research from Anderberg et al has shown that risk of victimisation from domestic violence is linked to unemployment of the victim, rather than the perpetrator, and have proposed a convincing mechanism: that financial dependence increases vulnerability in a relationship. A welfare system which prioritises individual agency would help avoid this by increasing the personal autonomy of all participants involved.

IMPLEMENTATION:

Lastly, and most significantly, there are the costs of administration and implementation. UC is reliant on updating and IT coordination between many departments, local offices and firms and so far this has proved phenomenally expensive. So far only 2,700 claimants are receiving the benefit, far short of the 1 million claimant target, at a cost of £612m in administration costs.

Clearly then, the existing system and even the reforms brought in as replacement have a number of problems. What qualities would a replacement for the existing welfare system need to avoid repeating the mistakes of the past?

It should:

- Replace the costly alternative measures, including those outside the existing bailiwick of welfare policy.
- Provide a basic floor standard of living
- Be paid to individuals, not households or heads of households
- Be as administratively simple and cheap as possible
- Be secure and transparent to maximise the ability of claimants to plan and take risks
- Avoid work disincentives where possible
- Work with the grain on societal free rider norms to ensure popular support

4. Why would a Negative Income Tax be a preferable policy?

To solve these problems, the UK needs a welfare policy which recognises that the assumptions of the labour market of the past cannot be maintained, maximises personal freedom and choice without crating moral hazards or violating social norms, and is simple and cheap to administer: a Negative Income Tax (NIT).

WHAT IS A NEGATIVE INCOME TAX?

First named the Negative Income Tax by Milton Friedman (though similar schemes had been proposed before), the NIT is a tax and welfare scheme which replaces many other benefits and services into one regular payment delivered to citizens on the qualifying basis of low income (potentially with top-ups for disability and children). If poverty is a lack of income, the NIT tackles this head-on by providing that income. If a citizen earns nothing, the NIT is their entire income and is paid at the highest rate – as they earn more, the payment is gradually withdrawn until the citizen becomes a net tax contributor. The payment scheme is structured so that the claimant is always better off working more hours or earning more market income, but the withdrawal rate can be set at any level. By having one single payment which is withdrawn at a gradual rate, the incentive structure is transparent and easily understood, moral hazards and perverse incentives are avoided, bureaucracy is limited to non-existent and most importantly the citizen is more free to choose how the money allocated from government funds for their welfare is actually spent.

Similar schemes have been proposed before, the first in the UK by the Liberal-turned-Conservative MP Juliet Rhys-Williams. Later work by Friedrich Hayek and Friedman led to the adoption of proposals by the Nixon administration in the form of the 'Family Assistance Plan' overseen by Daniel Patrick Moynihan. Although this was not a Negative Income Tax in the tradition of Hayek and Friedman, being paid only to families with children and including a work requirement, it represented a step in its direction. His electoral opponent in the presidential election, George McGovern, favoured a scheme which would include childless couples and individuals, called 'Demogrants', meaning that for a brief period there was bipartisan support for a welfare system focused on income.

These plans foundered, as have many other such proposals, for having been thought too generous by conservatives and too mean by liberals. Since then support for schemes has come from a range of political perspectives, mostly on the libertarian right but also among alternative left parties such as the UK's Green Party as well as social conservatives who prefer the income focus and ending of perverse incentives from means-tested systems. Charles Murray's book 'The Plan' advocates the replacement of all federal welfare spending with a single cash payment of $10,000 dollars to adults.

HAS IT BEEN TRIED BEFORE?

There have been a number of experiments with income schemes throughout the world, the most rigorous being the United States Negative Income Tax experiments in the 1960s-70s conducted by Dick Cheney and Donald Rumsfeld . These are of particular interest as they cover different population groups: urban and rural, single parent and dual parent families, working poor and welfare recipients. There was also a smaller Canadian experiment of the same era called 'Mincome', which took place in Manitoba.

