Universal basic income as a tool for tax and benefit reform

Introduction

Universal basic income (UBI) is often presented as a way of supporting an increase in the fraction of population not in full time employment. Here, I wish to outline an alternative vision based upon using UBI to simplify the tax and benefit system and enhance work incentives. Rather than funding an increase in the number of people without jobs, my proposed system is designed to produce higher levels of employment. By replacing many existing benefits with a UBI, families will no longer need to worry about their benefits being withdrawn as they start earning more, giving them stronger incentives to work, and pulling thousands out of the poverty trap created by the existing benefits system. Furthermore, while the poorest will obtain the largest direct benefit from the proposed system, its wider benefits will be shared by people of all incomes due to reduced economic distortions.

The existing tax and benefit system in the UK has two key deficiencies, both of which are shared by the systems in virtually all other countries. Firstly, the system is hugely complicated, with a bewildering array of tapered benefits, tax credits, allowances, staggered rates, and exceptions. This has a particularly large effect on people with low incomes, who must attempt to calculate whether it is worth working for more hours, given that it may change their eligibility for a variety of credits and benefits. Indeed, it has additional relevance to people on low incomes are often performing casual or shift work, and so have a lot more choice about their hours and incomes than better paid workers on annual contracts.

Secondly, under the existing system, many of those who manage to calculate their returns to working more will legitimately decide that there is no point to it. Research by the IFS implies that there are around 700,000 people in the UK who would only gain an additional 30 pence of disposable income after receiving an additional pound of gross income, and so it is understandable that they prefer to spend the time with their families. It is worth stressing that it is not bankers and CEOs who are facing such a high effective marginal tax rate, instead these are low income families whose benefits are being taken away as they work more. Why would an unemployed single mother go out and find a job if the money she would earn in it is less than the benefits she would lose and the cost of the childcare she would then have to pay for? Even if she broke even, raising her own children would no doubt seem preferable to entrusting them to a stranger.

By making benefits unconditional on income or employment status, people would have much stronger incentives to work, and would face a much simpler decision about whether they are better off spending their time at home or earning money. This is the key promise of a universal basic income.

Tax system reform

The benefits of a universal basic income go beyond this, however. Since an unconditional transfer to everyone in the country is highly redistributive, there is much less need for additional redistribution from the tax system. Thus, the current four bands of tax could be replaced by just one or two, while still ensuring that low income households are no worse off. Along with making the system easier to understand, this brings additional benefits. With fewer kinks in the income tax schedule, and a much lower top kink, people would no longer be able to avoid paying the tax rate they ought to be paying by paying their income into a company, and then limiting the salary they pay themselves from this company. This practice was in the news in 2015 after it was discovered that the BBC was encouraging its top staff to pursue it. Similarly, with average tax rates closer to marginal tax rates, the tax system would no longer reward people who are paid well enough that they can afford to work part time. For example, at present, someone earning £54,000 per year could reduce their average income tax rate from 28.2% to 24.7% by switching to working four day weeks, creating very bad incentives.

An additional benefit of a UBI is that the redistribution it provides would enable a move away from income taxation towards consumption taxation (e.g. VAT). Consumption taxation is preferable to income taxation as it results in lesser discouragement to work, it encourages investment and entrepreneurial activity, and because it also falls on people in the UK who obtained their money via inheritance, from overseas, or from black market activities. At present, the government could not replace income taxation by consumption taxation, as progressive taxation of consumption is almost impossible. However, with the need for redistribution taken care of by the UBI, the government would then be free to use VAT to the extent it desired. Indeed, a direct transfer from rich to poor could be accomplished by raising money via VAT and then redistributing it equally across the population as part of a UBI.

To see why consumption taxation may result in lessened discouragements to work, suppose that the government sensibly reduces the consumption tax rate during recessions. Then, even if today conditions are good, a worker knows that by saving some of their income and spending it during a recession they will face a lower effective tax rate. By contrast, reducing income tax rates during a recession is unlikely to have a large effect, as it is much harder to rapidly adjust your contracted hours of work than it is to adjust your consumption.

