

# Tax and Welfare Reform

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*University College London and Institute for Fiscal Studies*

Slide Presentation

# Tax and Welfare Reform – Richard Blundell, UCL & IFS

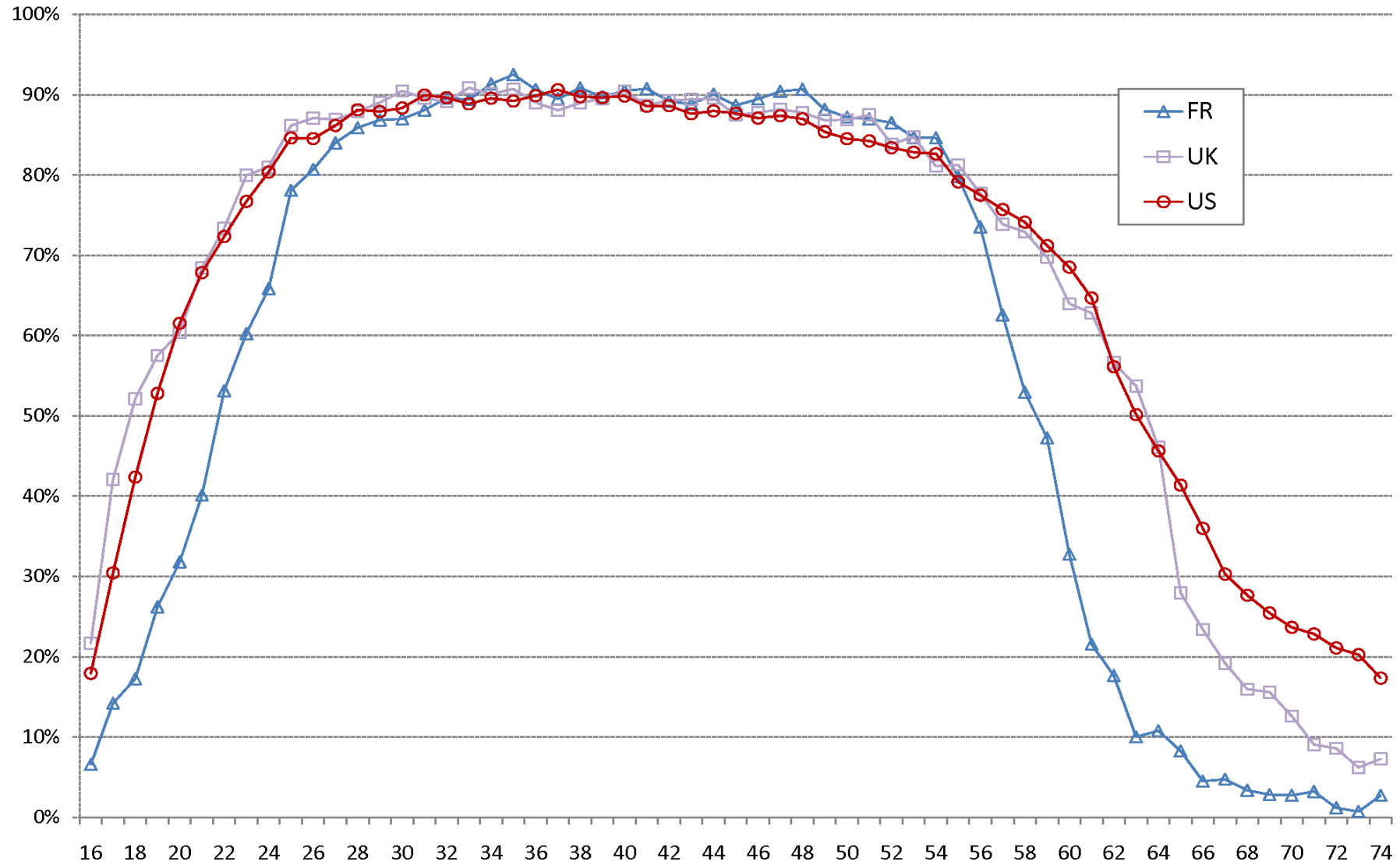
- Focus on the labour market and earnings tax reforms.
  - Even before the recent crisis, governments around the EU faced pressure to increase employment and earnings.
  - The current recession has added to the pressure on government revenues.
  - Ask two central questions:
    - What are the key margins where might expect reform to have most impact on earnings and employment growth?
    - How has this changed in the light of the great recession?
1. Key features of the labour market and earnings.
  2. Main issues with current tax systems.
  3. Prospects for improvement and coherent reform
    - EU 2013 Challenges for Tax Reform: coordinated ‘screening’.

# Evidence on longer-term adjustments suggest

- There are common key points in the life-cycle where individuals are likely to be most responsive to effective tax and welfare incentives
  - Derives from extensive comparative work across FR, DE, UK and US
  - Labour market entry, parents of younger children and older workers
- Effective budget constraints are complex and often poorly understood
  - Working age parents in France face the interaction of more than 17 different overlapping taxes, employer contributions and benefits – only 13 in UK!
- Effective tax rates can be extremely high for no real good reason
  - Interactions of means-tested programmes at the bottom and employer/employee taxes /contributions in the middle.
- Human capital on the job is strongly complementary with formal education
  - Pay-off to on the job experience and training is low for those with lower educational qualifications.
- Differential rates on similar sources of remuneration induce significant tax shifting and avoidance

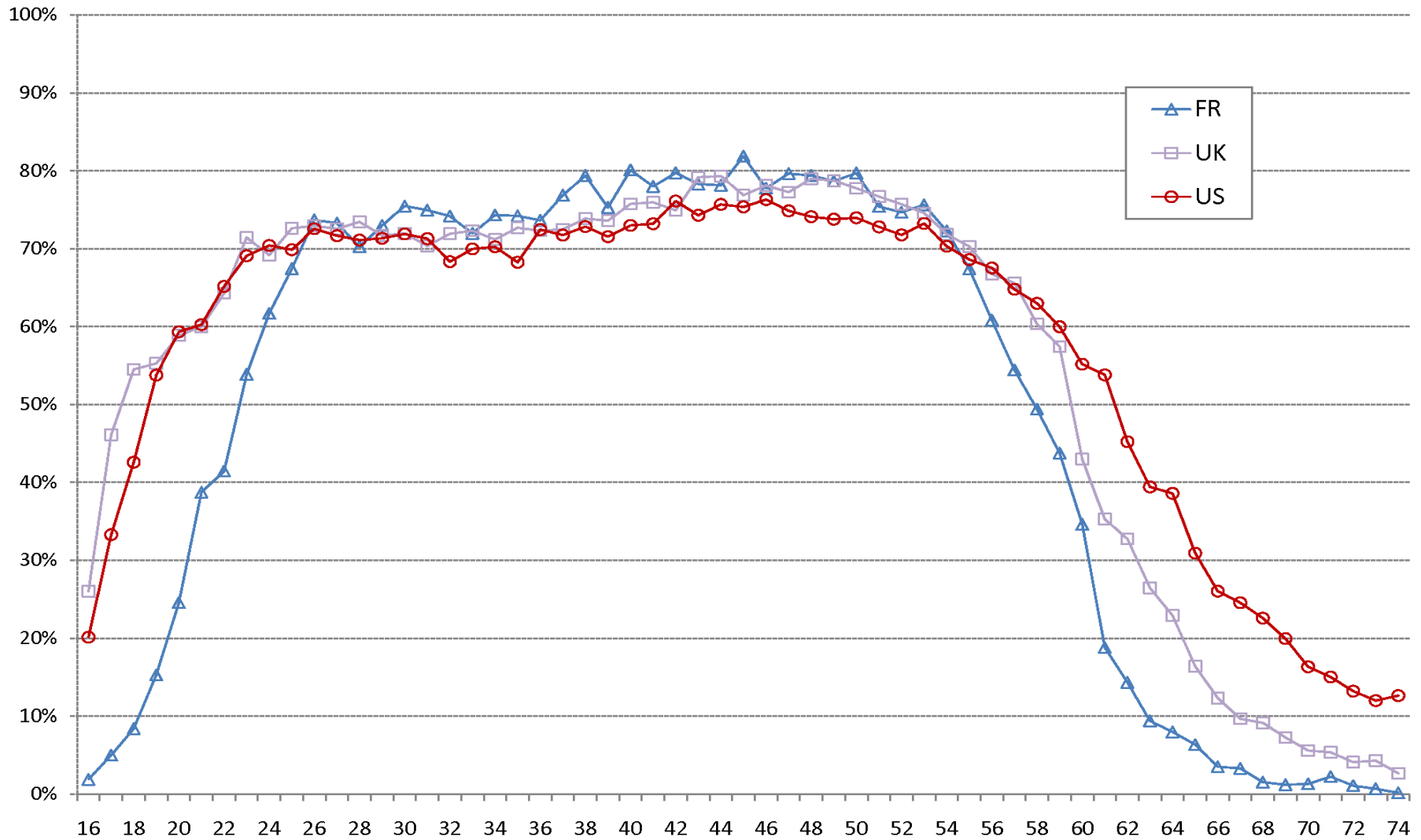
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## Employment for men by age – FR, UK and US 2007

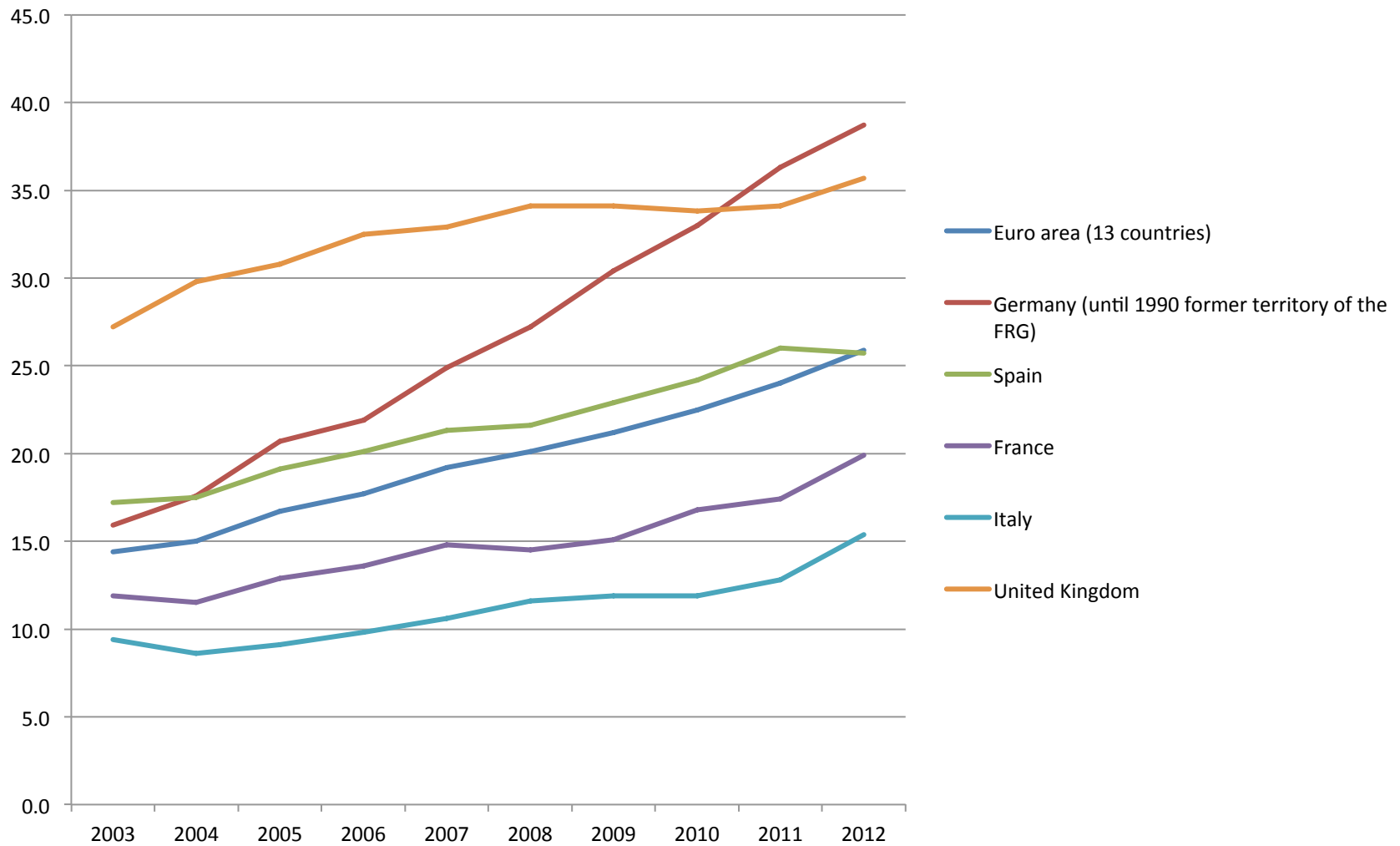


and for women .....

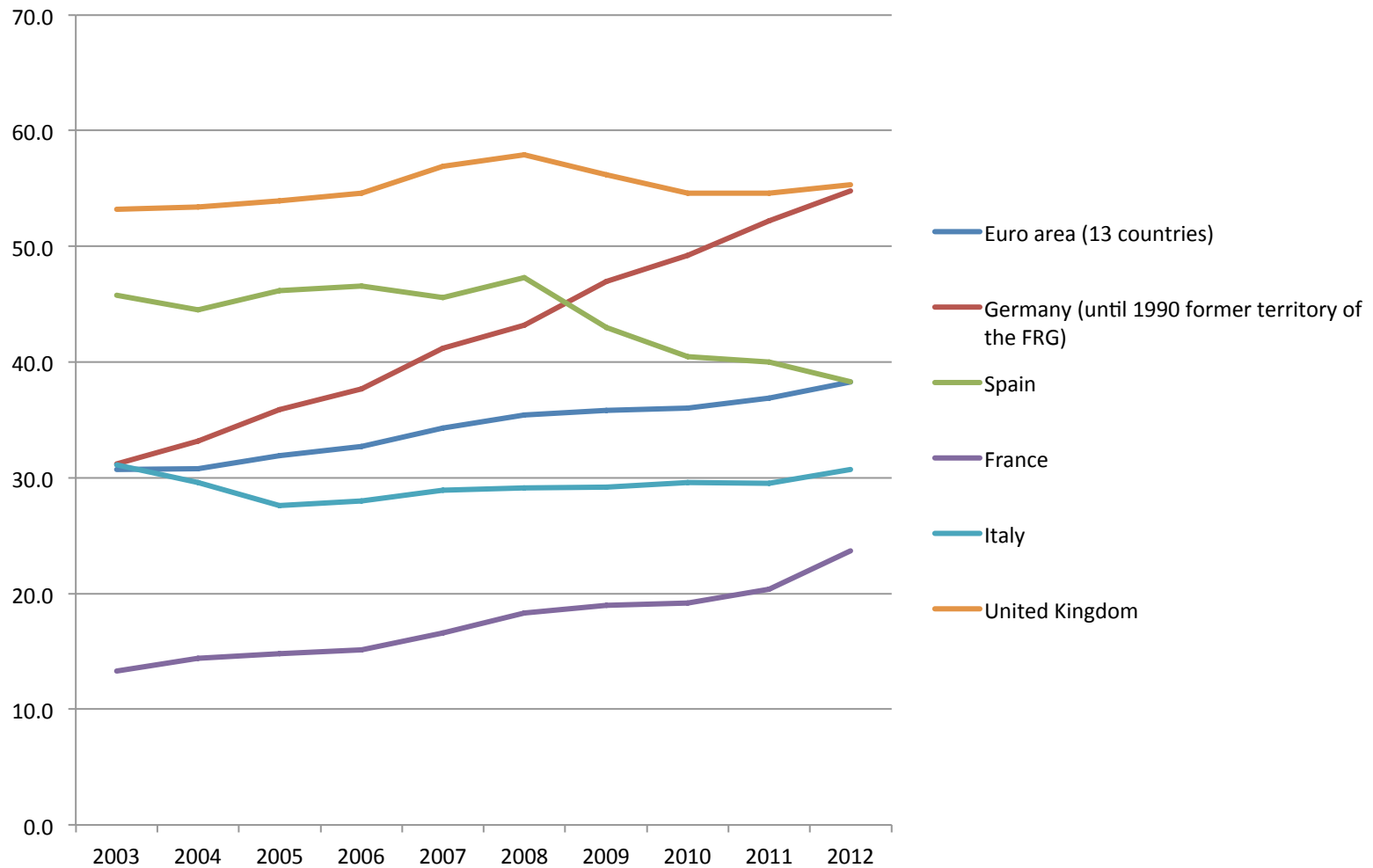
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# Employment rate for older workers: women aged 60-64



