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# CREDIT WHERE IT'S DUE?

## AN ASSESSMENT OF THE NEW TAX CREDITS

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*Mike Brewer*  
*Tom Clark*  
*Michal Myck*



THE INSTITUTE FOR FISCAL STUDIES  
Commentary 86

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*Institute for Fiscal Studies*

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## Preface

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## Executive summary

Two major reforms of the tax and benefit system are due in 2003: the integrated child credit and the employment tax credit. The integrated child credit will combine three elements of support for families with children into a single instrument. The employment tax credit will help people in low-paid work, whether they have children or not. Like most recent social security reforms, the credits will be assessed against couples' joint income. A recent consultation document provided some detail of how the credits would work, but said little on the most important features. Although it invited views on key issues, it provided no quantitative evidence on which one might base a sensible response.

The integrated child credit aims to simplify and streamline financial support to families with children, goals which are to be welcomed. The employment tax credit, though, extends financial support to full-time working families without children. The aims are to reduce poverty and ensure that full-time low-wage workers are better rewarded. But poverty amongst families without children is concentrated amongst those not working full time and amongst the young, groups which will not be eligible for the new credit. The immediate impact on poverty will therefore be small. The government also hopes that the credit will improve the reward to work and so encourage non-working individuals and part-time employees to work full time. In practice, though, these groups do not face particularly poor financial work incentives; it is more likely that non-financial factors are preventing them from working full time.

The new credits will operate differently from existing benefits. The government hopes that they will be easier to understand and administer, and less intrusive. But the conflicting aim of targeting the credits effectively has forced the government to compromise on simplicity for families whose circumstances change significantly during a year. Many families will find themselves in this position, although the government has not quantified them. The need for claimants to monitor annual income, average hours of work and, if appropriate, childcare costs may lead to a less certain and more complicated system for some families, with the associated risk of non-compliance.

The government has not indicated how many families will receive the new tax credits; nor has it estimated their cost and allowed for this in the public finances. We estimate that the reform for families with children will cost the exchequer around £1.8 billion a year, and that around 5.7 million families will receive the integrated child credit, of whom around 3.3 million will be made better off. Our costing assumes that no low-income families will be made worse off but that around 1.1 million better-off families would lose. If the government wanted to prevent these losses, the cost would rise by £0.6 billion. Extending the employment tax credit to workers without children could benefit around 400,000 families at an approximate cost of £350 million.

The new credits will improve the financial reward to work for some low earners, although for many of those on housing benefit, who currently face the weakest work incentives, the improvement will be modest. Second earners in some couples will see their incentive to work dulled, so the overall effect on labour supply is uncertain, but it is probably small.



## 1. Introduction

The government has announced three major reforms of the UK tax and benefit system for introduction in 2003 – the integrated child credit, the employment tax credit and the pension credit. These new credits look set to be the main new instruments the government will use in trying to achieve its goal of reducing poverty. The Inland Revenue published a consultation document on the integrated child credit and the employment tax credit in July (Inland Revenue, 2001b). The formal consultation period ends in October; this Commentary aims to be a contribution to the discussion.

The integrated child credit will bring together three different parts of the tax and benefit system that support families with children and combine them into a single instrument paid direct to the main carer. The employment tax credit will assist people with and without children in low-paid work, extending the principle of in-work support from families with children to those without. These two credits will be run by the Inland Revenue; the pension credit will be run by the Department for Work and Pensions and will extend means-tested support for pensioners by allowing those with small amounts of private income to receive extra help on top of the state pension. This credit is discussed in Clark (2001); we do not consider it further here.

In earlier work, Brewer, Myck and Reed (2001) have discussed why and how the government might introduce an integrated child credit. On the whole, they were supportive of the aims behind the integrated child credit, which are to simplify and streamline financial support for children. Although the integrated child credit will affect a larger number of families, the employment tax credit is perhaps a more significant reform, as it represents a genuine extension of support to new groups. In this Commentary, then, we focus our attention on three things:

- what the credits might cost and who might benefit, updating earlier estimates in the light of information in the consultation document;
- why the government is extending support to low-paid families without children through an employment tax credit;
- what we now know about how the two credits will work and what the most important issues are that the government is still considering.