The evidence from these experiments is remarkably robust, especially for its time, and demonstrated the feasibility of such a scheme. There isn't space to consider all the evidence obtained from the experiments, but Widerquist's review summarises the findings – poverty was reduced and lower spending on many social services was required (including health and in particular mental health). There was a small reduction in the number of hours worked, mostly among part-time second income parents, but among chief household income earners the only labour market finding was a small increase (a matter of 2 weeks or so per year) in time spent between jobs. This is hard to interpret across a great distance of time but it is plausible that more efficient matching of employer to employee would be one effect of such an increase. Certainly there was no evidence of main earners withdrawing from the labour market altogether (see the further section for a fuller discussion of labour market effects). These schemes also differ from current proposals in that they made the benefits system hugely more generous overall, rather than simply changing the structureof the system.

THE SWISS PROPOSAL

There is scheduled to be a referendum in 2016 on the provision of a minimum basic income of CHF2,500 (around £1,700) per month which would replace the large number of means-tested and bureaucratic benefits. Organised slightly differently to a Negative Income Tax, the Swiss proposal would, instead of gradually withdrawing the payment as incomes rise, pay everyone the full amount and claim it back from higher earners through the tax system. This question of whether to withdraw the payment or pay it and tax back is not just an administrative one; there are several considerations which must be taken into account, explored in the next section.

WHAT DOES THIS PAPER PROPOSE?

A proposal for the UK must take into account what has been learned from previous experiments and political controversies- they key is in the structure of the benefits, rather than getting bogged down in debates over the level of their generosity.

Even if benefit rates are kept at their current level, there are considerable gains to be made from mandating an unconditional minimum income level and the gradual withdrawal system.

It is important to note that while paying benefits to those in and out of work may sound like a radical departure from the status quo, thanks to a combination of tax credits and out of work benefits this is already the case for many people in the United Kingdom- A Negative Income Tax merely streamlines and simplifies the existing system.

This paper proposes a Negative Income Tax which resolves the problems outlined above. It should:

- Be paid to individuals, not households

- Be set at a level which provides a basic floor standard of living
- Be withdrawn at a rate which provides clear work incentives

HOW SHOULD IT WORK?

A starting point for a costed proposal would be the recent modelling from the Citizens Income Trust who estimate that by combining Child Benefit and Child Tax Credits, Working age benefits (Income Support, JSA, etc), Working Tax Credits, the State Retirement Pension, SERPS, S2P, Pension Credit, and MIG, and eliminating Personal Allowances (income tax), Primary Threshold and self-employed reliefs (NI) and higher rate tax relief on pension contribution a scheme could be proposed which would set a weekly income floor of £56.25 per week for those aged up to 25, £71.00 for those aged 25 to 64 and £142.70 for those 65 and over. As income is earned, the net amount of benefit is drawn off through the elimination of personal tax allowances until the worker becomes a net taxpayer.

This would be revenue neutral – such a scheme could be provided for without any current change in the level of taxation.

WITHDRAW, OR PAY OUT AND TAX BACK?

There is conflicting evidence on whether it is better to pay out the allowance as cash and tax it back from those who don't need it, or withdraw it as earnings rise as is proposed for Universal Credit. The best path depends on the particular administrative circumstances of the country in question: for the UK, it is possible that a pay out and tax back model might be administratively easier to manage. This is how Child Benefit currently operates: all households with children receive the benefit and it is withdrawn from higher rate taxpayers directly as a tax. A Negative Income Tax following this approach would avoid constant updating with information from employers and potentially very expensive administrative burdens from constant recalculations as incomes change – if part of the goal of such a policy is to operate in an increasingly flexible labour market then a sluggish bureaucratic response is not ideal.

For some of the social benefits of an NIT to be realised, a very fast response would be needed – a woman fleeing domestic violence can more easily have her tax burden reduced than her benefit level raised. The IT and communication problems which have arisen to date from the piloting of Universal Credit suggest that relying on smooth information exchange and collaboration between HM Revenue and Customs, employers (especially the short-term employers who operate at the bottom of the labour market) and the Department for Work and Pensions may not be prudent.