# Employment rate for older workers: men aged 60-64

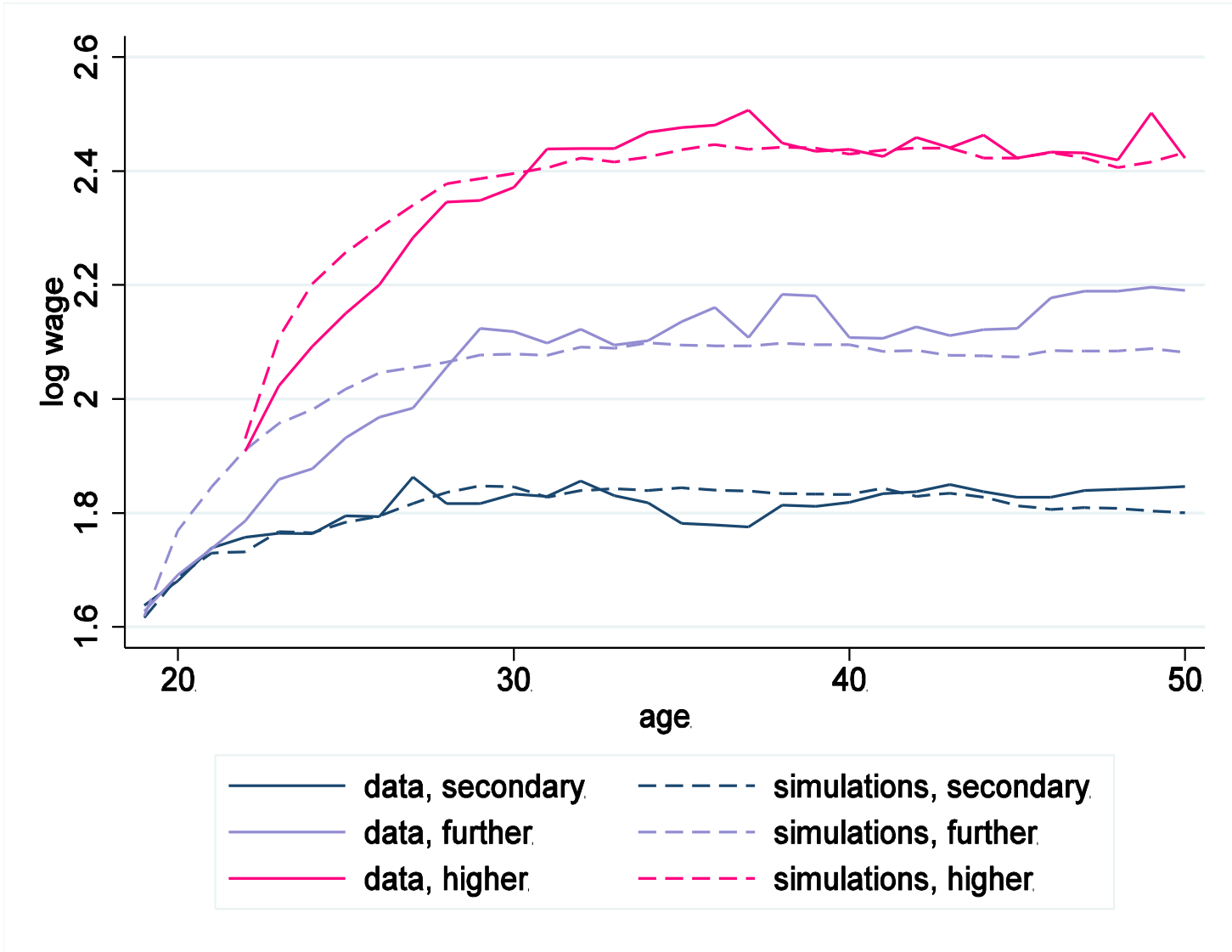


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- **Effective tax rates can be extremely high for no real good reason**
  - Interactions of means-tested programmes at the bottom and employer/employee taxes /contributions in the middle.
- **Human capital on the job is strongly complementary with formal education – and maybe getting more so**
  - Pay-off to on the job experience and training is low for those with lower educational qualifications.
- Differential rates on similar sources of remuneration induce significant tax shifting and avoidance



# Wage profiles by education and age



Data: UK women BHPS

Source: Blundell, Dias, Meghir and Shaw (2013)

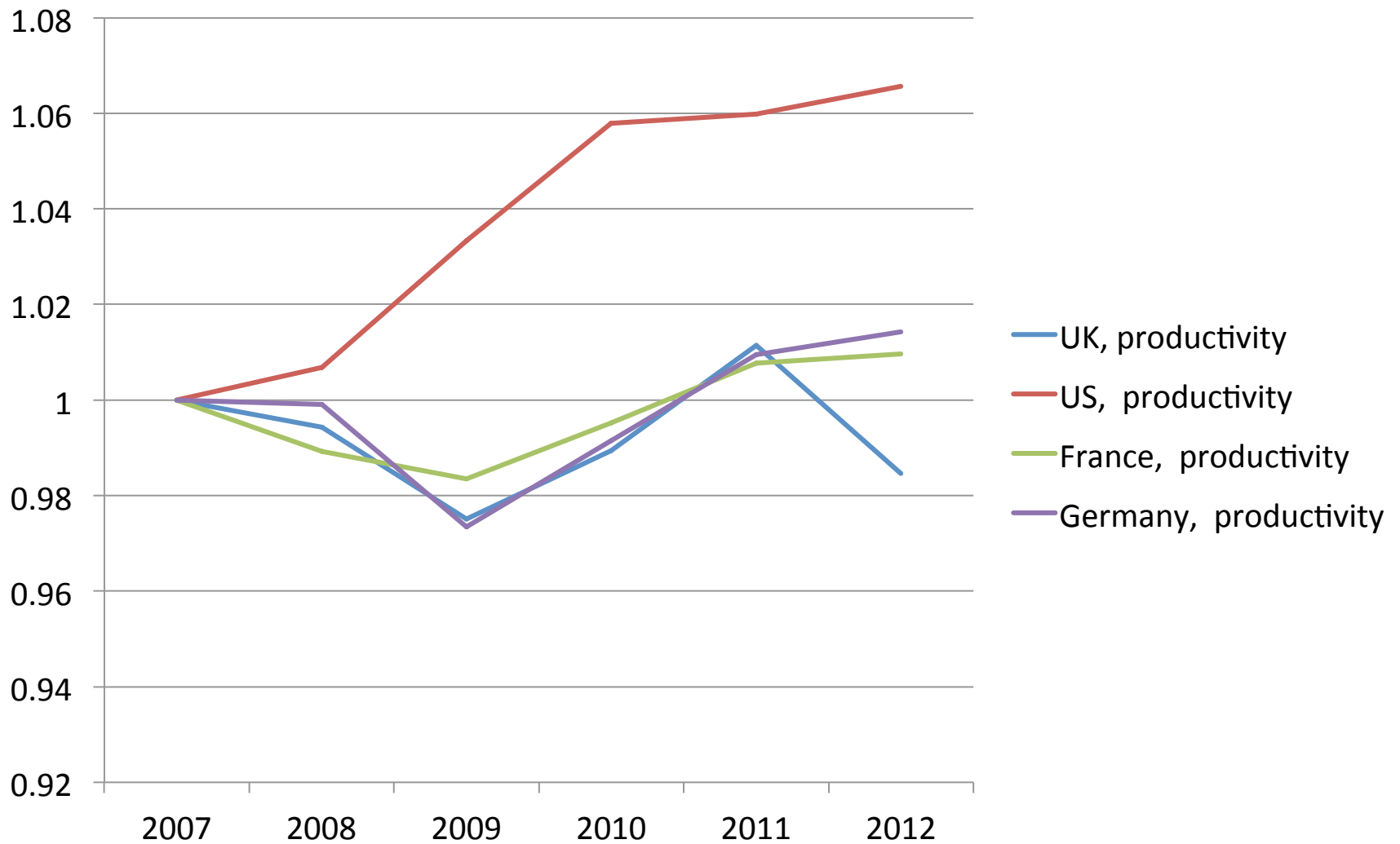
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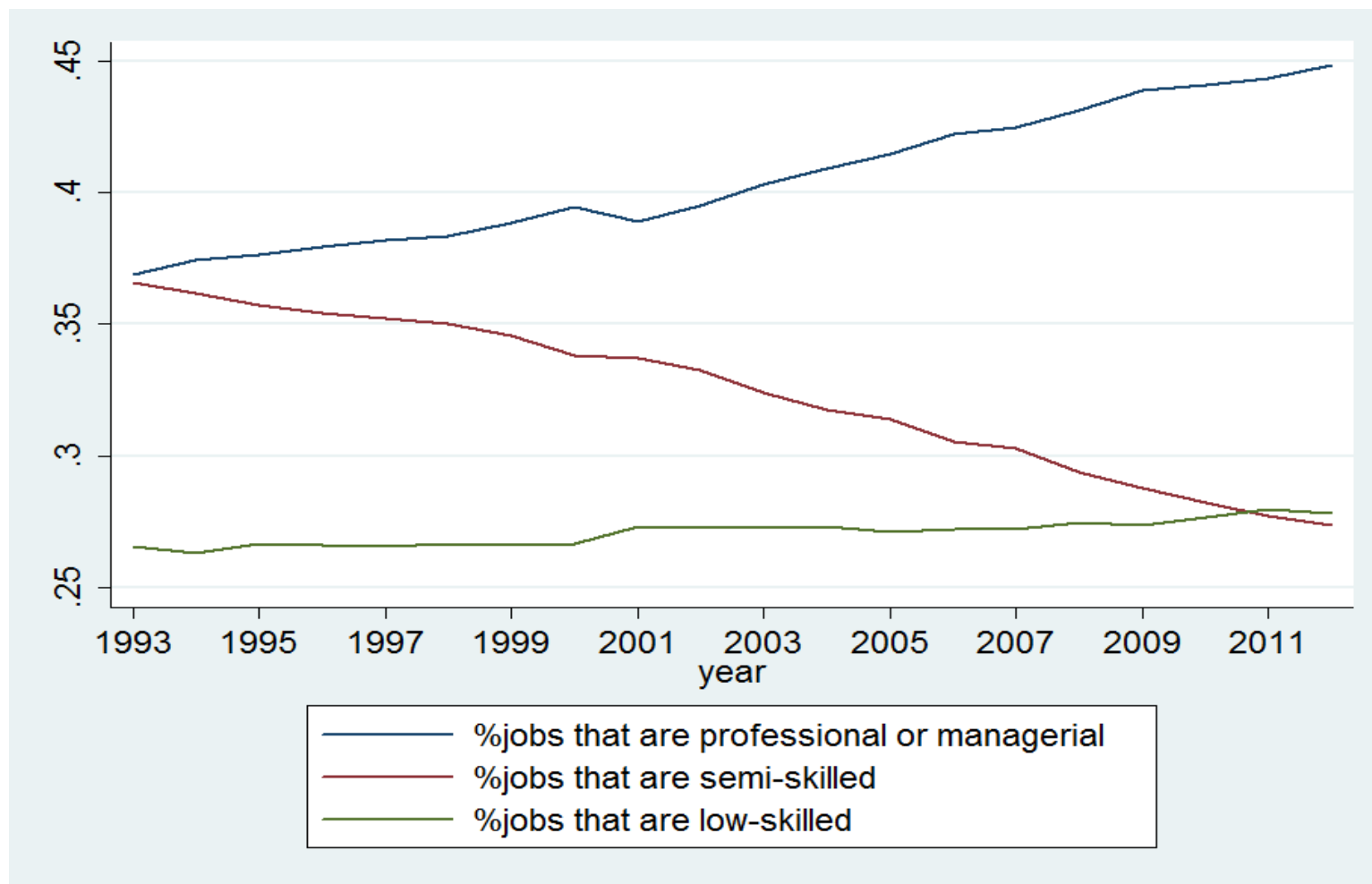
# Recent evidence suggests

- In general workers and families are acting as if they expect a long-run fall in relative living standards
  - evidence from consumption and saving; responses in labour supply.
- Productivity and capital investment have been slow to pick up
  - employment for the young/low skilled may bounce back, but what of real wages and productivity?
- Appears the number of routine jobs near the middle of the earnings distribution has declined steadily
  - more jobs are now professional or managerial.
- Suggests longer term earnings growth will mostly come from high-skilled occupations, with some at the very bottom.
- There remain the same key points where tax systems can be reformed to enhance earnings, employment and human capital.

# Productivity



# Employment shares of occupation groups: UK



Note: the discontinuities in occupation classification in 2001 and 2011 have been addressed in the following way. For the conversion of SOC 1990 to SOC 2000, we look at individuals who were surveyed in 2000Q4 and 2001Q2 and stayed with the same employer and infer the transition matrix from this group. For the conversion of SOC2010 to SOC 2000, we used the ONS two-way tabulation of the LFS 2007 Q1 sample by the major occupation groups under the two SOC systems.

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# Prospects for the loner term...

- Still much to do in focussing on older workers in general, on return to work for parents/mothers, and on entry into work.
- There are some potential big gains here,
  - for example, as (higher skilled) women age in the workforce.
- Tax/welfare reforms to enhance earnings (from *Mirrlees*):
  - refocus incentives towards transition to work, return to work for lower skilled mothers and on enhancing incentives among older workers.
- Productivity remains the key
  - (financial) capital misallocation and potential investment returns.
- Human capital and ‘on the job’ wage/productivity complementarity
  - note the relative importance of mismatch of entry skills in this recession.
- Productivity and wages are related but note recent growth in the wedge between labour costs and hourly wages
  - the growing importance of pensions and NI in the UK – future trends?