The government needs to pass legislation within a year to introduce these reforms by April 2003. But even at this late stage and after a consultation paper, many details of the two reforms remain unannounced. In particular, it is impossible for us yet to assess conclusively whether the credits will succeed in their most important aims – reducing poverty and making work pay – because the government has not said how generous the credits will be, at what income levels they will start to be withdrawn or how quickly they will be withdrawn as income rises. On other matters, the consultation document invites views, but without providing any information on which one might base a sensible response. It is also not known how the government intends to evaluate the introduction of these credits, a far greater reform than the comprehensively-evaluated working families' tax credit (WFTC). When we have to, then, we follow what was done in earlier

work (Brewer, Myck and Reed, 2001), by making educated guesses about the nature of these reforms and comparing the effects of different policy options.

This Commentary is organised as follows. The box on the next page explains what the consultation document tells us about how the credits will work. Chapter 2 focuses on how the new system of credits will operate for people with children. We explain how the integrated child credit's payments will be structured, and then consider the rates at which it is likely to be set. Under alternative assumptions about these rates, we then estimate the likely cost to the government, the impact on family finances and the effect on work incentives. Chapter 3 undertakes similar analysis of what the employment tax credit will mean for people without children. But because this element of the reform involves directing means-tested support to a new group of clients – low-wage workers without children – we discuss the rationale for this redistribution.

Chapter 4 examines a number of questions about the practical operation of both credits. Because the new credits are motivated by a desire to make the delivery of means-tested support less intrusive for recipients – and, presumably, to increase take-up – these matters are particularly important to the success of the reform. We explain why the aim of targeting the credits effectively may well compromise the goal of a simpler and more certain regime for those families whose circumstances change during a year, with the associated increased risk of non-compliance. Chapter 5 concludes with our assessment of whether the credits will achieve their stated objectives.

### **What do we know about the new tax credits?**

The government is proposing two related reforms:

- the integrated child credit will combine three parts of the tax and benefit system that currently support families with children into a single instrument paid direct to the main carer in a family, usually the mother;
- the employment tax credit will support people with and without children in low-paid work. For families with children, this and the integrated child credit merely replace the working families' tax credit, but the inclusion of people without children is an extension of state support to new groups.

In a recent consultation document (Inland Revenue, 2001b), the government clarified some of the detailed operation of the credits. It said the following:

- The credits will be based on taxable income, jointly assessed for a couple, possibly including income from savings and other forms of investment income. The credits will not directly depend on the amount of savings held by families.
- The integrated child credit, for some, will depend on how many children they have. Extra help will be available through the employment tax credit for those with eligible childcare costs or a disability.
- Most families will apply in the summer, and the award will be based on annual income in the previous tax year.
- The default will be to pay the credits at the same rate for a year, but payments will adjust if income or circumstances change. People who apply midway through the tax year, or whose income changes significantly, will have their award assessed on their own estimate of income in the current tax year. At the end of the year, there will be an adjustment if this estimate proved to be incorrect.
- The integrated child credit will be paid direct to the main carer – usually the woman in couples – throughout, hopefully direct into bank accounts, as part of the government's drive to pay all benefits electronically. The employment tax credit will be paid by employers and will only be paid to people while they are in employment or self-employed.
- The integrated child credit will not depend on whether the main carer or his or her partner is working, nor will recipients face any new obligations to look for work.

Both credits will be introduced in 2003, but the integrated child credit will be phased in over two years.

## **2. The new credits and families with children**

In earlier work, the possible structure and likely work incentive and distributional effects of the integrated child credit have been discussed in detail (Brewer, Myck and Reed, 2001). Here, we summarise the main points made in that discussion and update it to incorporate the new announcements that the government has made about how the integrated child credit will work (Inland Revenue, 2001b).

### **2.1 The structure of the integrated child credit and its relation to existing benefits**

The government currently directs financial support to children in four main ways: universal child benefit; premiums for children in the means-tested benefits for those without work (principally, income support and jobseeker's allowance); credits for children for low-paid parents in work (principally, the working families' tax credit (WFTC)); and the children's tax credit, which lowers the income tax bills of families by up to £520 a year, phased out where there is a higher-rate taxpayer in the family. The integrated child credit will combine the children's tax credit and the child support in both in-work and out-of-work benefits; child benefit will remain separate.