Additionally, with consumption taxation, workers will not be taxed on the part of their income that they are not spending on consumption. So, for example, if a worker wishes to give away part of their income to a charity, non-profit, or individual, they will not be taxed on that donated money. While at present GiftAid and tax deductions permit something similar, it comes at the expense of substantial administrative work for both charities, the state, and for individuals. Alternatively, if a worker wishes to save their income to invest in starting their own business, then they will not be taxed on the income going into those savings. This encourages entrepreneurial activity, creating jobs and benefiting the wider economy.

Imagine, for example, two junior tech industry employees. One of them is splurging all his money on designer clothes and cocktails. The other has an idea for a revolutionary new app, and is living frugally in her parents' basement so that she can save the required capital to get her own business off the ground. Even if the two employees have exactly the same income, it does not seem at all fair that they should have to pay the same amount of tax. The real unfairness in society is the degree of inequality in living standards, not the inequality of income per se. By taxing consumption, the government is directly curbing this inequality in living standards, while also encouraging responsible saving to assist people in providing for their retirement.

Finally, consumption taxation falls on people regardless of how they obtained their money. At present, people who earn money overseas can often avoid paying much UK tax on that money. However, with consumption taxation, they will be taxed on all their UK expenditure. The more time they spend in the UK, the more they will inevitably spend, and thus the more they will contribute to the government's finances. Consumption taxation also catches people who inherited their wealth, or who earn money via black market or illegal activities. Although in an ideal world, no one would be able to earn money from illegal activities, the reality is that enforcement of the law will always be imperfect, meaning that some people will be able to become quite wealthy while having very low incomes as far as the Inland

Revenue is concerned. Higher VAT rates would mean that at least these people are not paying less in tax than everyone else.

A switch to a UBI enables these assorted benefits of consumption taxation since it separates the provision of redistribution from the optimal raising of revenue. However, there are some practical limits on how high a consumption tax may go. With VAT rates very high, people may start doing more of their shopping abroad, or avoiding tax in other ways. While this may be partially prevented by monitoring and import duties, enforcement costs and trade deals place some practical limits on this. However, after some careful experimentation, the government should be able to raise VAT as high as around 40%, with the lowest band of income taxes cut to nothing.

Minimum wages

As an alternative way of improving the lives of those on low incomes, politicians in the UK and US have recently been proposing increases in minimum wages. Their argument is superficially compelling: "if we force firms to pay a higher minimum wage, then workers will be better off". The problem with this argument is hidden in the word "workers". While people who keep their job will of course be better off with higher pay, the higher cost of labour will incentivise firms to automate further jobs, and simply to do without many others. As an anecdotal example, compare a UK and a US supermarket. In the US, you are greeted as you enter the store, and when paying, there are at least two workers per till, with one scanning and one bagging. In the UK, not only is there no "greeter", but you are increasingly expected to scan and bag your own items, using automated check-out machines. While the higher minimum wages in the UK are surely not the entire story behind this difference, they are no doubt a contributing factor. Any worker produces a certain amount of economic value per hour, and no firm will employ a worker if they would produce less than the minimum wage.

Additionally, minimum wages reduce the incentives for people to pursue further education. In the UK, Labour are currently proposing a £10 minimum wage which is very close to the hourly wage of many junior academics, given the extremely long hours they work in practice. Why would someone undertake at least nine years of optional education to obtain a PhD, if they could receive the same salary working in a low skilled job? While other wages may increase as minimum wages increase, to ensure that people are still motivated to obtain the required skills, this increase in wages higher up the skill distribution is again accompanied by a corresponding cut in the supply of such positions, producing further unemployment.