# Summary overview for the longer term.....

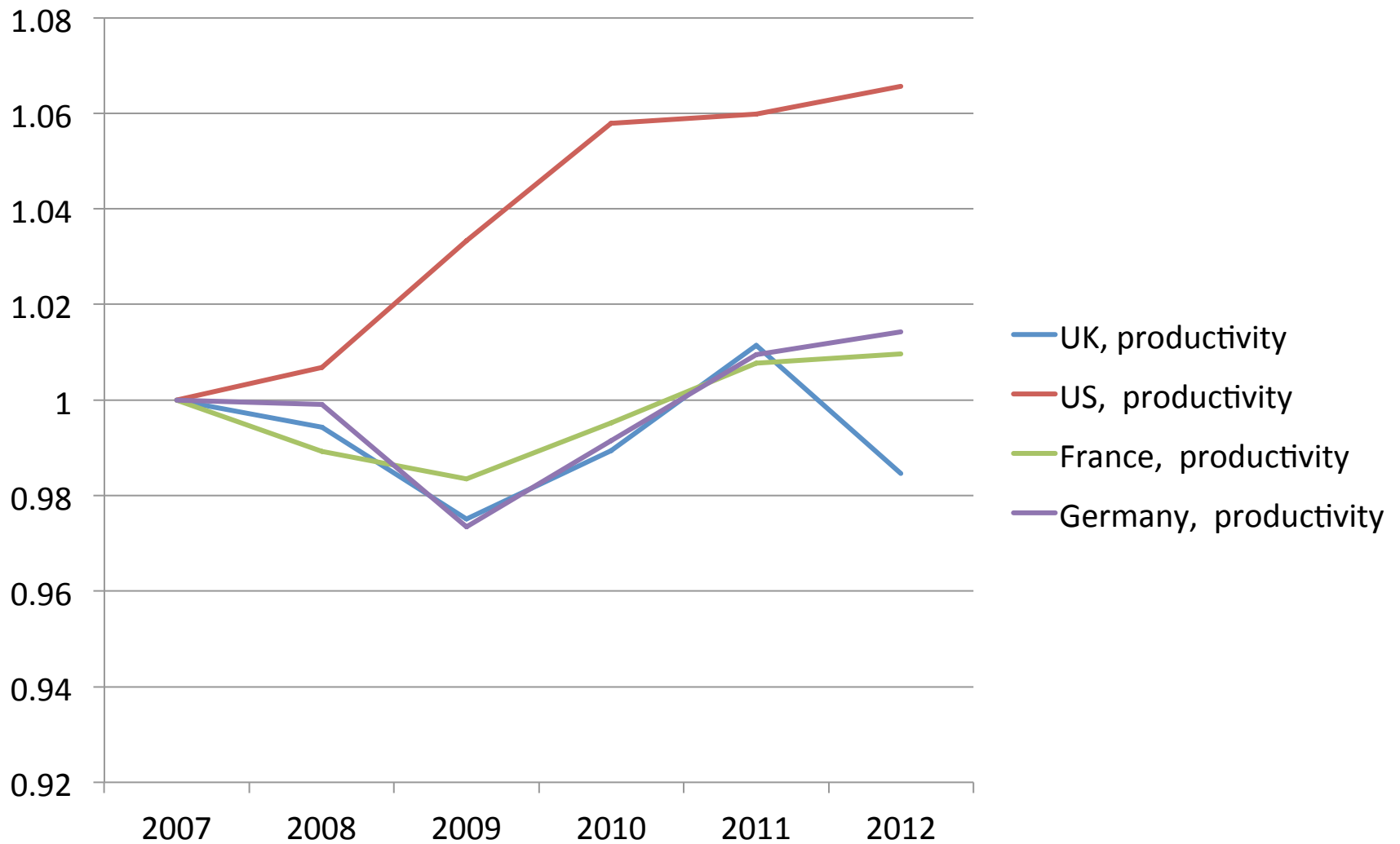
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- Current systems are unnecessarily complicated and induce too many people not to work or to work too little.
- Target work incentives where they are most effective
  - reducing means-testing and improving the flows into work for lower education mothers and maintaining work for those aged 55+.
  - at least do not increase taxes on labour at these points!
  - simulations in Mirrlees (2011) show key increase in work/earnings.
- Integrate overlapping benefits - a single integrated benefit
- Reduce disincentives at key margins for the educated
  - enhancing working lifetime and career earnings profiles
  - simulations show significant impact on human capital.
- Align tax rates at the margin across income sources
- Make better use of social insurance and welfare accounts.....



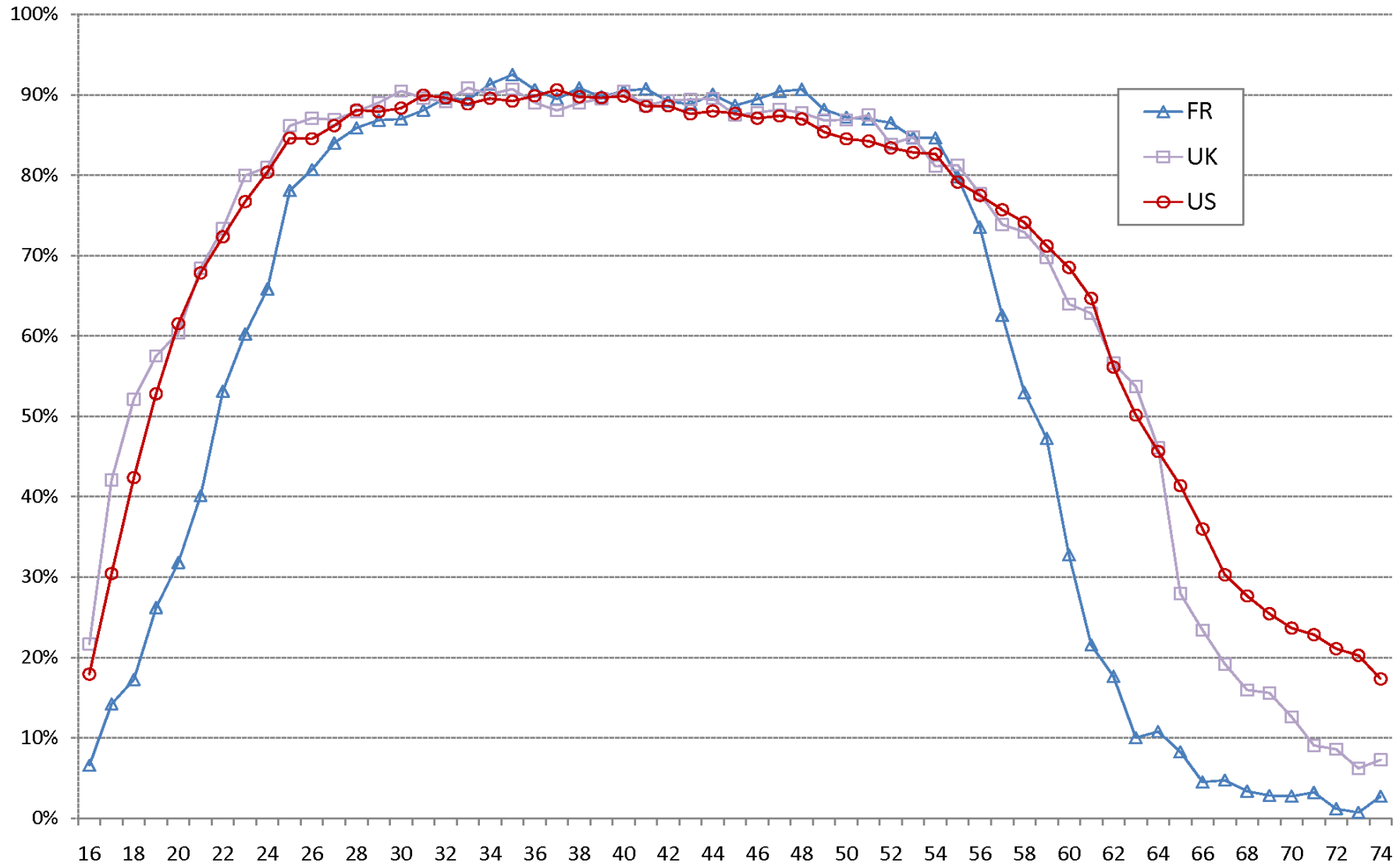
# Figures

# Productivity



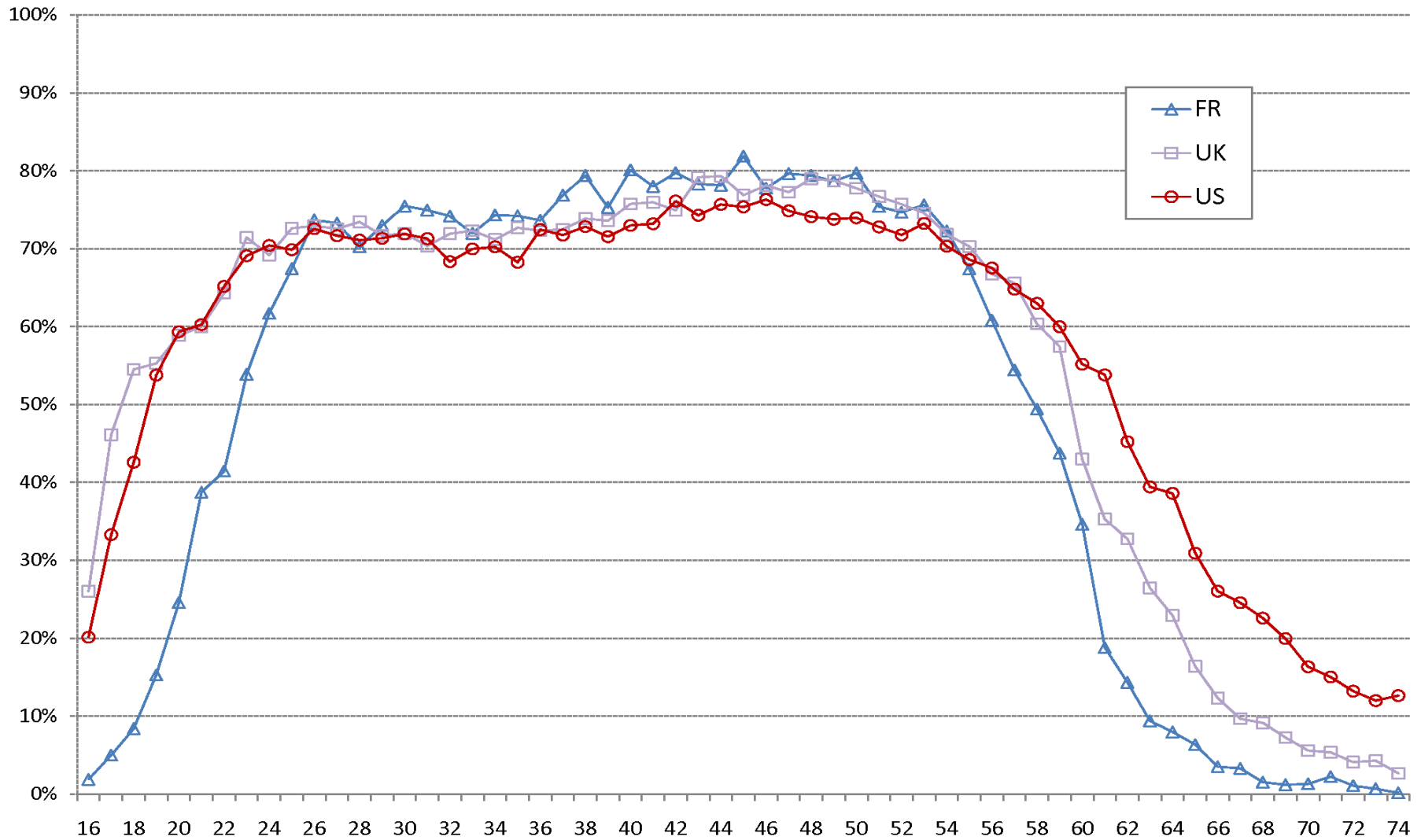
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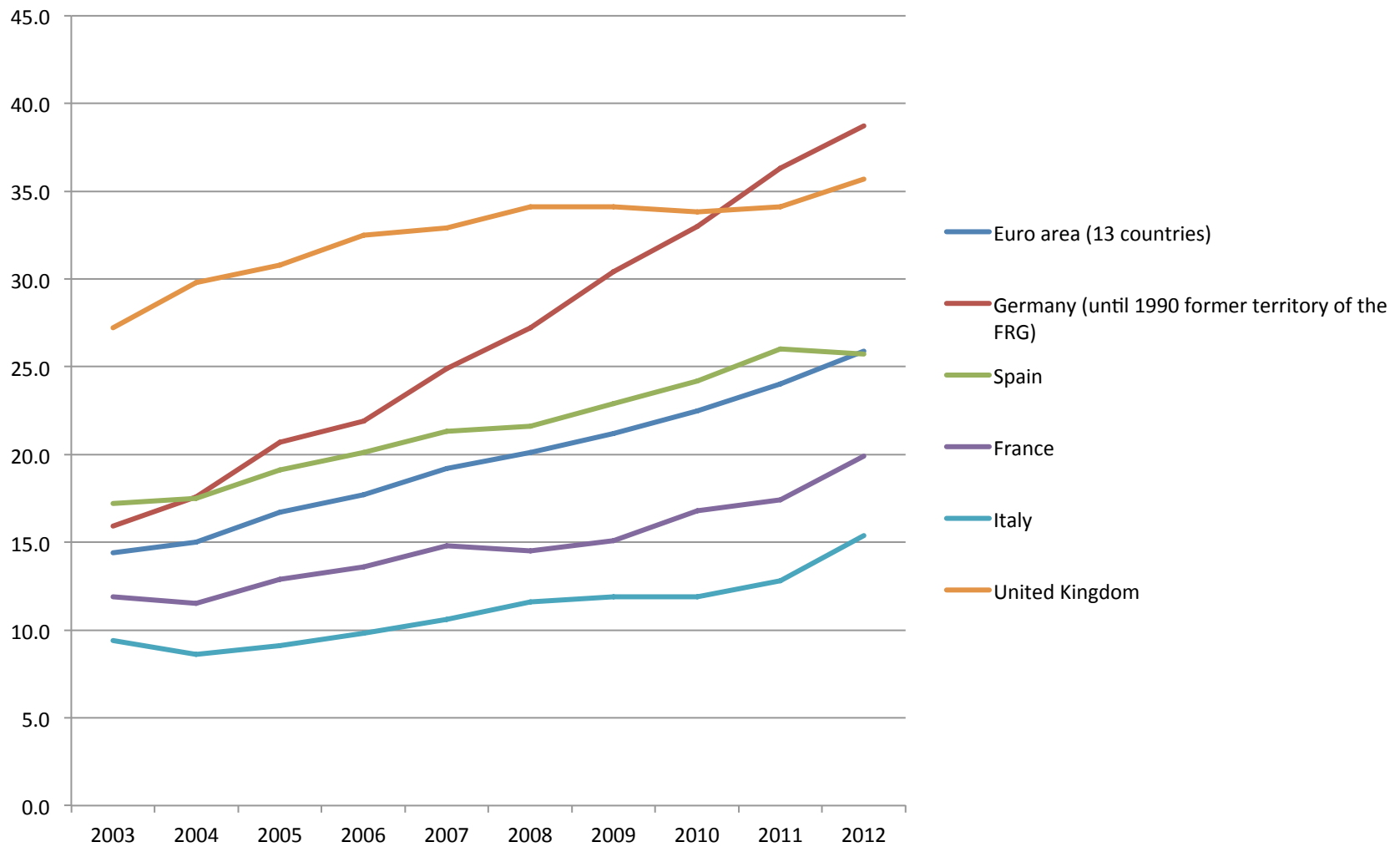