The different components of child support currently received by a family vary with income as shown in Figure 2.1. Figure 2.2 shows how these could be unified into a single payment, the integrated child credit. The basic credit of the WFTC will become the new employment tax credit, implicitly reflecting the government's view that this has always represented support for the adults in a family (the employment tax credit will be available to some workers without children, but its rules are likely to be different for that group, and we discuss options in Chapter 3).

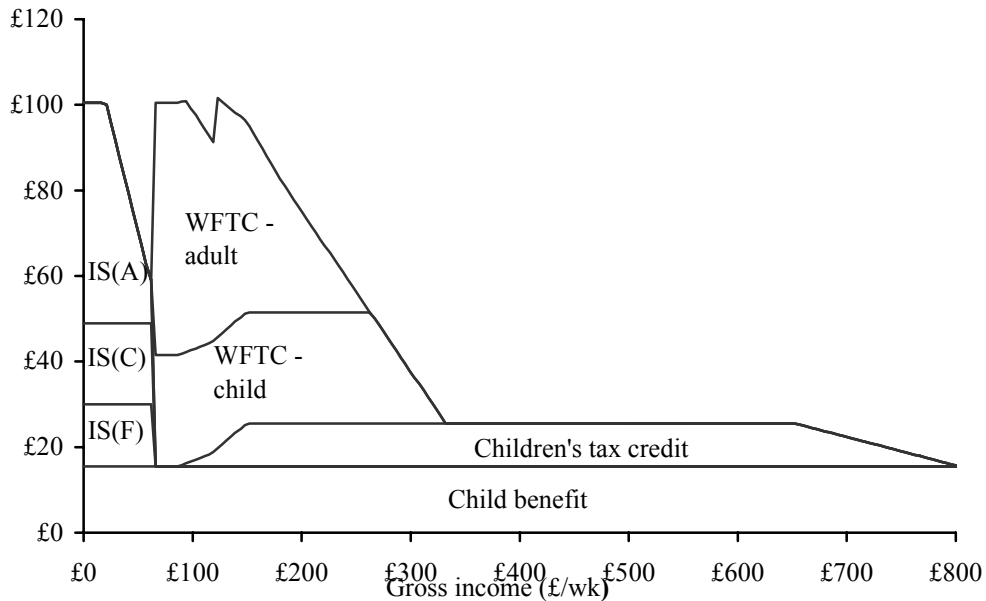
One feature of the integrated child credit is a rather odd-looking relationship with taxable family income (which Figure 2.2 illustrates). Out-of-work families claiming income support or low-earning working families will receive the full credit. At some point, entitlement begins to be withdrawn. This tapering continues until entitlement reaches £10 per week (corresponding to the value of the children's tax credit). As incomes rise, entitlement remains at £10 per week until a second taper is reached. At this point, the integrated child credit is tapered away until it is fully exhausted. This 'dual taper' mimics the separate withdrawal of WFTC and the children's tax credit in the current system.

A difference between the integrated child credit and the existing system is that entitlement will not depend upon whether or not the family is working.<sup>1</sup> In contrast to the WFTC, entitlement will not relate to hours of work – no minimum number of hours must be worked, and there is no increase in entitlement for working full time. Workless recipients will have no new obligation to seek work – the only pressure they will face in this respect comes from the conditionality attached to those claiming jobseeker's

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<sup>1</sup> In the new system, receipt of the employment tax credit for families with children will depend on working a minimum number of hours a week. We discuss the system for people without children in Chapter 3 and the detailed operation of the hours rule in Chapter 4.