There is no reason to suppose that political leaders are not well aware of these problems with minimum wages, problems that economists have been stressing since the first minimum wage was proposed. Still, they have been supported for two reasons. For parties of the left, with strong ties to unions, minimum wages enable unions to improve the conditions of their (employed) members, at the expense of the many who will never obtain a job thanks to high minimum wages. For parties of the right, wishing to reduce migration, minimum wages provide a way to give natives an unfair advantage. While migrants may be happy to work for half the salary of native workers, and firms would much rather hire a migrant at half the cost of a native, in the presence of a minimum wage the firm is forced to pay migrants the same salary as natives, in which case they are likely to marginally prefer a worker born in the country, due to ease of communication.

A higher minimum wage is thus an extremely poor substitute for a UBI. Instead, just as UBI frees the government to move away from distorting income taxation, without giving up on redistribution, so too the UBI frees the government to move away from distorting minimum wages, without giving up on those with low incomes. A sensible level of post-UBI introduction minimum wages would ensure that someone working full-time on the minimum wage had the same amount of disposable income before and after the UBI introduction. Given that UBI represents a substantial transfer to people on low incomes, this ought to correspond to a sizeable cut in minimum wages, which would be associated with a correspondingly large increase in employment.

Some “back of the envelope” figures on UBI

As a rough guide to the winners and losers of a UBI, we will present the numerical details of a potential implementation of the ideas presented here. All figures will be conditional on people’s hours of work not changing. However, since the UBI designed here should result in an increase in both labour supply and labour demand, if anything, people will be better off than our figures suggest.

In the 2014-15 tax year, the top 10% of households from the income distribution earned £107,597 in income from work and savings, on which they paid £24,543 in income tax and national insurance (ONS data). This works out at an average tax rate of 22.8%, the highest for any decile. However, the top percentiles face an even higher average tax rate, reaching around 32% for the top 1%. In line with our desire to use the UBI to simplify the tax system, we assume that following the introduction of a UBI, all income will be taxed using the same schedule, whether the income is from savings, investment or work.

We will consider two different possibilities. In the first scheme, the income tax would be completely flat, with a rate of 32% seeming reasonable given the prior discussion. With everyone receiving the same transfer from the government, and everyone paying the same income tax rate, there would be a fairness to the resulting system that would no doubt have easy popular appeal. Such a flat income tax would raise an additional £4,510 per household per year on average, that could go towards the cost of the UBI. In the longer term, this 32% income tax rate could be lowered, with VAT raised correspondingly in order to raise similar amounts, with lower distortion of hours and investment decision.