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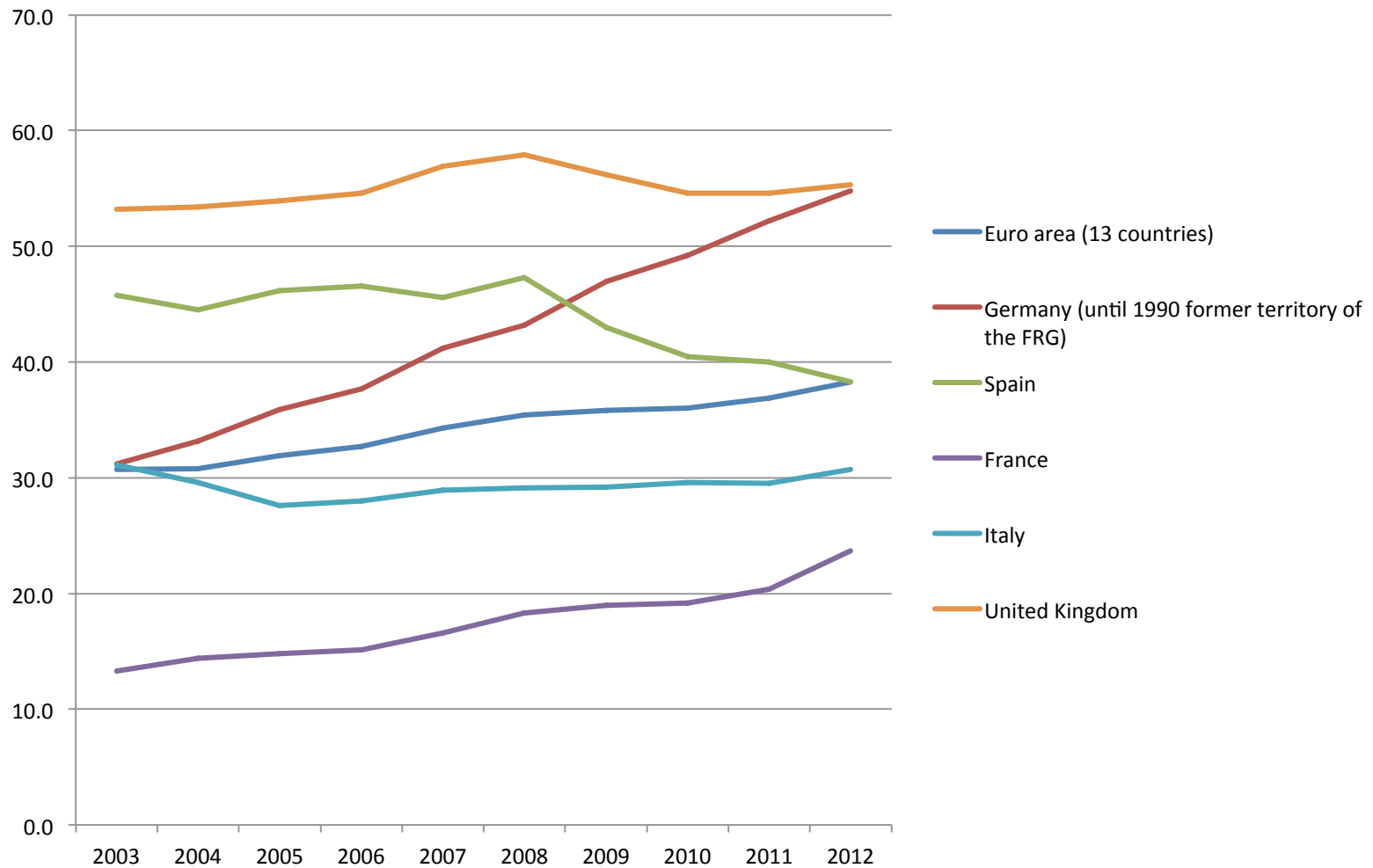
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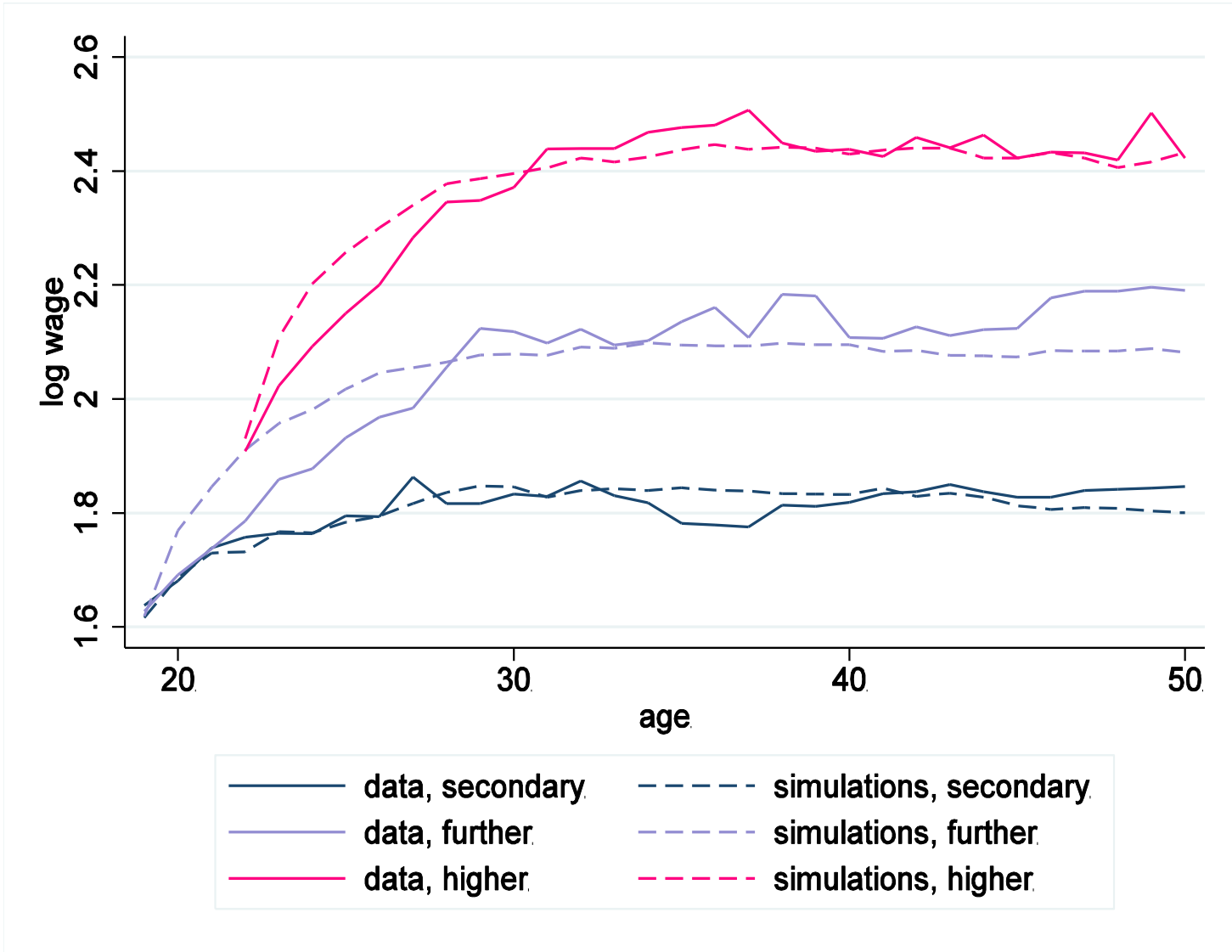
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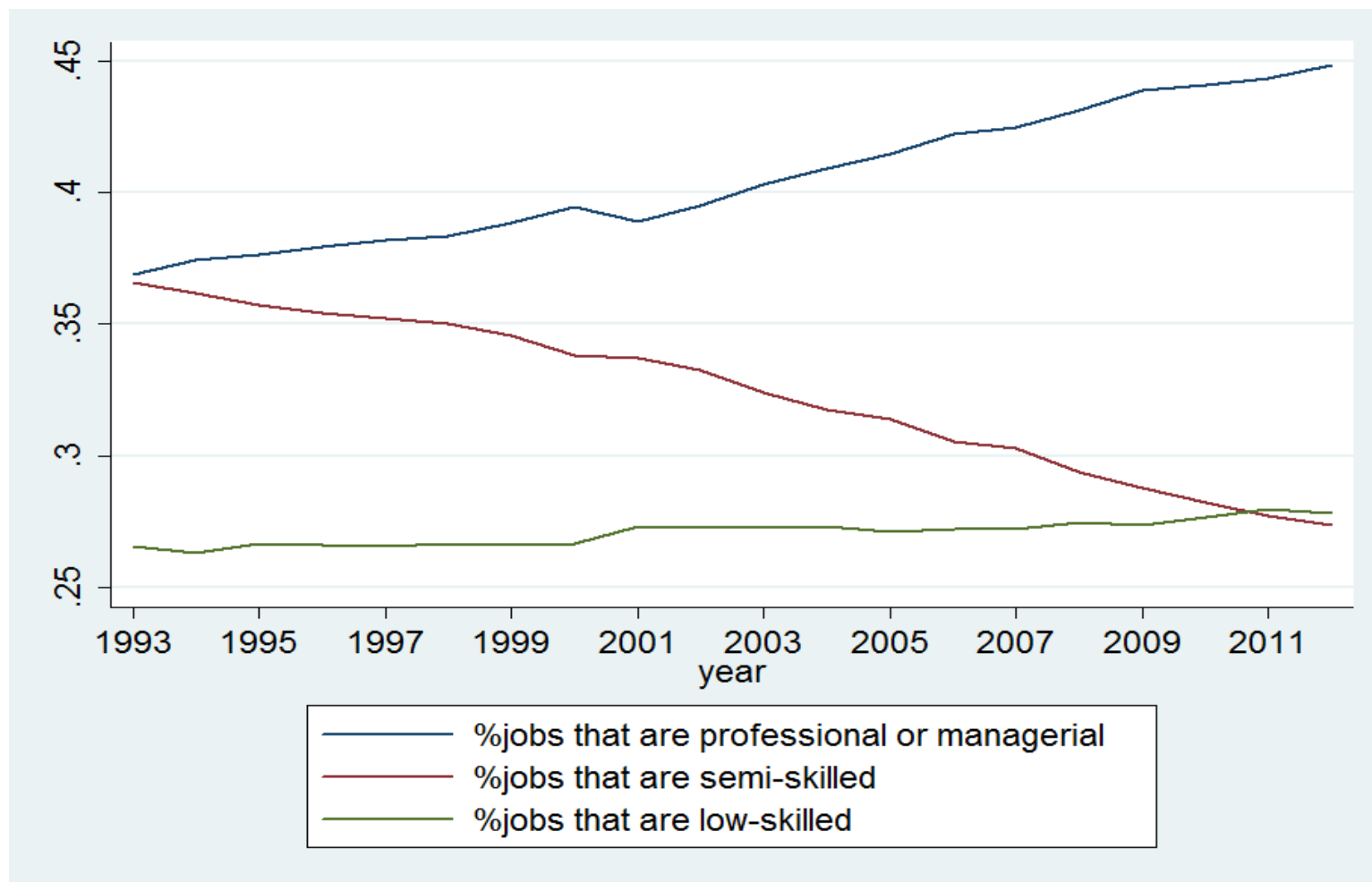
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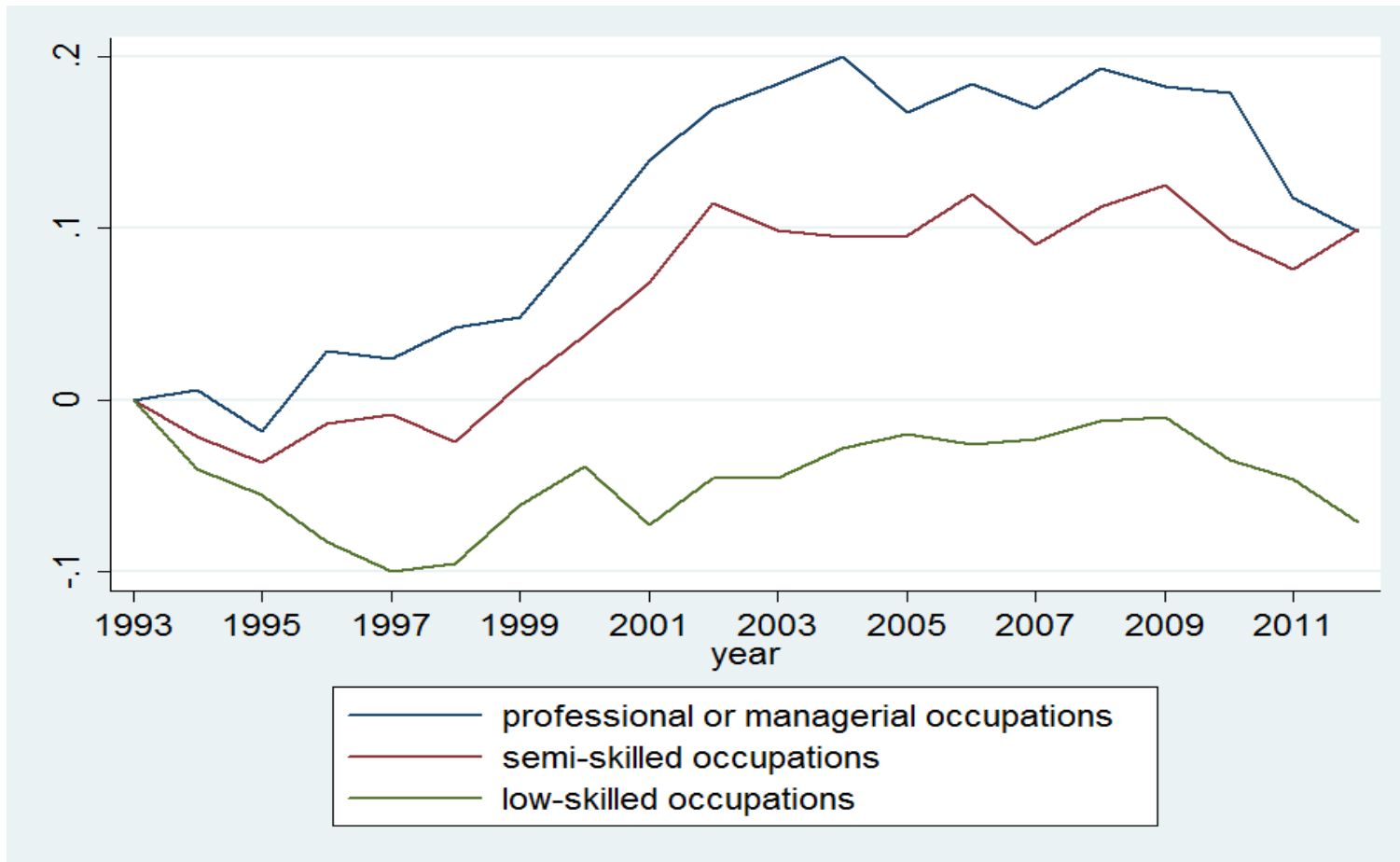
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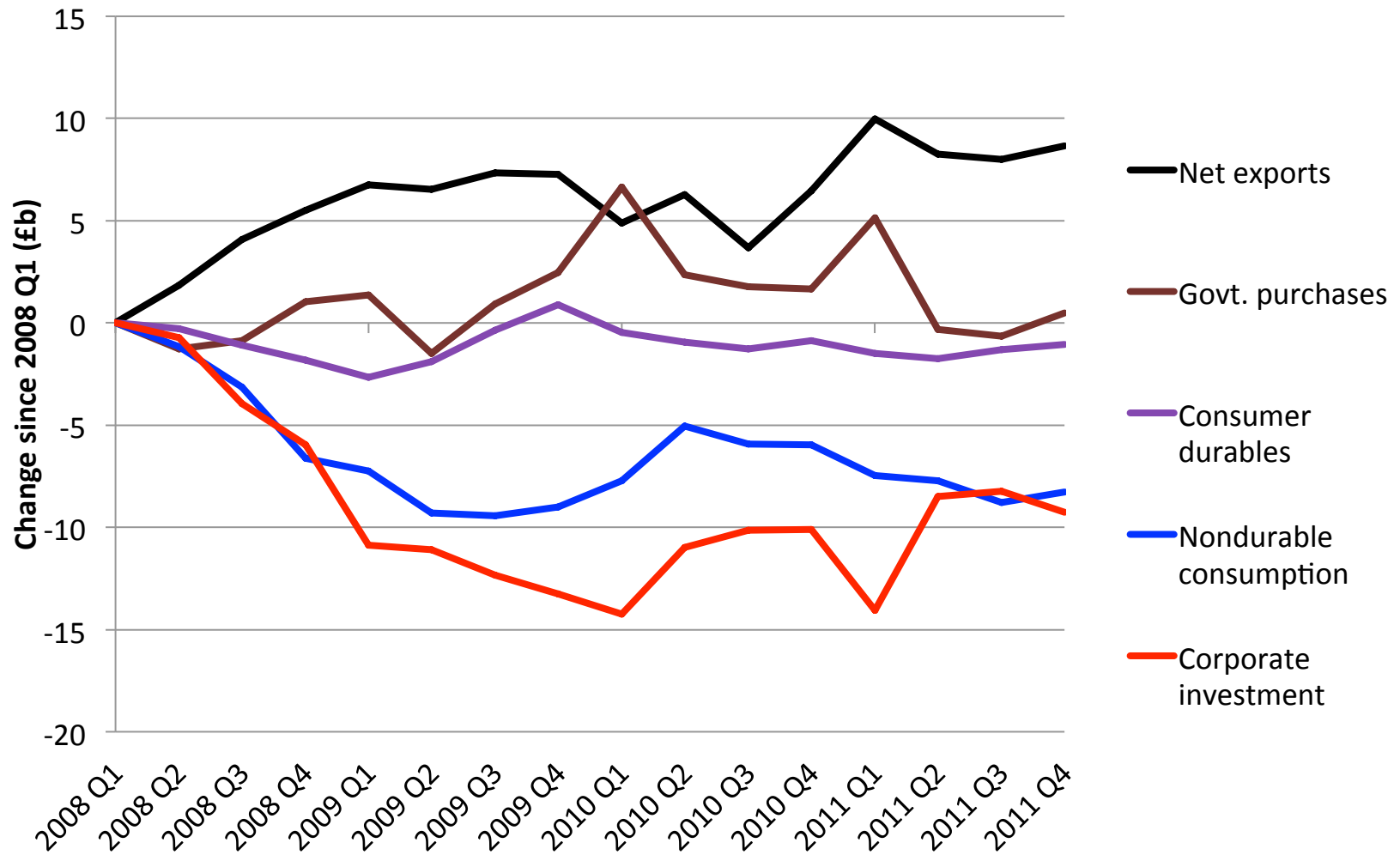