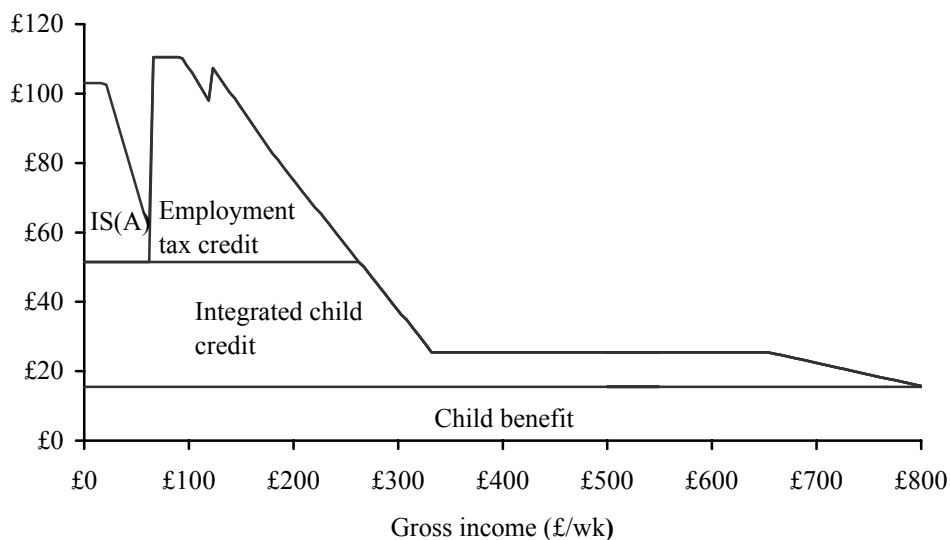
**Figure 2.1. Financial support for a family with one child from April 2001, split into 'adult' and 'child' components (£ p.w.)**



*Notes:* Assumes family qualifies for WFTC at a weekly wage of £65.60, corresponding to 16 hours of work at the minimum wage. IS(A): adult income support; IS(F): family premium in income support; IS(C): child additions in income support.

*Source:* Authors' calculations from the IFS tax and benefit model, TAXBEN.

**Figure 2.2. How an integrated child credit might be formed from the current system of financial support for a family with one child (£ p.w.)**



*Notes:* Assumes that new tax credits are implemented immediately in a way that just equalises support for families with children on low incomes. Also assumes that family qualifies for employment tax credit at a weekly wage of £65.60, corresponding to 16 hours of work at the minimum wage. This graph does not reflect all of our parameter choices discussed later in Box 2.1.

*Source:* Authors' calculations from the IFS tax and benefit model, TAXBEN.

allowance. The decision to remove all work conditions from the integrated child credit means that all families will be eligible for support for their children over and above child benefit, whereas, at present, some parents can claim neither income support nor the WFTC (one group affected will be students with children, including student nurses; another will be non-working families with significant unearned income, such as incapacity benefit or interest from savings).

The WFTC currently makes a substantial contribution to childcare costs for lone parents and for two-earner couples. As this payment is dependent on working status, the government is suggesting that this element of support should be delivered through the employment tax credit rather than the integrated child credit under the new system. We leave discussion of this change to Section 4.4.

## **2.2 The cost and distributional impact of introducing the integrated child credit**

Estimates for the cost and distributional impact of introducing the integrated child credit were presented in earlier work (Brewer, Myck and Reed, 2001). Those estimates need to be revised because of announcements in the recent consultation document (Inland Revenue, 2001b). But the government has still not announced the generosity of the credits, the thresholds at which they are tapered away or the rates at which they will be tapered, so we have had to make some guesses again. In doing so, we have tried to introduce a seamless system of support for low-income families with children whilst avoiding having losers at the bottom of the income distribution.<sup>2</sup> We call this our base system, and the parameters we settled on are shown in Box 2.1.<sup>3</sup>

The impact of the new system, if operated along the lines of these assumptions, on the amount of support received by low-income families with children is shown in Figure 2.3. The main gains and losses produced are the following:

- Out-of-work families will gain, as the reform will allow them to keep child benefit rather than see it offset by reduced income support. Once the integrated child credit is combined with child benefit, it is more generous than income support child rates: by £4.05 for the first child and by £3.40 for each subsequent child. These gains follow directly from creating a ‘seamless’ system of payments for children. Income support currently provides less for each child than the total received by some families on WFTC; so if no low-income families are to lose, others must be ‘levelled up’.
- Families currently on WFTC cannot take full advantage of the children’s tax credit, for one or both of two reasons. First, people earning less than £8,000 a year pay insufficient income tax to benefit fully from the credit. Secondly, people on the WFTC taper see some of the tax cut that the children’s tax credit represents offset by a reduction in WFTC. When the children’s tax credit is incorporated into the integrated child credit, these families will gain by up to £10 a week.

