Comment on “Making Work Pay: The Design of Tax Credit Reforms for Low Wage Workers” by Richard Blundell

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1. Why are tax credits useful in theory?
2. What do tax credits do in practice?
3. How could we improve tax credit schemes?
Why are tax credits useful in theory?

- Why should work pay... and to what extent?
- Answers reflect, to a large extent, collective preferences:
  - a tax scheme implements a second best allocation except if it is on the wrong side of the Laffer Curve: i.e. if reducing _tax rates_ allows the government to raise more taxes (Laroque, 2005)
  - any decrease in tax rates which is costly for public finances is a matter of preference
Why are tax credits useful in theory?

- Interest of the model with labor supply at the extensive margin (Saez, 2002):
  - labor supply elasticities can be quite high for low income workers
  - this gives rationales for marginal tax rates significantly below 100% at the bottom of the distribution of income

- The labor supply model
  - implies that it is inefficient (in empirically relevant situations) to have marginal taxes below 100%
  - does not imply that it is always efficient to subsidize low skilled work (i.e. to give more to those who work than to those who do not work)
Why are tax credits useful in theory?

- There are other rationales for subsidies to low skilled work (society values work per se to avoid the spread of culture of poverty, Bertrand, Luttmer and Mulainathan, 2000...)
- What is the motivation for tax credits?
  - labor supply model?
  - externalities (should know more about this?)
Why do tax credits do in practice?

Fig. 5. WFTC and the Interaction with Other Taxes and Benefits.
How can tax credit schemes be improved?

- In practice, it seems that the issue is not so much to fine tune a tax credit scheme in isolation, but rather to design coherent schemes with limited marginal tax rates
  - Brewer, Saez and Shephard (2009) recommend to fold six existing programs (the child tax credit, the working tax credit, income support, child benefit, housing benefit, and council tax benefit–into)
  - Same problem in France with the RSA (PPE, “droits connexes”)
- Is it important? (In France: Anne and L’Horty, 2002)
- How can this be achieved?
How can tax credit schemes be improved?

Hours restrictions and hours rules

- UK’s tax credit:
  - individuals must work at least 16 hours a week to be eligible for in-work tax credit
  - further smaller credit when working 30 hours or more

- Rationale for hours restrictions and hours rule
  - Societal preference for work per se (Besley-Coate, Moffitt)
  - Not the standard Mirrlees model, except if hours are observed: allows the government to observe productivity of people who work

- Do we have any evidence that hours requirements are verifiable?
How can tax credit schemes be improved?

- What about the minimum wage?
- According to the OECD (2009), the minimum wage is a useful complement to tax credit, because
  1. (gross) wages decrease when tax credits are introduced
  2. minimum wage allows the government to redistribute income towards low wage workers at low cost for public finance
- What about the UK?