# Real wages by occupation group: UK



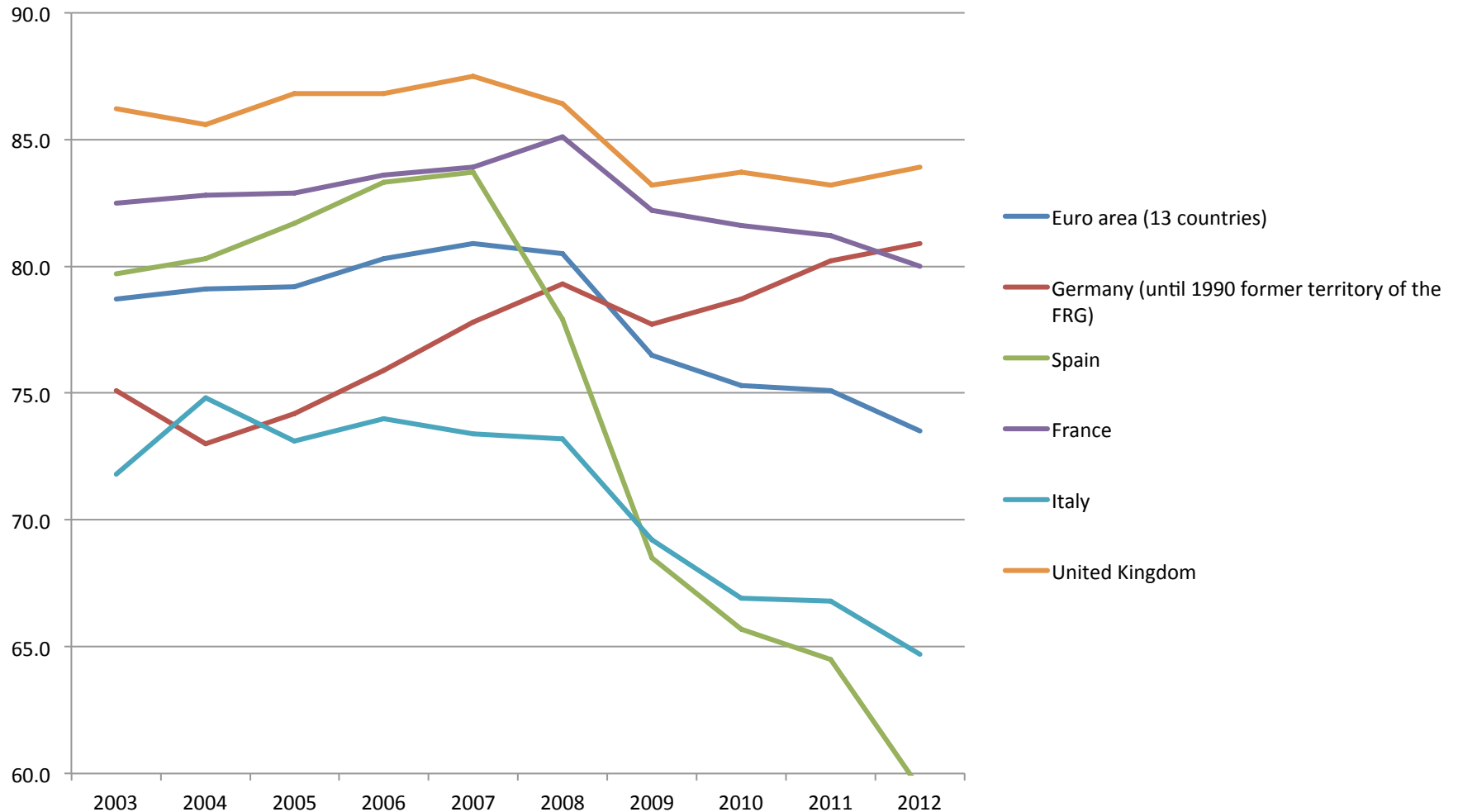
Note: the low-skilled wage would end up around the 1993 level if we use CPI instead of RPI. Each log wage series is normalized to 0 in 1993.

# Components of GDP: UK

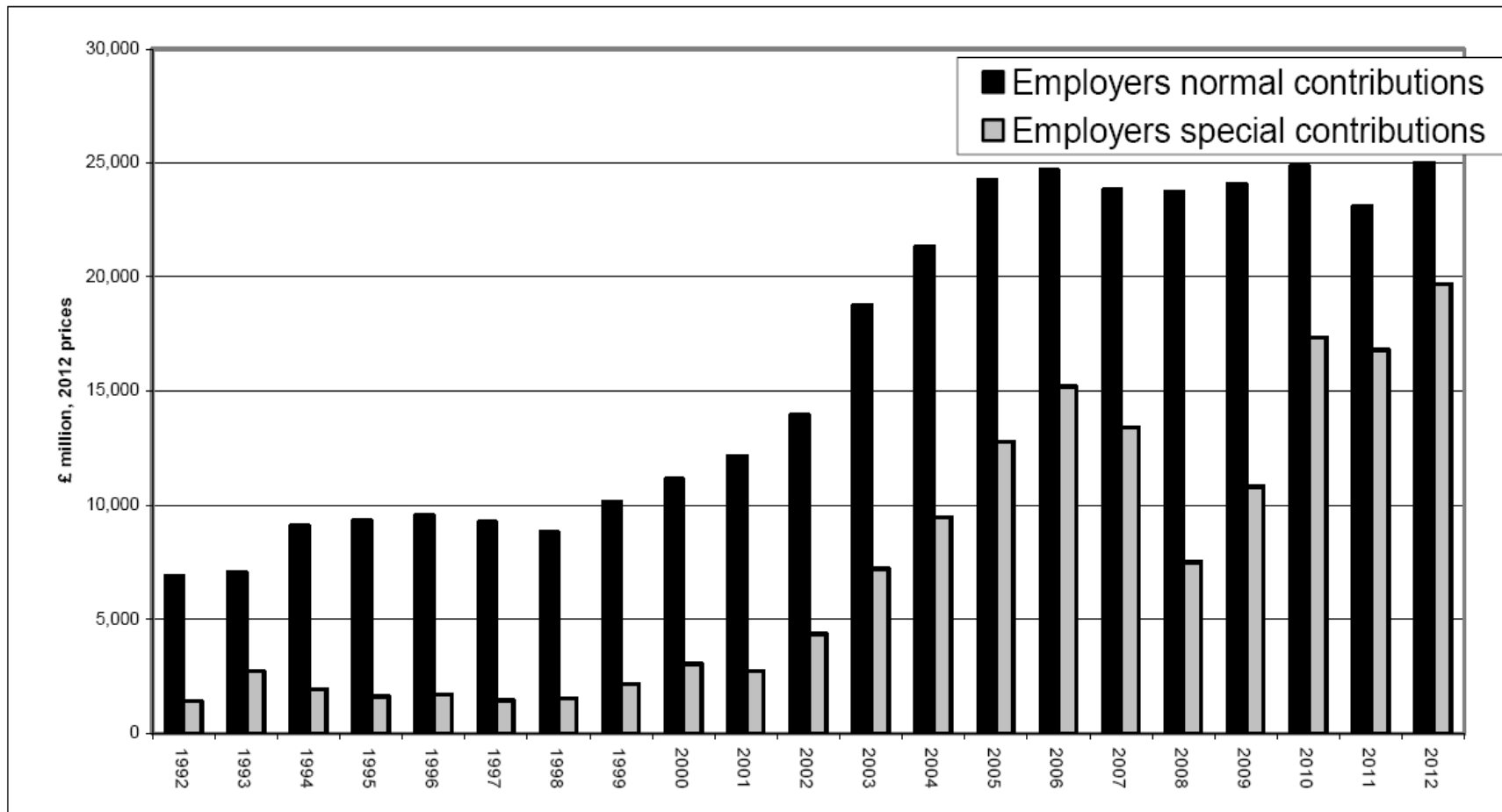


# Employment fell back differentially....

## Employment rate: men aged 25-29



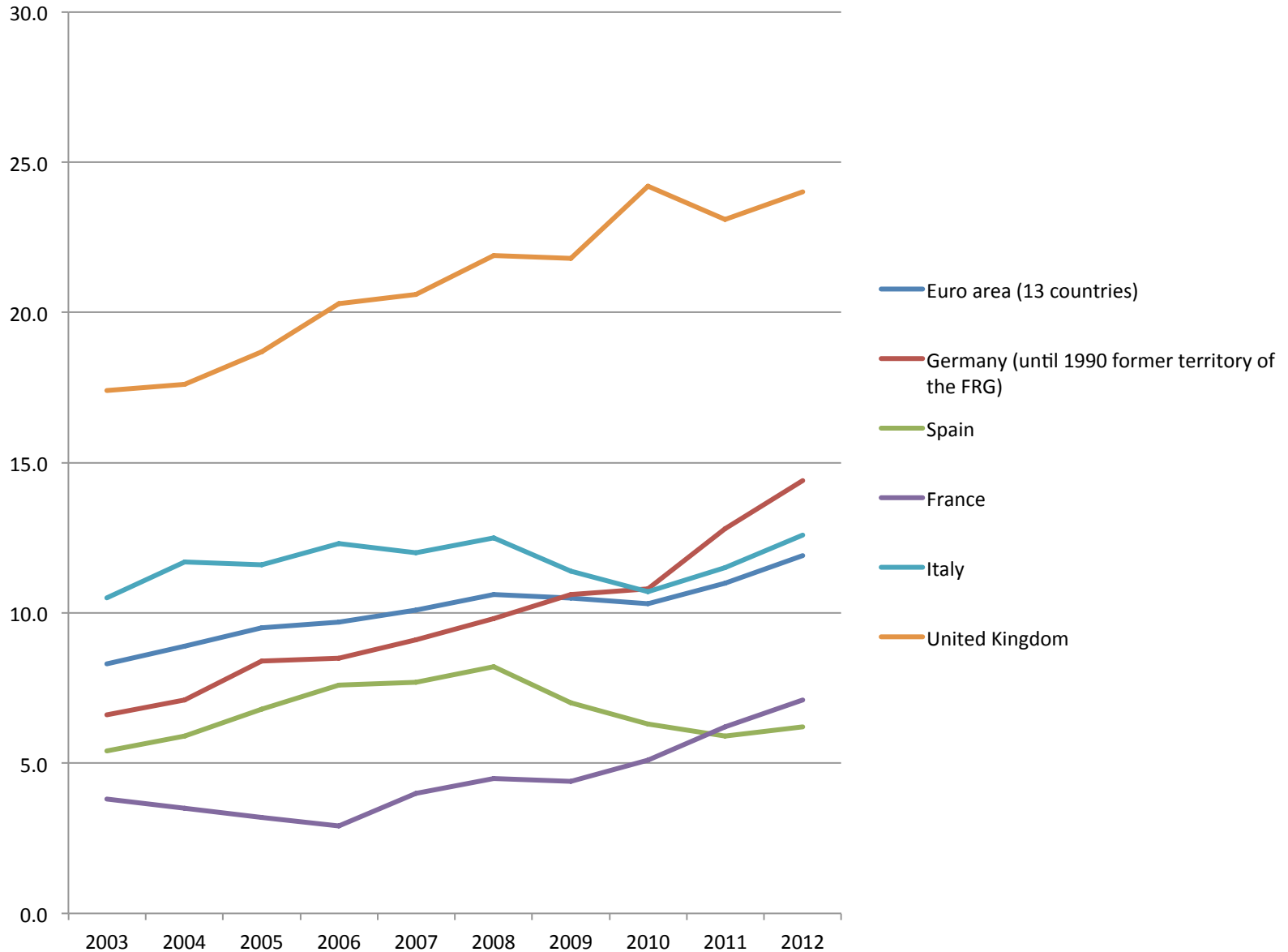
# Employer (real) contributions to pension funds – UK