But the pay out and tax back model does have two large potential downsides. First of these is that it will result in greater economic churn as money is sent out as benefit and then taxed back, undermining the transparency and clear incentive goal. Secondly there is some evidence that the behavioural effect of income incentives on labour supply differs according to whether the benefit is given and taxed back or gradually withdrawn, though recent, generalisable evidence on behavioural responses is very sparse.

In lab experiment in Japan (Toshiji 2008, translated 2011), a real-work task was rewarded according to either a traditional Negative Income Tax (gradual withdrawal) or a pay out and tax back model, sometimes referred to as Basic Income. The researchers found that the overall rate of labour supply was lower in the Basic Income model. Despite the explicit design of the experiment to make the two schemes completely financially interchangeable, such that there was the same relationship between gross and net income per hour worked in either the NIT or the BI scenario, there was a statistically significant difference in the labour supply between the two, with Basic Income faring worse.

While the IT problems which have dogged the introduction of universal credit may raise flags over the ability of government to cope with the infrastructure required, the relative success of the HM Revenue and Customs in withdrawing Tax Credits as incomes rose gives hope for a future in which a gradual withdrawal approach may be managed as seamlessly as a pay and tax back model. This also suggests that a future, simpler, better welfare system may well be run by HMRC, rather than DWP, whose vast administative apparatus is unnecessary when the system is so much less complex.

HOW WOULD A NEGATIVE INCOME TAX RESOLVE THE PROBLEMS OUTLINED ABOVE?

An NIT resolves the problem of maintaining a flexible labour market without giving rise to the innovation costs and stability threats of large within-country inequality.

A BETTER FIT WITH THE CHANGING LABOUR MARKET:

As outlined above, current policy often obliquely aids the losers from recent global labour market and technological changes in ways which are more costly and potentially damaging to the UK than a direct transfer. A Negative Income Tax meets these problems head on allowing for a relaxation of these costly indirect policies.

HELPS ORIENT MARKETS TOWARDS POORER PEOPLE

One key advantage of structuring the benefit system in this way is the opening up of markets to benefit recipients. What ought to be a basic benchmark of any policy—that the welfare of the policy target group ought to increase at least as much as if they had just been given the budget of the policy to spend as they wish—is rarely reached. Giving recipients more freedom to choose how their money is spent will result in immediately superior outcomes thanks to being better able to meet their preferences. Further, over time firms can reorient their production towards consumers at the lower end of the income spectrum whose guaranteed income ensures large and consistent economies of scale for firms serving this market.

SIMPLER AND CHEAPER TO ADMINISTER

There are potentially massive costs savings from eliminating DWP civil servants, reducing the administrative burden of means testing, and rolling all essential welfare functions into HMRC. Universal Credit is attempting to reduce DWP bureaucracy, but a simpler and more transparently structured Negative Income Tax could achieve the same goal much more efficiently. If Child Benefit were the model for administration, the cost of delivery could rival that system's 1% cost. So far the Universal Credit administration has cost over £650 million in administration and IT fees for a target population of 1 million claimants and as of May 2015 only 64,000 of them have so far been registered, at an average cost per claim to date of over £10,000

According to a 2012 Freedom Of Information request , the amount spent by the Department for Work and Pensions on administration was £5.3bn, representing 3.5% of the total spend- amalgamating benefits spending into existing HMRC infrastructure would represent a massive saving with no loss of welfare for recipients.

TRANSPARENT AND SEEN AS FAIR

Working with the grain of the UK's social norms is very important for the success of any policy: the structure of a Negative Income Tax provides clear and consistent incentives towards work and the protection of an income floor while maintaining a very wide freedom of choice. To paraphrase the Chancellor, a 'striver' going out to work will not be able to see non-working neighbours enjoy a similar or higher standard of living, but neither will that non-working neighbour starve.