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<sup>2</sup> This sort of system seems to be implied by the vague illustrations in Inland Revenue (2001b).

<sup>3</sup> Full details are available from the authors.

- The new tax credits will probably be assessed against gross income rather than net income as currently used by the WFTC. As explained more in Box 2.2 at the end of this section, this means that couples currently on WFTC will gain.
- Some couples higher up the income distribution will be worse off because the family premium of the integrated child credit is withdrawn against joint income, whereas the current children's tax credit is withdrawn only against the higher income in a couple. This would affect couples where both adults earn but neither is a higher-rate taxpayer (i.e. each earns less than £33,935). They could lose up to £10 a week.

### **Box 2.1. Parameters assumed in our 'base' new system**

#### *Weekly value of credit*

The integrated child credit is set at £26 for each child (£26.75 for dependent children aged 16 or above), with £10 extra for the first child (the 'family premium'). Child benefit becomes fully additional to the new credits, as it will be disregarded in all means tests. The employment tax credit is set at £59 for couples without children and for families with children and at £29.50 for single adults without children. The 30-hour premium remains at £11.45.

#### *Lower threshold and taper*

The taper rate for both credits is 37.4 per cent, and this is applied to gross income (see Box 2.2). The employment tax credit starts being withdrawn when gross family income reaches £94.35 a week (£4,906 a year). For families with children (and couples without), it will be fully withdrawn once gross income reaches £252 a week (£13,110 a year). At this point, the integrated child credit starts being tapered. Extra income of around £3,600 annually is required to exhaust the payment for each child, so the income required to exhaust all credits depends on the number of children. Once they are fully withdrawn, families are left with just the £10 'family premium'.

#### *Higher threshold and taper*

Beyond gross family income of £653 a week (£33,935 a year), the family premium of the integrated child credit is withdrawn at 6.66 per cent, until it has all been withdrawn at incomes of £803 a week (£41,735 a year). This exactly replicates the children's tax credit for a single-earner family. We also model a more generous system that doubles this threshold to £67,870 to ensure that no higher-income families with children lose.

