3 The Tax and Benefit Systems, and Their Effects on People With Low Earnings Potential

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1 DEFINITIONS

For the purposes of this chapter the term *unemployment trap* refers to the situation whereby paid work is not worthwhile by comparison with life on the dole, with the latter defined to encompass all out-of-work benefits, including invalidity benefit and income support for lone parents as well as unemployment benefits. The term *poverty trap* refers to the situation whereby extra earnings are barely worthwhile, due to loss of means-tested benefits, extra tax liability and (sometimes) extra work expenses. *Low earnings* means low in relation to benefit entitlement when not in paid work, after deduction of income tax, National Insurance contribution (NIC), local authority rates/community charge, and work expenses.

2 THE NEED TO TAKE A WIDE VIEW OF THE PROBLEM

Most current discussion of the ‘traps’ concentrates on readily available, easily quantifiable information of the sort that lends itself to state-of-the-art, computer modelling techniques. The results are confusing because they over-simplify. Some components of the unemployment and poverty traps can be evaluated using computer models, others have to be left out, either because they are non-quantifiable, or because there is insufficient information about them. These omissions are important. They include liability to maintain laws and family breakdown (non-quantifiable), travel-to-work, childcare costs and behavioural change (quantifiable but insufficient information available).

Before we can begin to understand how those at the margins of
economic activity could be brought into more effective competition in the labour market, it is necessary to include descriptive as well as computer analysis. Descriptive analysis fills the gaps that computer models cannot reach, especially in regard to reform proposals. A proposal that looks cost-effective in year one, using computer analysis, may look quite different by year 10, after its behavioural effects have worked their way through. Using descriptive analysis the scale of those effects remains unknown, but not the direction.

Taking a wide view of tax and benefit reform is not easy. Both systems are heavily departmentalized, and the information is often hard to come by. On the tax side, it is no use looking just at income tax. NICs and local authority rates/Community Charge are at least as important, since they remove a proportionately larger chunk from the earnings of people at the bottom of the income distribution than they do from the better off. On the benefit side it is misleading to look just at Department of Social Security (DSS) benefits. Department of Employment, Department of Education (DES) and local authority benefits, grants and allowances also play a part.

Those affected by disincentive are not just the unemployed. Anyone with low earnings potential is at risk. By disaggregating the problem it can be shown that low earnings (defined in relation to out-of-work benefit entitlement) correlates with family responsibilities, disability and lack of skills. Most at risk are the following:

- anyone who is unskilled or only semi-skilled,
- people with disabilities, and those who care for them,
- families with young children, especially lone-parent families and single-earner, two-parent families,
- young people,
- older people, especially those with chronic disability, and those with skills that are no longer in demand.

In Britain today an unskilled family man in poor health has almost no chance of becoming financially independent. The more children he has and the higher his rent, the fewer his chances. In 1985 some 40 per cent of those with families of four or more children were out of work (sick or unemployed), and those in work were heavily concentrated towards the upper end of the earnings distribution (Hansard, WA, 21 January 1988, Cols. 836–40). Family credit (FC) is supposed to encourage such families into the labour market, but it does not give them economic independence, it merely replaces the unemploy-