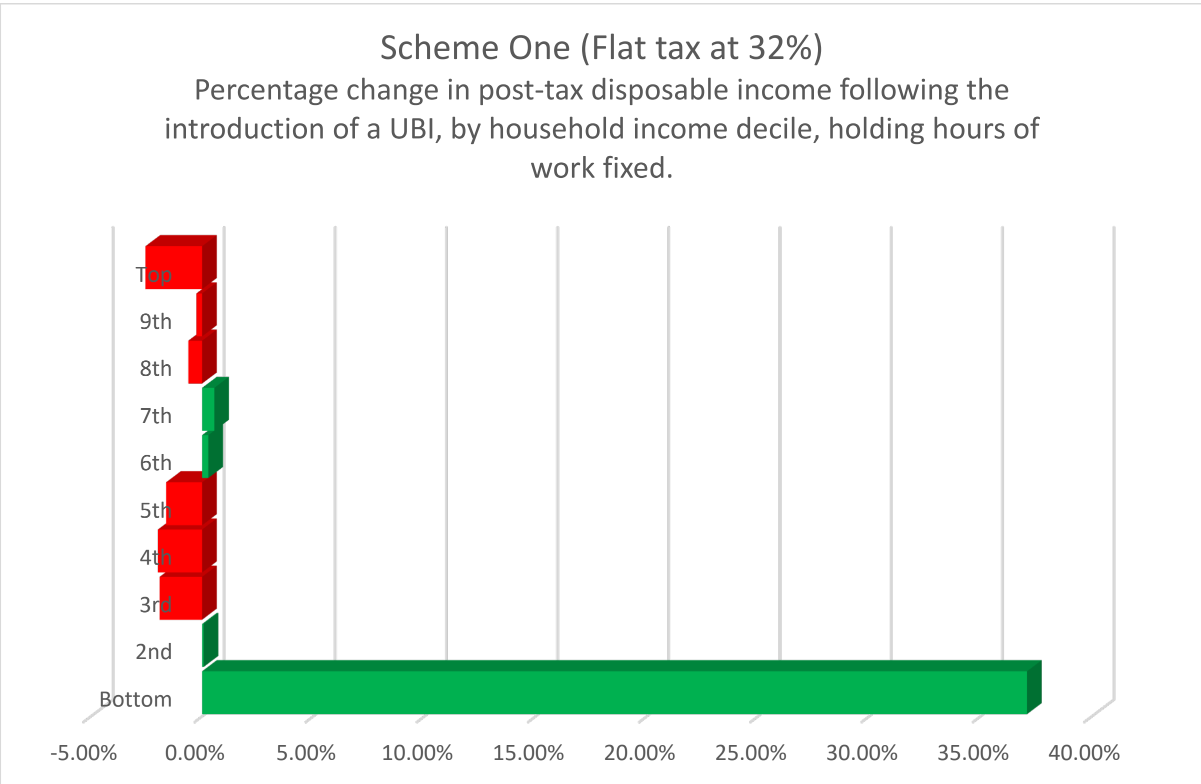
As an alternative scheme, we consider an income tax which is 17% on all income up to £12,250, and then 34% on all income beyond this cut-off. This scheme raises slightly less per household, £3,343 per year on average. Again, this extra revenue could go towards the cost of the UBI. In the long run, we would increase VAT by 17% to 20% so that the base rate of income tax could be cut to zero, further simplifying the system.

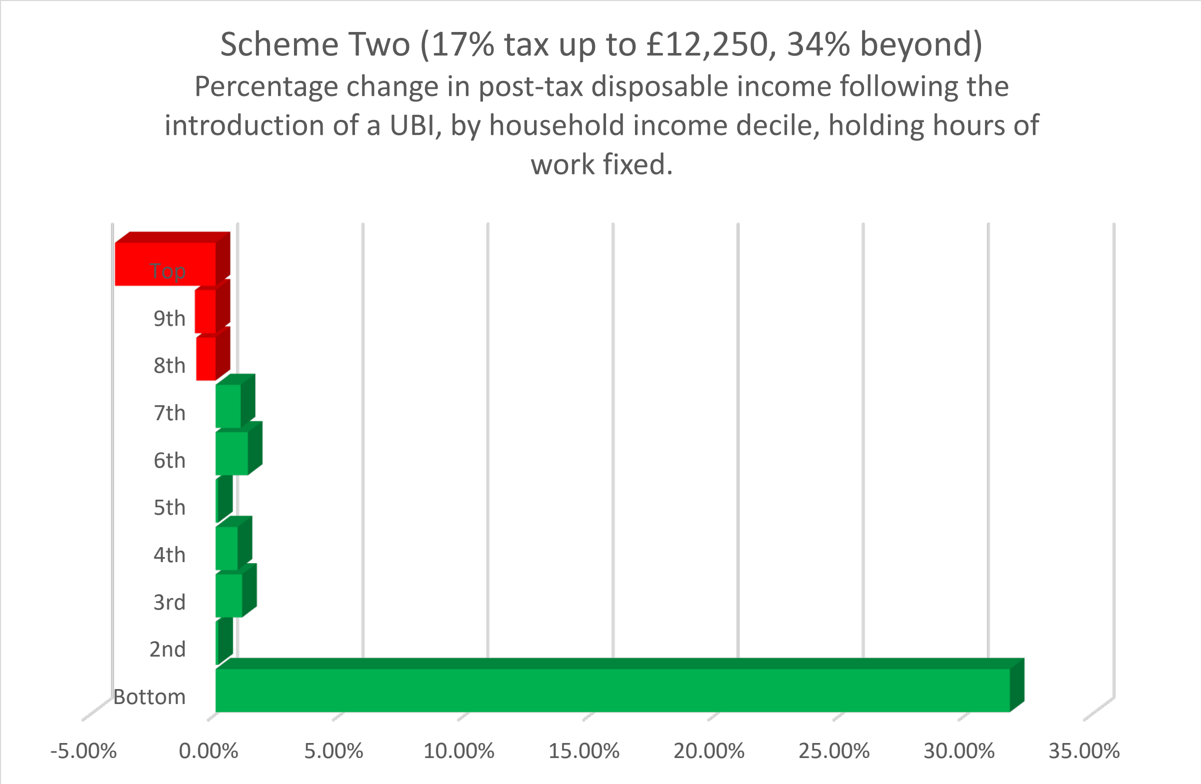
Under either scheme, a UBI would remove the need for jobseeker's allowance (contribution and income based), employment and support allowance, income support, tax credits, housing benefit, pension credit, student support, universal credit, government training scheme allowances and the state pension, which at present cost the state £5,171 per household per year. With the £4,510 in new tax income from the first scheme, this sums up to £9,681 per household per year that could be spent on the UBI. Dividing this by the average number of adults per household gives a total UBI level of £5,177 per person per year, or £99 per week. For the second scheme, we would have £8,514 per household per year to spend on the UBI, giving a total UBI level of £4,553 per person per year, or £87 per week. While this is not as high as the levels some have discussed, it is high enough to provide the necessary insurance against temporary spells of unemployment, which should, in any case, be less common following the introduction of a UBI, as discussed before.

