TAX CREDITS: THE UK PERSPECTIVE

Summary

Paper prepared for

2004 IRS Research Conference

Washington, D.C.

June 2004

Introduction and an historical perspective

There has been a system of support for working families with dependant children in the UK for over 30 years. In 1971, Family Income Supplement (FIS) was introduced as a supposedly temporary measure to address the problems of family, and especially single parent, in-work poverty. FIS was a means-tested (assessed against household income and circumstances) benefit. It was payable to families with a dependant child and an adult working at least 30 hours a week (lone parents could claim if they worked at least 24 hours a week). FIS worked to increase the income amongst working families and thus make work pay. The amount a family received was set by reference to calculation of a fixed amount which was primarily determined by household composition and number of children. Where a family's actual gross income from work was less than the fixed amount, half of the difference was payable through FIS. FIS awards ran for six awards (until 1973 when they were extended to 12 months) and were paid by order book to the mother. In its first year, 71,000 families received FIS.

Over time the numbers receiving FIS increased, partly as a result of successive increases in its generosity, partly through higher take-up and partly through a growth in the eligible population, in particular a growth in the number of lone parents.

Although intended as only a temporary measure whilst policies to address the problems of family poverty were worked up, FIS lasted until 1988 when it was replaced by Family Credit. Family Credit built on FIS, but with some structural changes. Family Credit was more generous than FIS. The hours rule – the number of hours a week that needed to be worked by an adult in a family with dependant children to qualify for Family Credit – was reduced to 24 hours or more per week. And the structure of the in-work support was changed. Whereas FIS comprised a family credit based on a one child family with small increases for additional children, Family Credit comprised a family element (with couple and lone parents receiving the same adult element) and per child elements that were also age related. The way in which Family Credit entitlement was calculated differed compared with FIS: each family was potentially eligible for a maximum amount, dependant on the number and age of the children in the household. This maximum was payable if the family's net weekly income (after income tax and National Insurance contributions) was lower than a set threshold (which did not vary by family size). In this way, FC targeted help more effectively on the poorest households. The amount of FC payable was reduced by 70p for every £1 of income above this threshold. Once awarded, FC was payable for six months at the awarded level. Family Credit continued to be paid to the mother, even when eligibility was in respect of a father's earnings, but with an option of direct payment into bank accounts rather than by order book which required encashment at post offices and were considered stigmatising.

The numbers benefiting continued to rise. But so did the eligible population driven both by increased generosity which brought greater numbers of families with children into entitlement but also by increases in the numbers of low income working families, again driven in part by the continued increase in the lone parent population.

Family Credit remained until 1999 when it was replaced by Working Families' Tax Credit (WFTC), although a number of changes were made to it. For example, in 1992, FC became payable to those working 16 or more hours a week. This was targeted specifically at encouraging lone parents to move into work and in effect to provide a continuum in support between the out of work benefits system (which restricted work to less than 16 hours a week) and the system of in-work support. Then, in 1994, a childcare disregard was introduced. The disregard was only available to help with the costs of childcare for children up to the age of 11 years and for eligible childcare – registered childminders, nurseries and out of school clubs. This was intended to encourage higher participation in work, especially amongst mothers of young children and recognised the fact that childcare costs both acted as a financial barrier to work and also affected family income. In 1994 the disregard was set at £40 a week. It worked by allowing families using childcare to deduct some of the value of their childcare costs from the income against which entitlement to FC was assessed. Because it worked as a disregard it was only of benefit to those not receiving maximum Family Credit, ie it did not benefit the poorest families. The disregard was increased to £60 pw in 1996 and to £100 a week from 1998 for two or more children.

In 1995 an extra credit, set at £10 pw, was introduced payable to those working at least 30 hours a week. This credit was introduced in response to research which provided evidence that the system created strong incentives to work 16 hours a week, but little incentive for people to work longer hours or increase their hours worked.

Working Families' Tax Credit

In 1999 the Working Families' Tax Credit was introduced. This replaced Family Credit and had a number of noticeable differences. First, WFTC was a tax credit and distinct from a benefit such as Family Credit. Responsibility for administration passed from the DSS (as was) to Inland Revenue. This was to draw a very clear distinction between in and out of work support. Out of work support, or benefits, continued to be administered by the benefits department, whilst responsibility for in-work support transferred to the tax authority. At the same time, it was hoped that by making the distinction between out of work benefits and in-work support clearer, any stigma associated with claiming and receiving the latter would be eroded and as a consequence take-up would increase. At the same time, to make it clearer to recipients that the payment was a reward for work, PVE set up. This allowed for the tax credit to be paid in the wage packet. The other main change that happened was that provision was made for partial reimbursement of childcare costs for working families with children. This replaced the childcare disregard of Family Credit. Under WFTC, a specific childcare element was included, which meant that all families incurring childcare costs would benefit – including the poorest families – and that the income run-off point for eligibility would be increased thus extending in-work support further up the income distribution. At the same time WFTC was made more generous that

FC with a lower rate of withdrawal 55 pence per extra pound of income versus 70p under FC, and higher value credits – particularly those for young children.