KEY BENEFITS TO FAMILIES AND CHILDREN

A Negative Income Tax structure provides many benefits to families and children over the current system, primarily by ending the couples penalties which, though designed to avoid trapping individuals in economically unbalanced violent relationships, many have argued serve to incentivise family breakdown. But by paying the benefits to people individually, such a system guarantees a measure of economic independence for anyone at risk of domestic violence.

A key plank of NIT schemes is their lack of conditionality; giving free money to people who are not working with no compulsion to do so is a hard pill for many to swallow, at east initially. Yet even setting aside the high cost and low efficacy of compulsive labour or useless training, income distribution has been shown to be produce better outcomes for children than schemes with a work component (Gennetian and Miller). On top of that, Cooper and Stewart's systematic review of the effect of income vs other interventions for child outcomes has shown considerably superior effects for money-based policies, especially for poorer children, including greater paternal investment, and lower levels of mental ill-health for mothers.

FINANCIAL SECURITY AND FREEDOM

Perhaps the most important benefit of a Negative Income Tax is its provision of financial security and freedom for claimants, regardless of the actual level of income paid. By eliminating costly and often ineffective controls and conditions claimants are more secure and freer than if the exact same money had been spent under the existing system. The Canadian Mincome experiment provided the unexpected result that hospital admissions, particularly those for mental-heath crises, fell after the introduction of the income scheme, most probably as a direct result of the stress-reducing effects of some degree of income security.

5. Are such proposals possible?

This section will explore the evidence for the two most common objections to a Negative Income Tax, then consider the potential political and administrative roadblocks to implementing such a policy.

POSSIBLE OBJECTIONS:

The two principle objections to Negative Income Tax and similar schemes are tax cost and concerns that a safety net based on poverty rather than conditional upon work will lead to lowered labour supply.

COST

The scheme can be made revenue neutral, more expensive, or less financially burdensome than the existing system- the cost is only subject to the generosity of its implementation. The Citizen's Income Trust proposal would be revenue neutral, a scheme replacing and including more parts of the existing Welfare State might be able to deliver a higher state-provided income with an overall lowered burden to the taxpayer.

Overall the cost depends on the behavioural response to the unconditional nature of the payment- one of the most common responses to the lack of conditionality and sanctions is the anxiety that people will choose not to work and will instead sit unemployed, subsisting on their benefit payments.

WORK INCENTIVES AND EFFECT ON LABOUR SUPPLY

The first key point is that Britain is not operating in labour shortage, so it is unwise to weigh overall labour supply concerns very highly. In particular the incentive to simply consume leisure and live off the NIT payment will be highest for those workers whose productivity would command the lowest wages and so would be of the least concern to a UK policymaker if that were the most pressing incentive. By contrast the elimination of high marginal withdrawal rates will increase the relative returns to additional less low-skilled labour. It is not possible, without a significant experiment, to say which of these incentives would win out in the UK—however recent reviews of the evidence suggest that only a small reduction in hours worked is likely, driven by falls among those searching for work, or second earners performing childcare. On the other hand there would be potential compensatory effects among the work searchers from higher productivity gains from improved employer-employee matching.

Among second earners in households with children, the experimental evidence from North America and recent smaller n studies in Europe suggests that the most likely effect would be a partial reduction in their labour supply to spend more time in a caring role. This does not suggest the consumption of leisure so much as higher investment in children which has future implications for non-cognitive skills, crime and potentially productivity.

PSYCHOLOGY OF LABOUR SUPPLY

There is good evidence that concerns about labour supply may be overemphasised compared to their potential economic effects- the free-rider hostility norms to which politicians are responding when they institute expensive punitive policies targeted at working age 'shirkers' do not apply to pensioners, whose lack of labour supply and cost to the state dwarf that of inactive working age adults.

These norms, part of the Protestant work ethic tradition, can be incredibly beneficial to society as a whole- we should be wary of dismissing them, as have many proposers of welfare reforms. A rationalised system which, however effective, fights the grain of public opinion cannot succeed.

However, rather than being a roadblock, a model which incorporates these norms and uses them to strengthen participation will be much stronger- by supporting lower incomes and opening employment, there will be no sense among workers that they are worse off for their participation in the labour market. The 'Striver' will always be better off than that 'Skiver' under a Negative Income Tax.