As an alternative way of justifying this level of UBI, note that in the 2014-15 tax year, the bottom 10% of households from the income distribution received £4,467 in income from work and savings (on average), £5,469 in government benefits that would be replaced by a UBI, and a further £764 per year in benefits that would not disappear under a UBI. From this income, they paid £658 in income taxes and national insurance and £764 in council tax (net of council tax rebates and benefits), giving a disposal income of £8,514 for those not entitled to any of the benefits that would not disappear under a UBI.

Arguably, a reasonable level for the UBI would be at least high enough that a household in which no one worked, and which was eligible for no other benefits, would receive income comparable to the average income of a household in the bottom 10% entitled to no other benefits beyond those being replaced by a UBI. Thus, UBI should be high enough to give a total transfer from the government to all households of £8,514 per household per year. This is satisfied by both of our proposed schemes.

With a move to one of these two schemes, the wealth distribution would change as illustrated in the graphs below, still assuming no changes in hours worked. The bottom 10% of the population is made 37% better off by the first scheme and 32% better off by the second, meaning that either scheme is highly redistributive. Additionally, people in the 2nd, 6th and 7th deciles are made a bit better off by the first scheme, while the second scheme makes the entire bottom 70% of the population better off. In either case, most of the costs of this transfer to the poor fall on the top 10%, however, since these people will face a lower marginal tax rate under either scheme, even the top 10% will be induced to work more, and so they may well actually break even overall. The fact that the 3rd, 4th and 5th deciles are slightly worse off under the first scheme may be somewhat concerning, but this fall is both very moderate (less than 2%, even for the 4th decile), and likely to be more than compensated for by reduced unemployment spells. In any case, this deficiency is fixed by the second scheme, at the cost of a slightly more complicated tax schedule.





Conclusion

Hopefully, this exercise has convinced the reader that a UBI could be both quite affordable, and quite palatable to people from across the political spectrum, and across the income distribution. While a UBI may be a “left wing” cause, and our proposed system delivers substantial redistribution, the arguments we have used here have a much more centre-right flavour, focussing on the economic distortions caused by taxation and minimum wages. That a UBI enables us to reduce the economic distortions caused by the tax and benefit system is a strong argument in its favour, and one that deserves to be more widely understood.