Between 1999 and April 2003, there were significant increases in the value of the credits in WFTC and also increases in the childcare limits. There were also changes to the definition of eligible childcare. The numbers receiving WFTC grew steadily from 1999, reaching 1.4m by February 2003.

What have we learnt? The evaluation of WFTC

Inland Revenue launched a comprehensive programme of economic and statistical analysis and research, as well as social research to seek to evaluate WFTC. This work is near completion, with many pieces of research having been published. The evaluation programme sought to answer questions such as how effective WFTC had been on making work pay and reducing in-work and child poverty, as well as how it was perceived by claimants and employers.

In terms of making work pay, the focus has been on whether the unemployment and poverty traps have been reduced. Internal analysis as well as external research showed that WFTC (taken in conjunction with other reforms of the tax and benefit system and the introduction of a National Minimum Wage) did help make work pay. Notably, from April 1999 a family with one child working 35 hours a week was guaranteed an income of £182 per week (and by October 2004 this had increased to £252). A family with one child working 16 hours a week was guaranteed a weekly income of £136 (£195 by Oct 2004). WFTC (and predecessor systems of in-work support) has been instrumental in helping people move off out of work benefits and into work. It has also been one of the main policy instruments in helping people remain in work and also in tackling child poverty.

Independent researchers[1] using difference in difference analysis and labour supply modelling have found that tax credits, as part of the Government's wider welfare to work strategy since 1997, have increased the lone parent employment rate by 4.5 percentage points and have added an estimated 94,000 extra people into the labour force. Analysis of the Families and Children Study has confirmed the findings of other research, particularly that tax credits have enabled and encouraged parents to remain in work. Of course it is difficult to quantify this effect, but the results are nonetheless encouraging and are backed up by research with employers. One fifth of employers surveyed[2] who had paid tax credits through the pay packet said that WFTC had definitely or possibly had a positive impact on recruitment and one quarter said that it had had an impact on retention.

Tax credits have reduced the numbers of families facing very high marginal deduction rates. Before 1998, 130,000 families faced marginal deduction rates in excess of 90%, by 2003/04 this had fallen to 45,000, but conversely as tax credits have been extended to more and more families, the numbers facing moderate to high marginal deduction rates have increased and in 2003/04 around 1.45m families faced marginal deduction rates of over 60%. Gains to work have been improved – in 1997/98 a lone

[1] Inland Revenue Working Paper 2: Did WFTC Work? An Impact of in-work support on labour supply and programme participation.IFS (quote papers) and IESR (quote paper)
[2] Inland Revenue Research Report 4. Working Families' Tax Credit and Disabled Person's Tax Credit: a survey of employers. BMRB International and Policy Studies Institute.

parent with one child would have been £31 a week better off in part-time work compared with being out of work and receiving benefits. By 2003/04, the gains to working part-time were improved to £42 per week. For full-time work, the gains increased from £45 per week to £59 per week, and for a couple where one moves into work the financial gain from working increased from £28 per week to £33 per week. [These examples are in 2003/04 prices and the lone parent examples assume childcare costs of £60pw and £30pw for full and part-time work respectively].

Further research, again from the Institute for Fiscal Studies[3], found little evidence that WFTC had had an adverse effect on wage progression; in fact their work suggested that WFTC may have encouraged wage growth.

In terms of child poverty, tax credits are part of a package of measures designed to reduce child poverty and meet the Government's target of reducing child poverty by one quarter by 2004/5 compared with 1998/9. By 2002/03 (the latest year for which statistics are available), the number of children in poverty fell by 0.8m after housing costs and 0.5m before housing costs.

The programme of work to evaluate the tax credits also considered the impact on claimants and employers. In terms of claimants, econometric work demonstrated that the costs of taking up WFTC, which encompass stigma, fell. Research with tax credit recipients, showed that tax credit receipt was less stigmatising[4]. than benefit receipt and that many found WFTC easy to apply for. Research with employers was designed to investigate the impact of payment of tax credits in the pay packet via the employer. This research showed that employers found payment via the employer (PVE) easy to operate and the majority said that it had little or no impact on the payroll. And, as mentioned above, some mentioned that PVE had had positive effects on recruitment and retention of employees. Satisfaction with the service provided by Inland Revenue to support employers and PVE was high[5].

From April 2003 WFTC was replaced by the Child and Working Tax Credits. The introduction of these two new tax credits was part of the process of reforming the tax and benefit system which aimed to support families with children, tackle child poverty and help make work pay more than welfare which began in 1997. Its too early to say anything about the effectiveness of the new tax credits, but already 6 million families are benefiting from one or both of the new tax credits.

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May 2004

[3] Inland Revenue Working Paper 3: Welfare to Work, wages and wages growth. IFS
[4] Families and Children Study 1999: Low Income Families in Britain. National Centre for Social Research and Policy Studies Institute; Families and Children Study 2000: Low and moderate income families in Britain: work, WFTC and childcare. National Centre for Social Research and Policy Studies Institute. Families and Children Study 2000: WFTC in 2000. National Centre for Social Research and Policy Studies Institute
[5] Inland Revenue Research Report 3: WFTC and DPTC: The views, attitudes and experiences of employers. Kingston Business School