ADMINISTRATIVE FEASIBILITY:

A 'PAY OUT AND TAX BACK' MODEL:

The best UK precedent for a 'pay and tax' scheme would be, as indicated above, child benefit, which for a small administrative cost manages to pay out a fixed benefit to all households with children. For those whose incomes are above the new threshold for eligibility for the payment, the benefit is taxed away by HM Revenue and Customs. The difficulty with such a system is the high degree of churn and circulation- while the cost of paying out the benefit is very small (estimated to be around 1% of the total cost, the cheapest administration of any state benefit) the cost of collecting the unused benefit is unknown as it is absorbed by the general budget of HMRC.

Child benefit too may not be the best model in other ways: the number of households earning enough to have the benefit withdrawn is comparatively small but even there the process of reclaiming the benefit is rough-hewn: instead of a gradual taper, individuals earning over the limit simply have their child benefit taxed away in one lump. This is to say nothing of the fact that the withdrawal only affects the highest earner, making couples where one parent stays at home more likely to cross this threshold for a given income level.

A Negative Income Tax, covering many more people and requiring gradual smooth income tapering, might find itself in considerable difficulties if it relied on this system.

A GRADUAL WITHDRAWAL MODEL:

This could operate more along the lines of Tax Credits, or their replacement in Universal Credit. Workers would claim higher rates of tax credits when their incomes fell below a certain level and have the credits withdrawn when their incomes rose, all through the existing infrastructure. Here too there are potential difficulties—without major reform a system would rely on regular updating and communication between employers and the DWP/HMRC who would be administering it, but there is precedent here. Tax Credits are themselves a form of Negative Income Tax, though ties to employment are not part of a true NIT proposal, the existing system could be adapted to include those not in employment at all. The difficulty here is that the flexible, unstable and liberal market conditions for which the NIT is designed have also caused problems with Tax Credits and look likely to do so with universal credit, particularly overpayment and delays in updating entitlements.

At a universal scale, a 'gradual withdrawal' implementation of NIT is preferable, provided that real time robust updating can be implemented. If instead of adding to the administrative burden of the Department for Work and Pensions this work was undertaken by the HMRC who already administer Tax Credits, a huge saving could be made.

POLITICAL FEASIBILITY

Such a plan is not beyond the bounds of political possibility; the existing Tax Credits administration system provides a platform from which to take reform further. Some earlier DWP reports on Universal Credit indicate a willingness to expand beyond conditionality. NIT and similar schemes were on the Liberal Democrat manifesto and are currently a Green policy, and whether the Swiss proposal gathers traction across Europe remains to be seen.

RISK FROM CIVIL SERVICE RESISTANCE:

Policies which rest upon reducing the bureaucratic burden (and therefore requiring fewer civil servants to administer them) are often not as successful as policies which require an increase in the state's human resources. While one would not expect Britain to experience the same level of resistance as has occurred in India, where civil servants organised a riot at the offices of the UK economists overseeing a transition from complex means-tested welfare to an income scheme not dissimilar to NIT, it would be naïve to assume that the development would be welcomed with open arms. Still, the government has in recent years drastically reduced its total employment, and with similar resolve in this area it is not unrealistic to wonder if they might be able to do it again.

CONCLUSION

Britain needs a basic safety net that prevents poverty but maximises freedom from punitive government interventions and perverse incentives. As Britain's labour market liberalises, with higher job churn and greater income inequality, the country needs a flexible and instantly responsive welfare system, which can maximise welfare and security for those in need while preserving personal choice and work incentives. This system is the Negative Income Tax, which can drastically reduce the administrative and personal costs of the current system, work with the grain of public intuitions about welfare, and enhance flexibility and productivity in the workforce. Politicians should abolish DWP and roll its essential functions into HMRC, which should combine all the major benefit payments into one fixed floor which is paid to individuals, and withdrawn steadily and predictably as waged income rises.