Source: Office for National Statistics

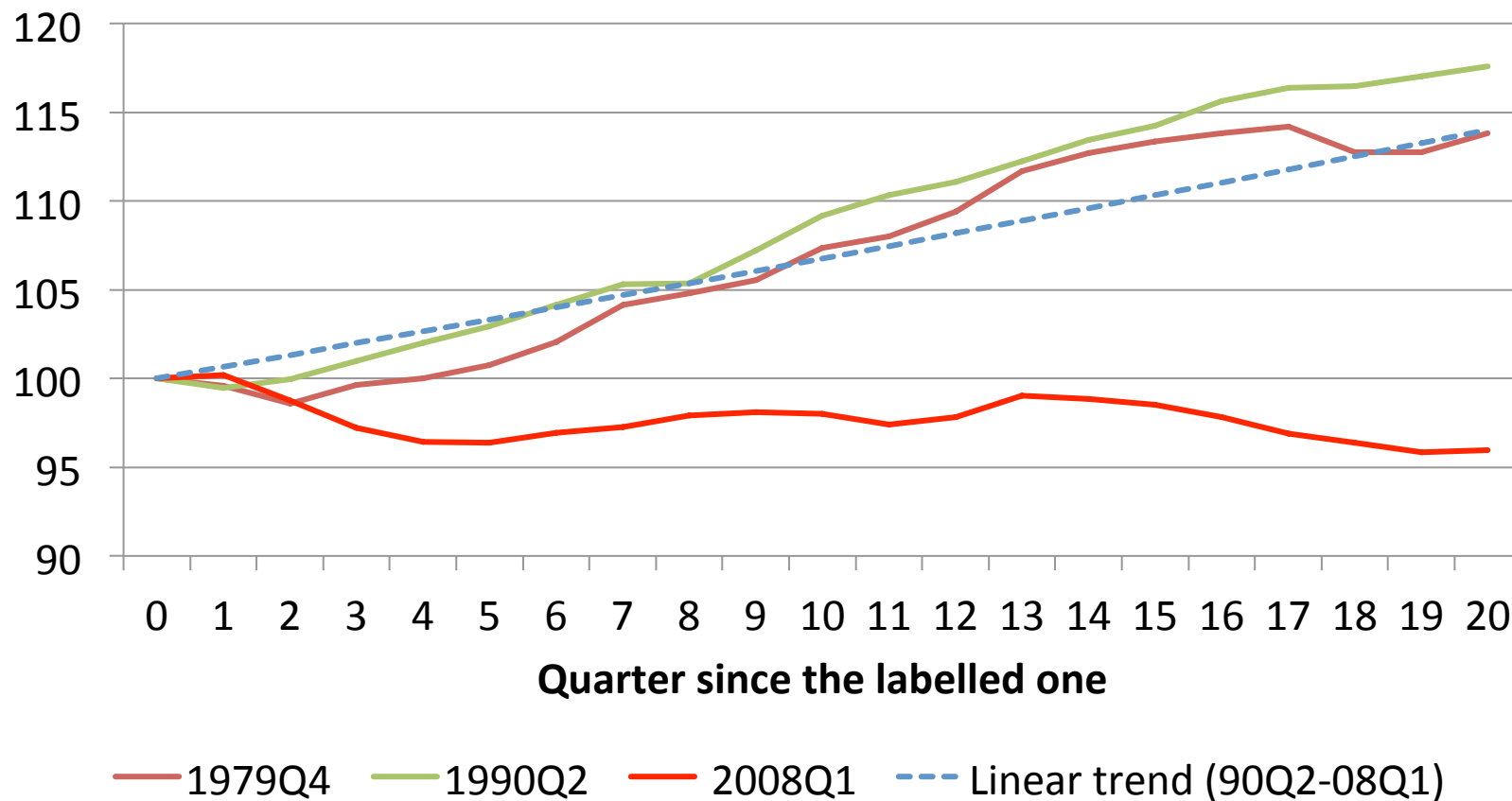
Notes: Data for Q4 2012 is not yet published so has been estimated based on Q4 2011 to Q3 2012 data

# Employment rate for older workers: men aged 65-69



# Productivity growth is quite different to previous recessions

## Real output per hour



# Extra Slides

# Bringing it all together

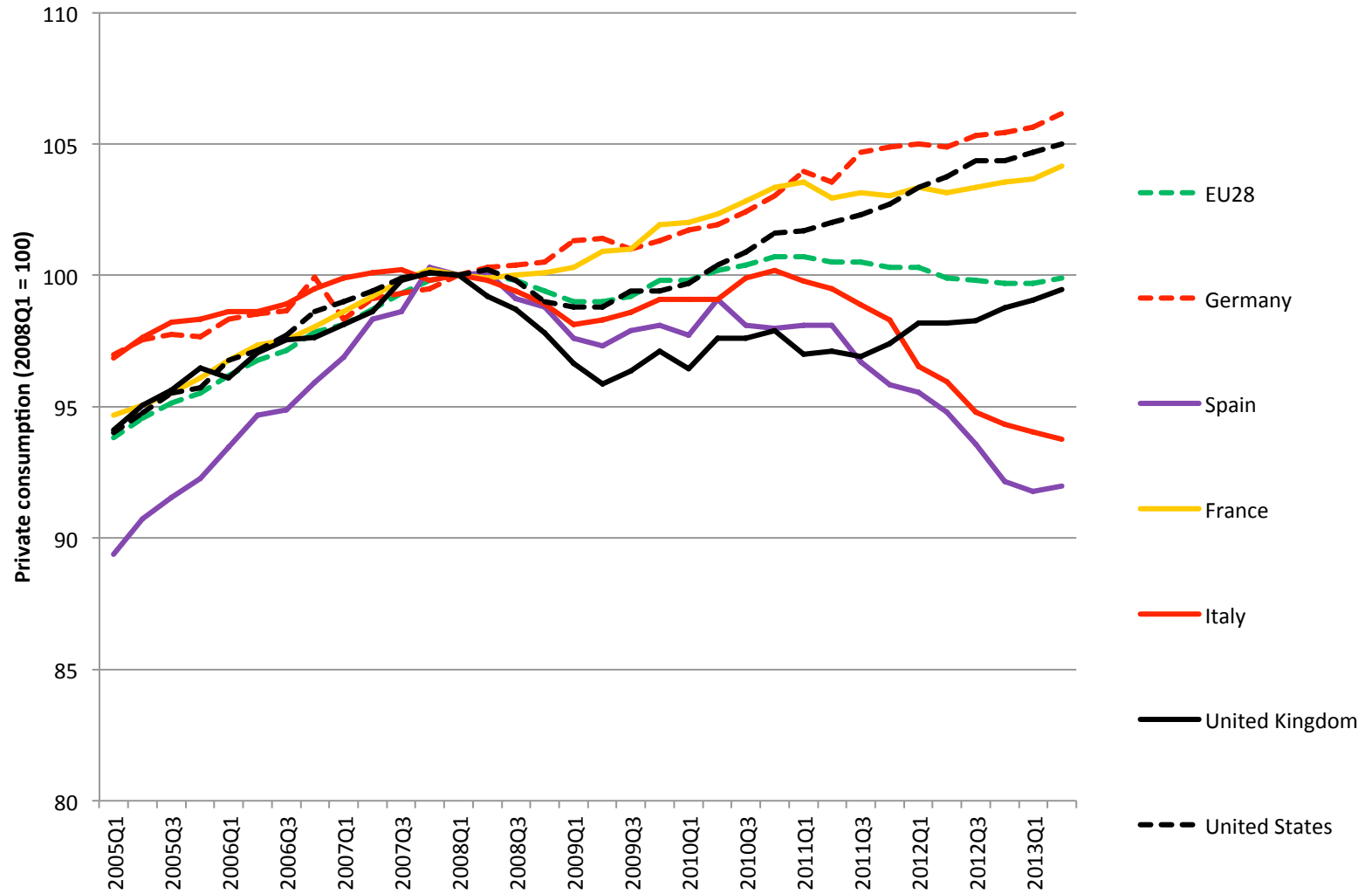
- The key to improving these trends will be to focus policy labor market entry and retirement.
- Enhancing the flow into work for those leaving education and for returning mothers after childbirth, while expanding work among older workers.
- These margins are precisely where labor supply is most responsive to tax incentives.
- Human capital policy has a complementary role by improving the pay-off to work and ensuring earnings hold up longer through adult life.



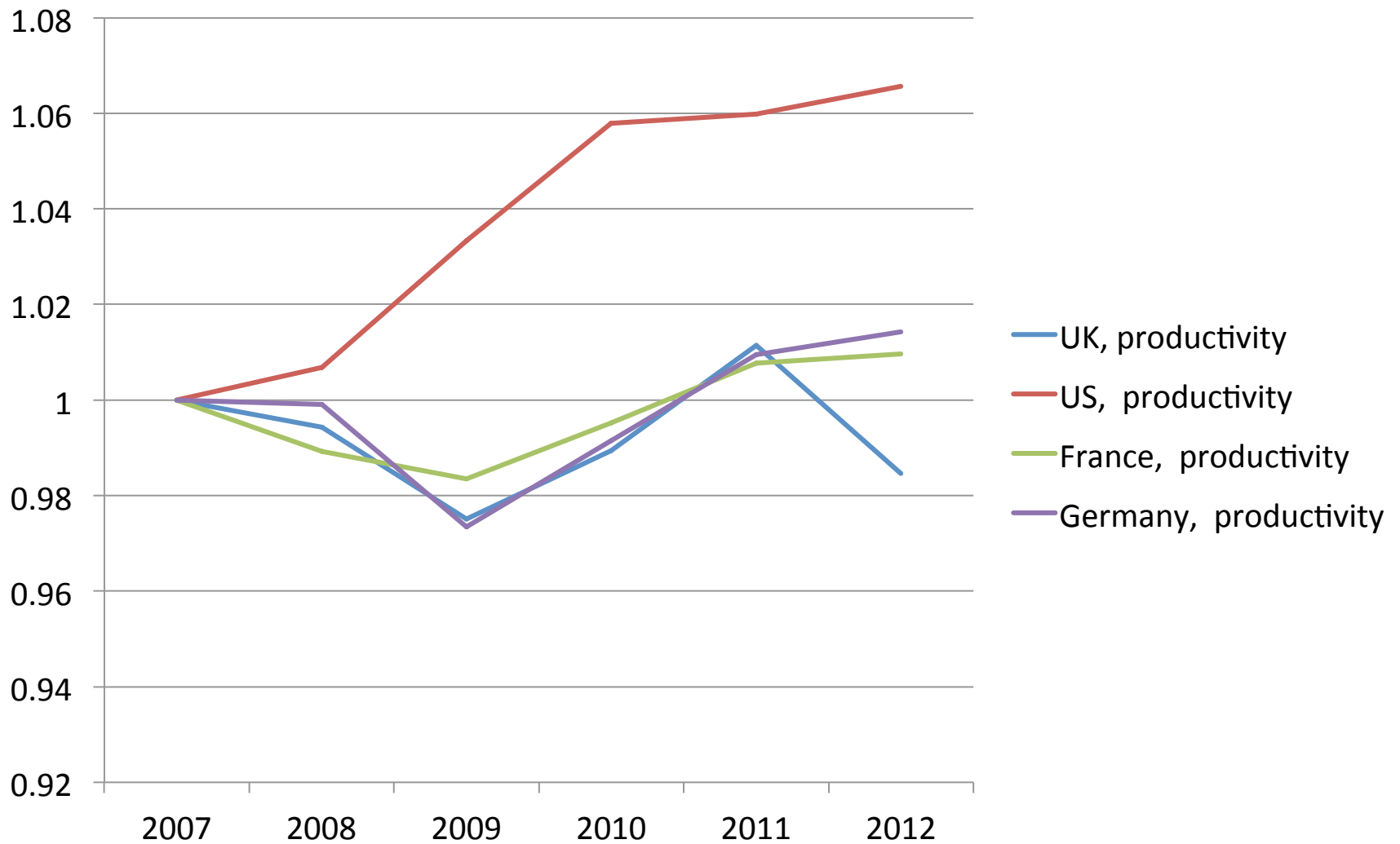
- The evidence points towards a blueprint for a coherent and effective policy.
- At a broad level key proposals would follow those in the Mirrlees Review - to simplify and integrate the benefit/welfare system, target work incentives where they are most effective and align rates across similar sources of income to reduce avoidance opportunities and broaden the tax base.
- More specifically, tax policy should be designed to acknowledge that incentives have been found to operate most effectively at certain key points in the life-cycle. In terms of enhancing lifetime earnings the evidence suggests three key policy ingredients:
  - improving labour market entry - for those leaving education and for women after childbirth,
  - maintaining employment among older workers, and
  - increasing human capital investments.

- These three ingredients can go hand in hand.
- The path to improving long-term trends in employment and earnings would be to reduce disincentives in the tax and welfare system around labour market entry and retirement.
- These are the margins of labor supply that have been found to be most responsive to tax incentives. Improving the flows into work for those leaving education and for mothers with young children, while maintaining work among those in their late 50s and 60s.
- Reforms should recognize that early human capital investments enhance the incentive to work and to accumulate human capital while in work, ensuring gross earnings hold up longer through the life-cycle. In turn, net income earned later in the working life provides an important incentive for human capital investments.