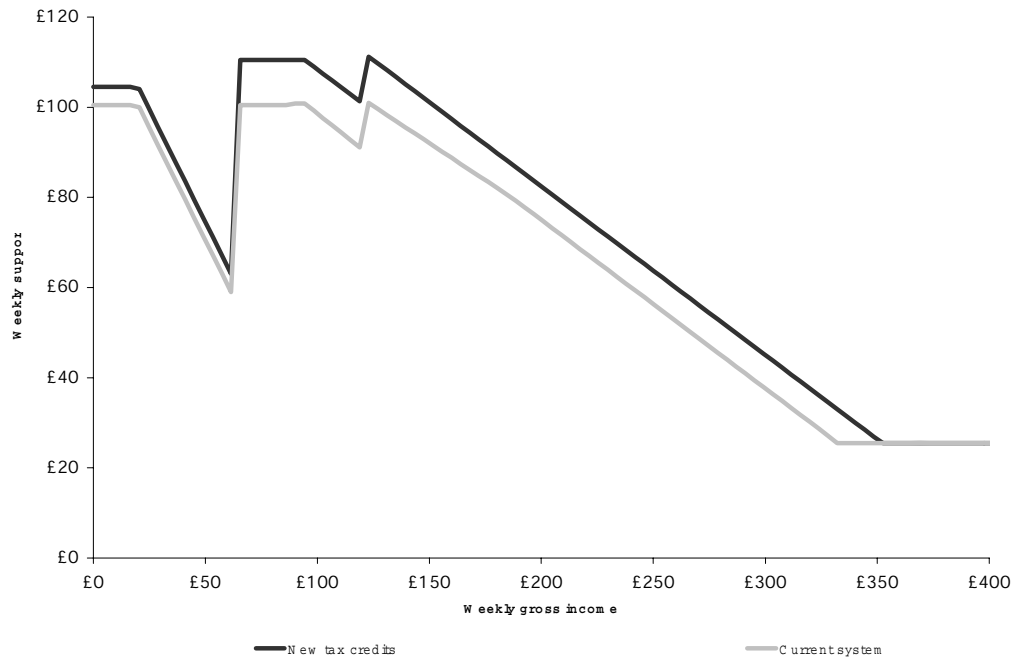
#### *Definition of income*

We assume that the credits are assessed against gross taxable income. In addition, we assume that there will be no direct testing of savings capital in the new system, but that, instead, interest from savings will be included in income (although the government has suggested that it might ignore very small amounts of interest income (Inland Revenue, 2001b, para. 111)). This treatment of savings aims to get rid of the disincentive to save that the current system of means-tested benefits imposes.

#### *Interactions with other benefits*

The parameters of housing benefit and council tax benefit are adjusted so that none of the extra child support for those currently on income support is offset by reductions in housing benefit or council tax benefit.

**Figure 2.3. Financial support for families with children**



*Notes:* Assumes lone parent with one child, and that the tax credits are implemented immediately. The vertical axis shows the sum of child benefit, income support, WFTC and the effective value of the children’s tax credit under the current system, and the sum of child benefit, the employment tax credit and the integrated child credit under the reformed system. The graph does not illustrate the tapering away of the integrated child credit amongst high-income families.

*Source:* Authors’ calculations using the IFS tax and benefit model, TAXBEN.

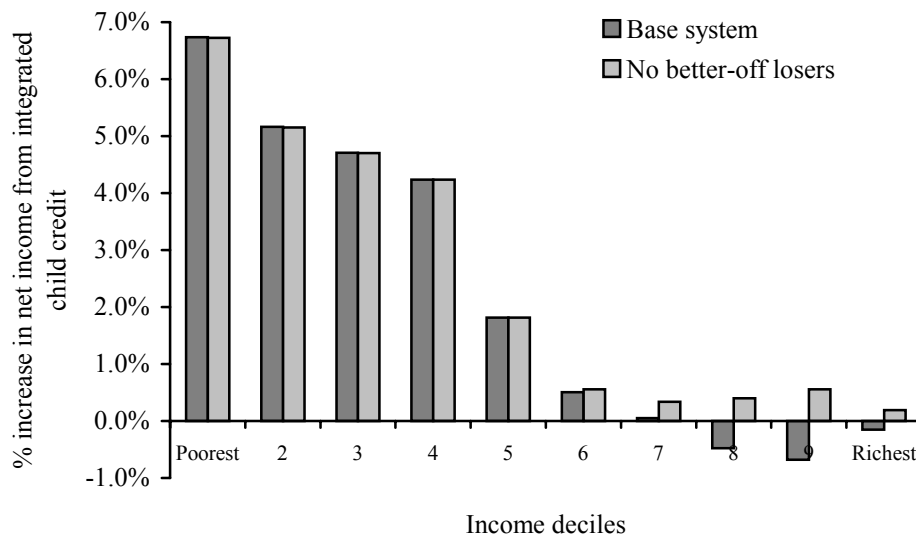
Looking at the impact across the income distribution, families with children in the bottom income deciles will gain most in percentage terms, and families in the top three deciles lose slightly through the change to full joint assessment (see Figure 2.4). The cash gains are highest in the first decile, at £12.30 a week on average.<sup>4</sup> A system that ensures no losers has identical effects at the bottom of the income distribution, and some gains – rather than losses – at the top of the income distribution (to achieve no higher-income losers, the higher threshold needs to be doubled to an annual gross family income of £67,870).

Lone parents gain by more, on average, than couples with children (£10.37 a week rather than £3.16 a week) because they tend to be found at the bottom end of the income distribution. Under our assumptions, 5.7 million of the 7 million families with children in the UK will be entitled to some integrated child credit. Around 3.3 million families will gain more than £1 a week from the reform, 2.5 million families will be relatively unaffected financially and 1.1 million families with children will lose by more than £1 a week. Almost all of the losers are two-earner couples who suffer from the move to full joint assessment (indeed, about 32 per cent of two-earner couples with children could lose, many losing the full value of the children’s tax credit, or £520 a year). Just 100,000 couples with either one or no earner lose out, and they have significant unearned income.