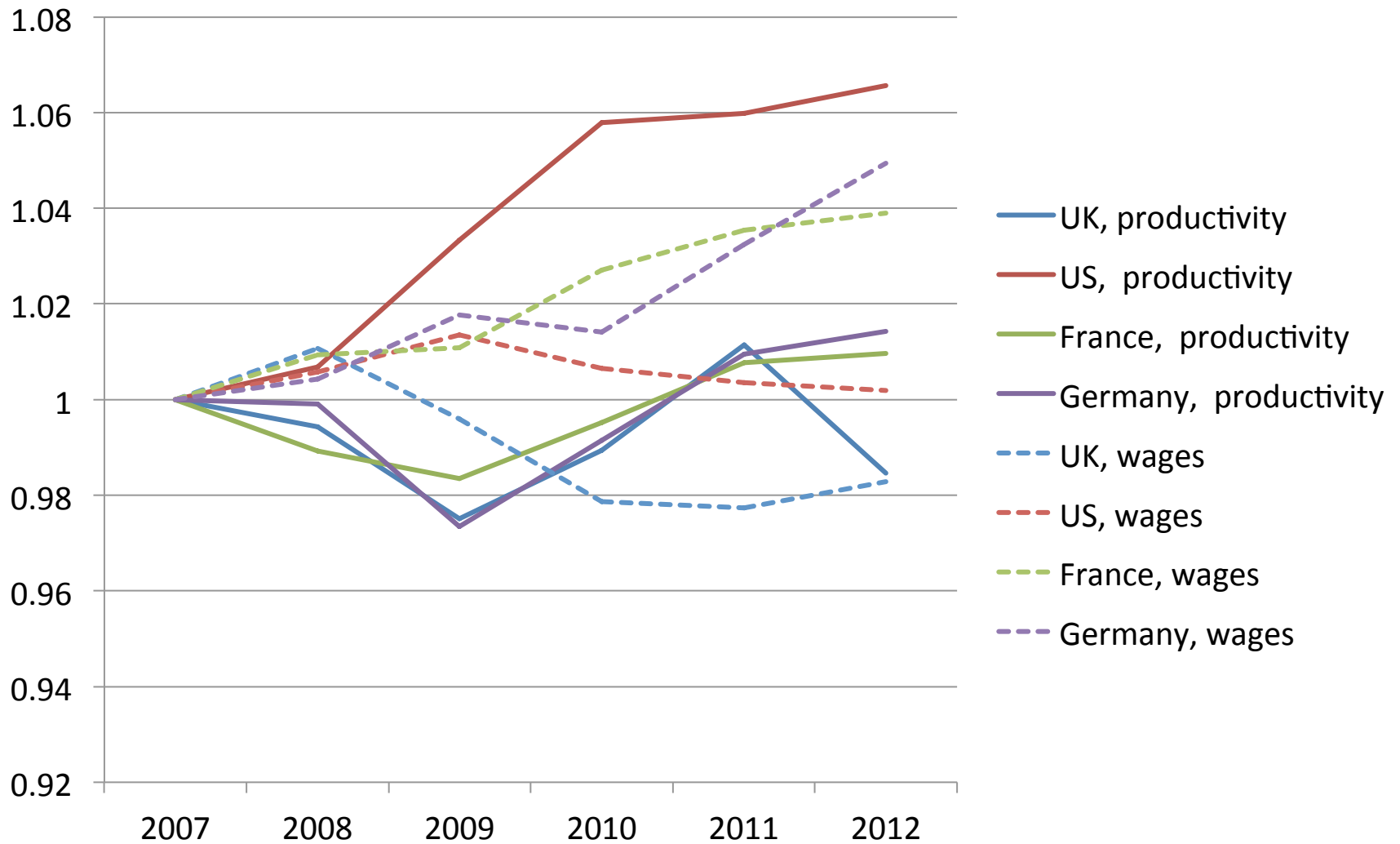
# Consumption Growth



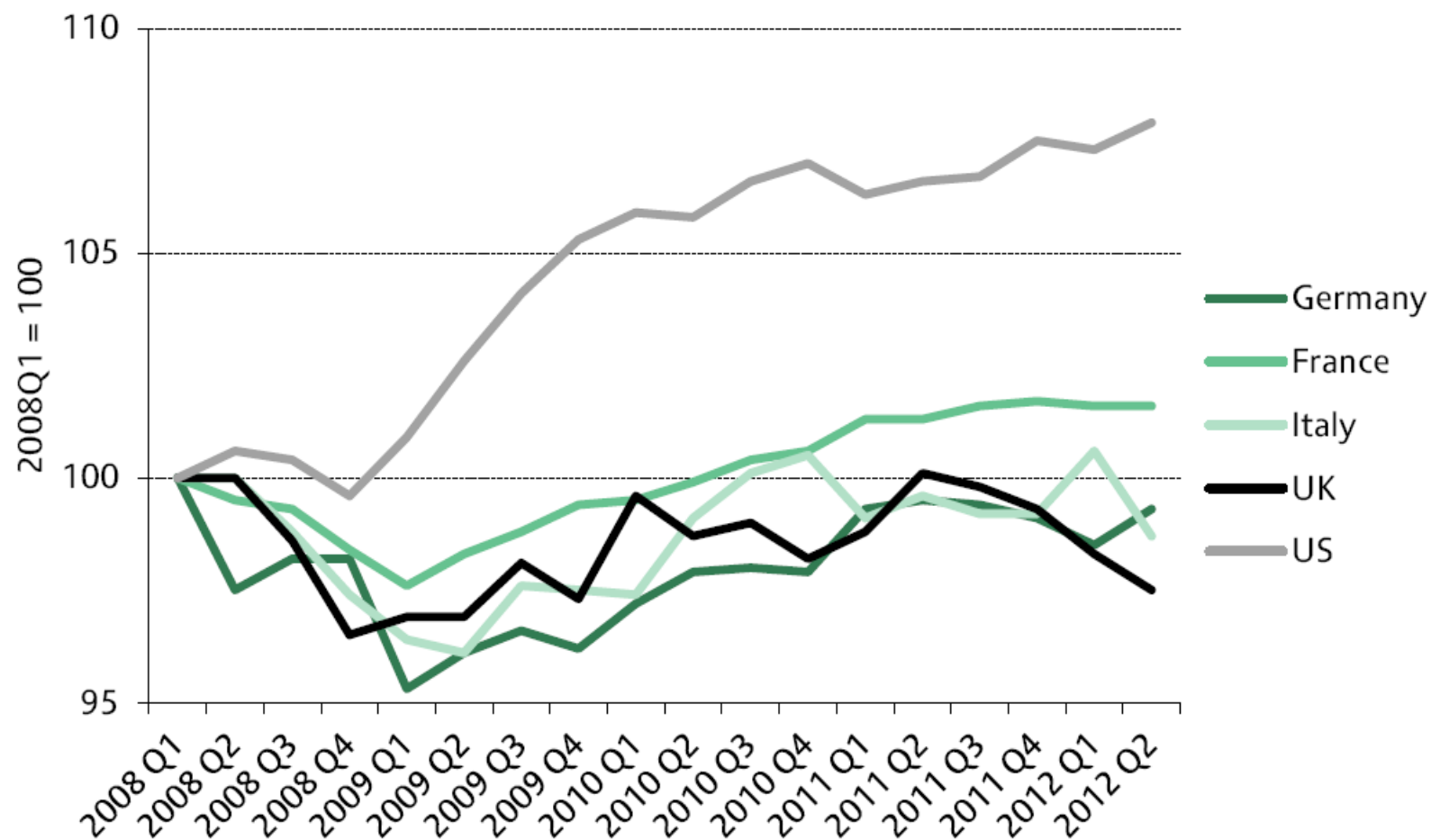
# Labour productivity



# Real wages held up - initially



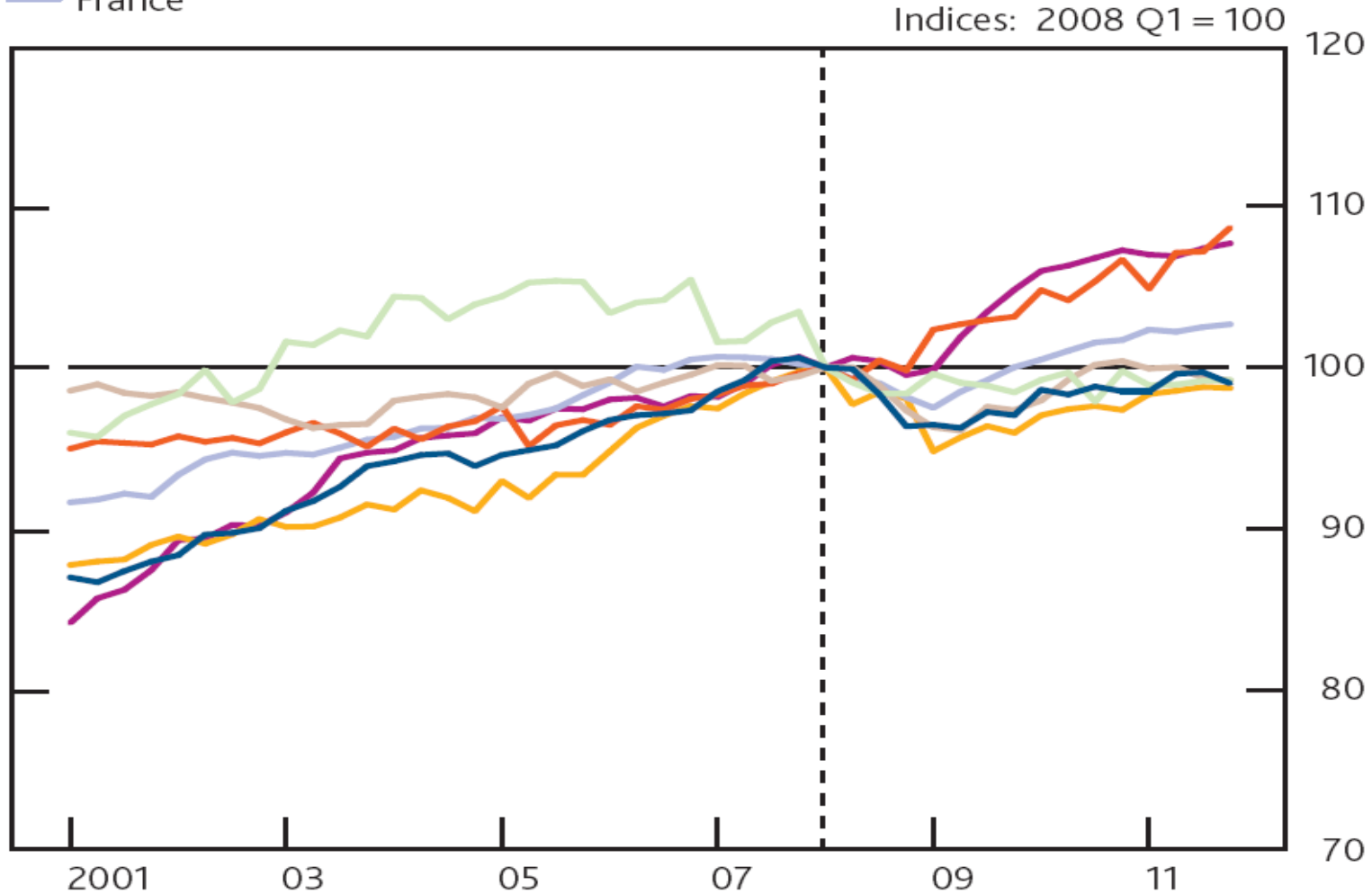
# Labour productivity



Source: Eurostat, Bureau of Labour Statistics and ONS (data available from chart 6 in [http://www.ons.gov.uk/ons/dcp171766\\_283259.pdf](http://www.ons.gov.uk/ons/dcp171766_283259.pdf)).

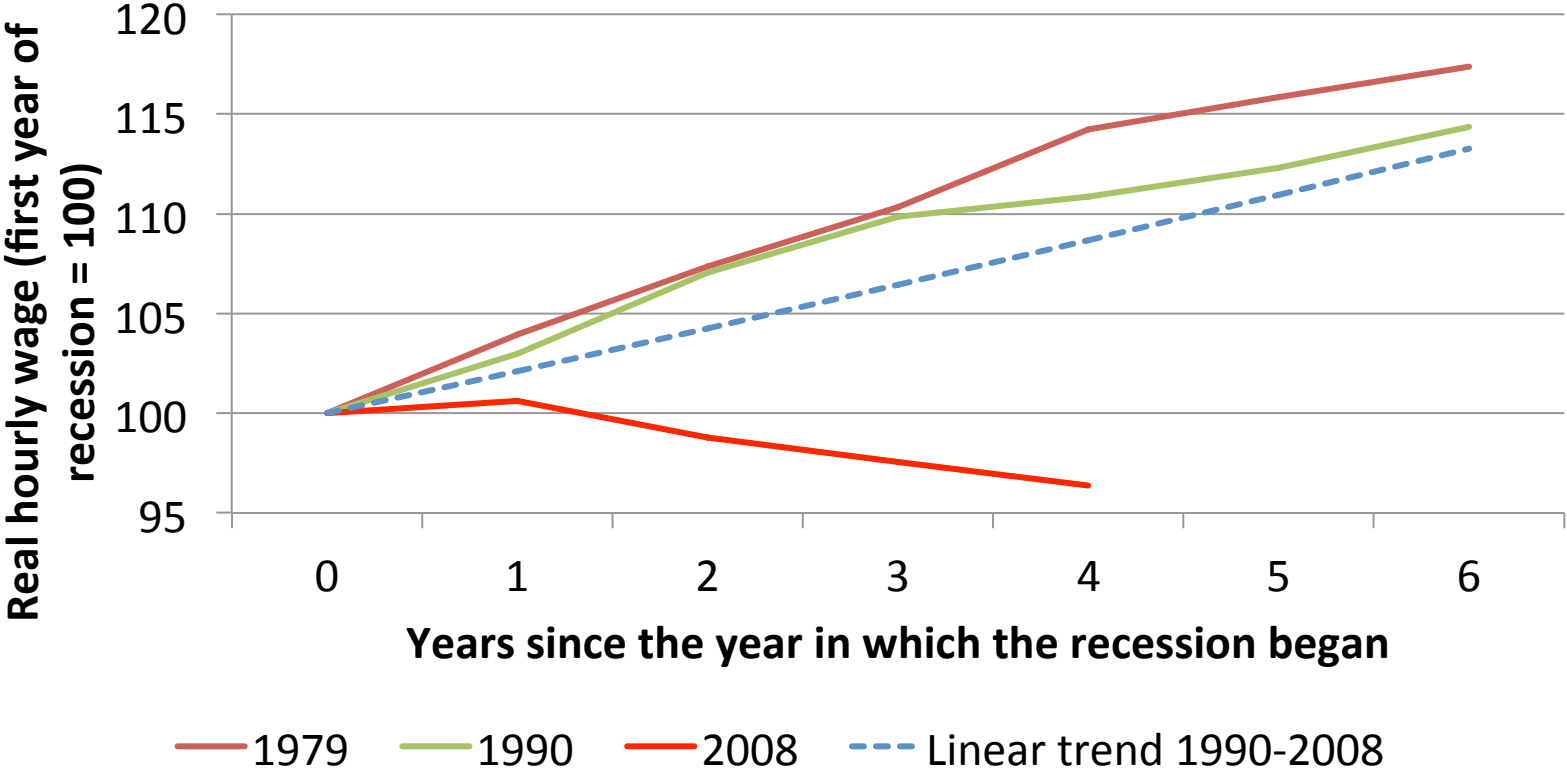
# Labour productivity across countries

- United Kingdom
- United States
- Germany
- France
- Spain
- Italy
- Norway



# Average real hourly wages have also been stagnant in the UK too

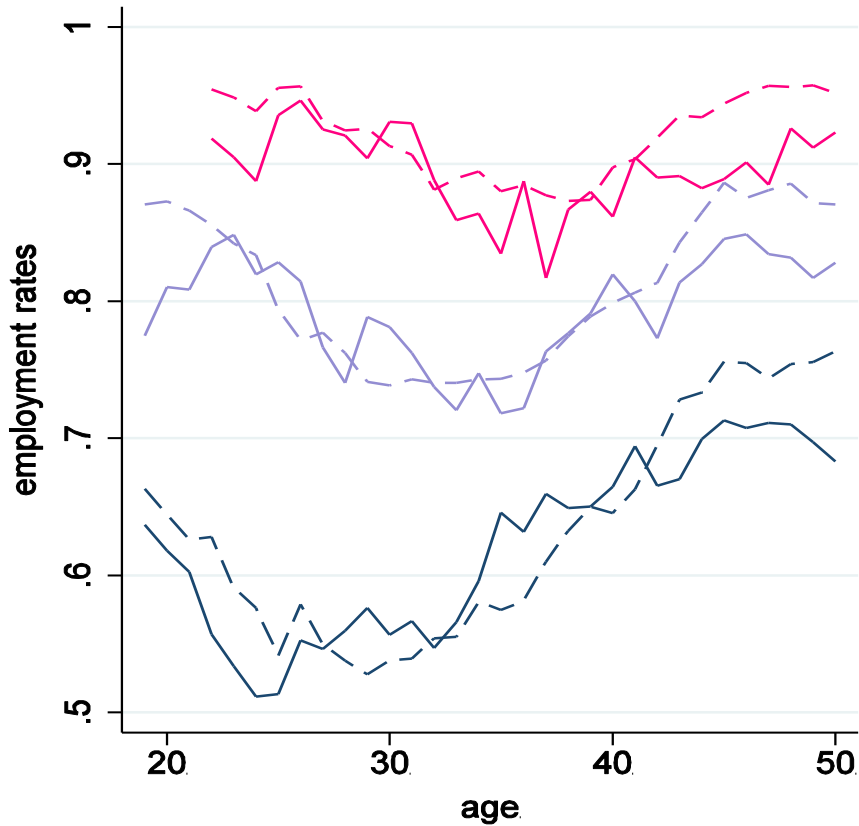
## Average real male hourly wage (using GDP deflator)



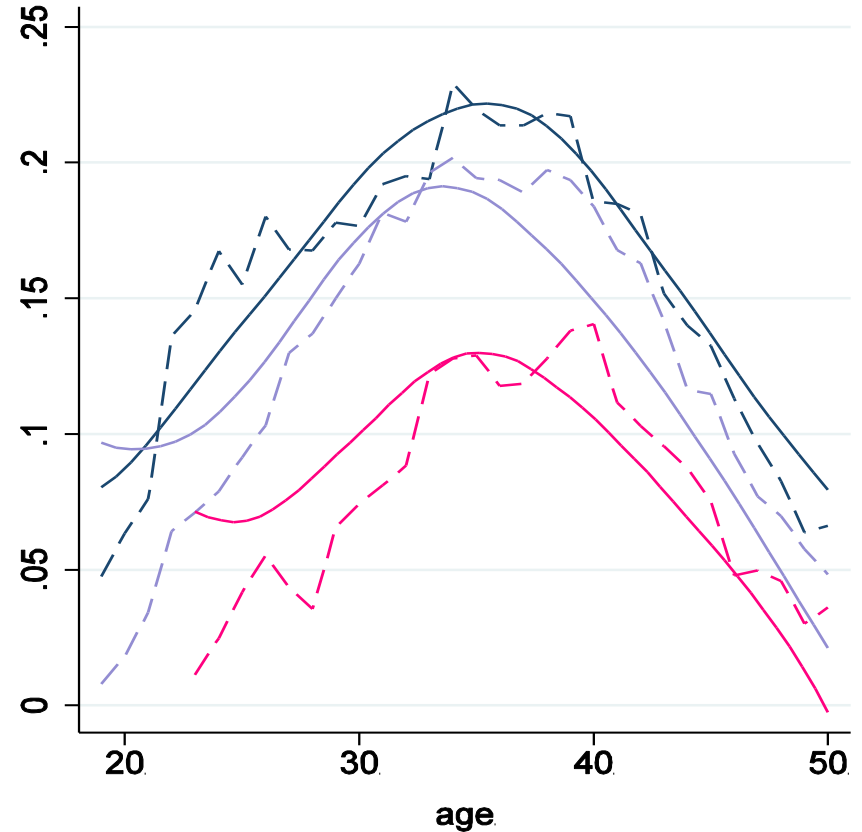


# Women's employment - UK

## All employment

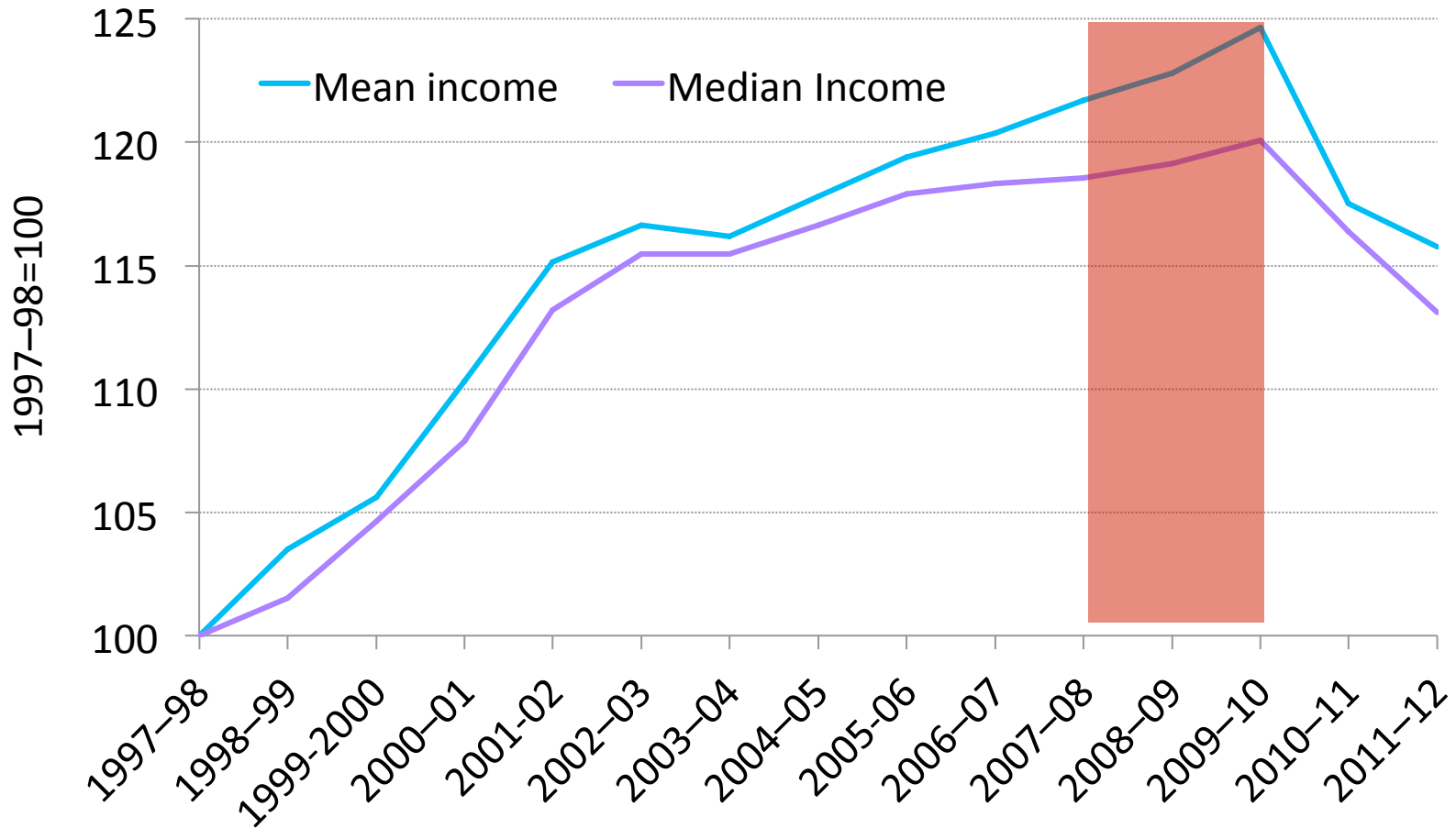


## Part-time employment



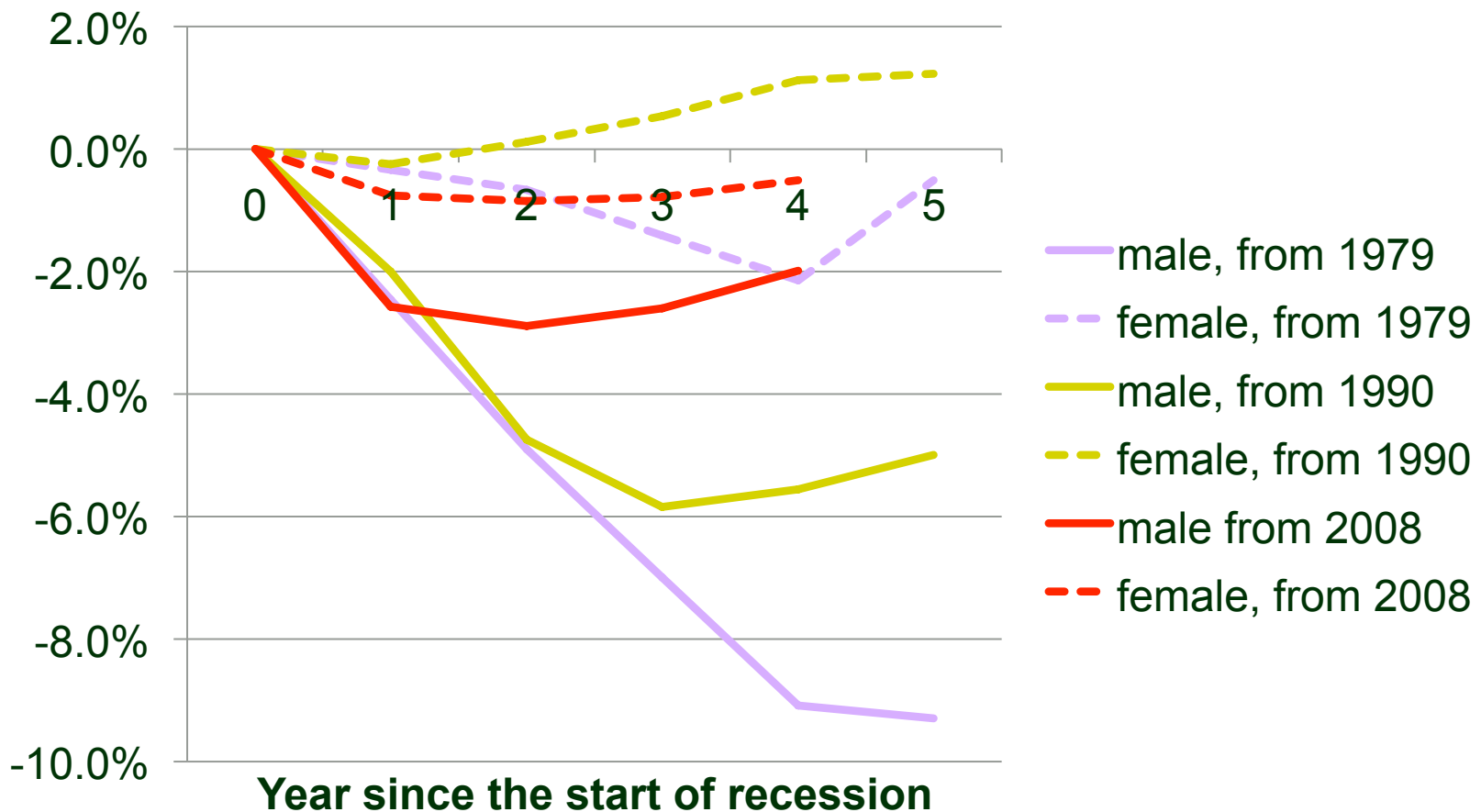
— data, secondary      - - - simulations, secondary  
— data, further        - - - simulations, further  
— data, higher         - - - simulations, higher

# Family Real Incomes in the UK



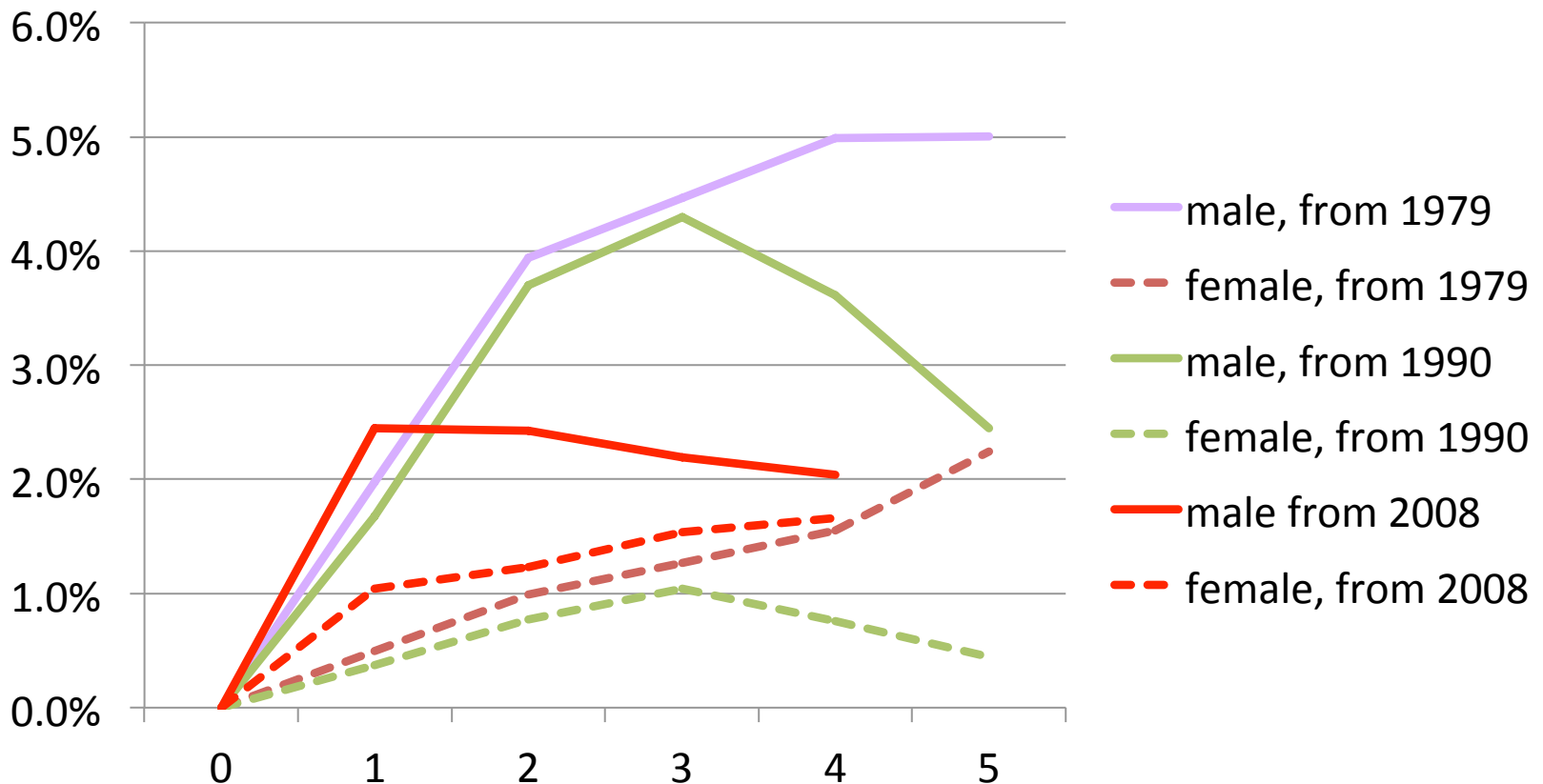
Source: Family Resources Survey, various years

# Employment and labour market participation - employment rate of 23-64-year-olds by recession



Source: LFS every year. No data point for year 1980, 1982. Quarter 2 is used for years since 1992.

# Change to the proportion of 23-64-year-olds who are unemployed by recession



Source: LFS every year. No data point for year 1980, 1982. Quarter 2 is used for years since 1992.