<sup>4</sup> The large gain in the bottom decile is due to a number of families, who were previously receiving little or no income support or WFTC, becoming entitled to some integrated child credit.



**Figure 2.4. Effect of the new tax credits on incomes of families with children**



*Notes:* Income deciles are derived by dividing all families (with and without children) into 10 equally sized groups according to income adjusted for family size using the McClements equivalence scale. Decile 1 contains the poorest tenth of the population, decile 2 the second poorest and so on, up to the top decile (decile 10), which contains the richest tenth. This graph shows the effect on families with children only, so the interpretation is that the employment tax credit will increase incomes of working-age families with children in the poorest tenth of the population by 6.7 per cent. For other assumptions, see Box 2.1 and the text.

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

These reforms are expensive: under our assumptions, the new system of credits for families with children would cost £1.8 billion a year to introduce, and a system with no well-off losers would cost an annual £2.4 billion. A lot of the cost comes from the use of gross income and our assumptions about the taper and the threshold. Operating the system on net income would reduce the cost by about a third.<sup>5</sup>

This analysis assumes full take-up in both the pre- and post-reform systems (i.e. that all those eligible for any benefit or tax credit claim it). At present, take-up of income support for those with children is very high, but take-up rates for WFTC and the children's tax credit are lower.<sup>6</sup> Part of the appeal of integrating support for children is that it should increase take-up because almost all parents will be entitled to some support. Whether take-up increases in practice, though, will depend also on how the system is administered, and this is discussed in Chapter 4.

<sup>5</sup> This assumes that the credits will be withdrawn in the same way that WFTC operates. The saving of a third comes from considering the option of using a net income taper on both the integrated child credit and the employment tax credit for families with and without children.

<sup>6</sup> Income support take-up for lone parents is estimated to be at least 95 per cent; family credit take-up was around 66–70 per cent in 1998–99 (no estimates have been published yet for WFTC); and the children's tax credit take-up was reported to be almost 80 per cent in March 2001, although parents can claim it at any time during the tax year. Sources: Department for Work and Pensions (2001a) for income support and Department of Social Security (2000) for family credit.

### **Box 2.2. Gross or net income?**

The government is considering whether to use gross taxable annual income in assessing entitlement to the new credits (see Inland Revenue (2001b, paras 112–15)). This definition of income is different from that currently used by income support and WFTC, which look at income after tax and National Insurance payments (see Section 5.3 of Brewer, Myck and Reed (2001)).

One attraction of using gross income is simplicity. Most taxpayers are sent a form (known as a P60) by their employer at the end of each tax year telling them the amount of earnings they received in the past year. Self-employed people have to keep records of taxable income for income tax purposes, and many sources of investment income have to inform people how much gross interest they received. Most importantly, for individuals assessed exclusively through the PAYE system, the Inland Revenue will know their gross annual earnings shortly after the end of the tax year. In combination with the shift to annual assessment, then, the move to gross income could reduce the information that has to flow between claimants and administrators.

Another difference from the existing system that would flow from using gross income is that integrated child credit recipients who pay income tax or National Insurance would feel the impact of income tax and National Insurance changes in full; at present, the WFTC taper claws back part of the gain from any tax cut (and partially makes up for any tax rise). The children's tax credit, for example, is worth up to £10 a week to some taxpayers with children, but it is worth at most £4.50 to those on WFTC.

Perhaps the most significant difference in moving to gross income assessment is that it could improve the work incentives of second earners within couples. At present, the WFTC withdrawal rate is 55p for every extra pound of net income, and this combines with basic-rate tax and National Insurance to give a total marginal withdrawal rate of 69.4p on every pound of gross income.<sup>a</sup> Indeed, second earners in couples on WFTC face marginal deduction rates of 55 per cent even if they are earning too little to pay any income tax or National Insurance, and this is why academic studies have concluded that the introduction of the WFTC improved the work incentives for the first person in a couple to work, but worsened them for the second potential earner (see Blundell et al. (2000) or Gregg, Johnson and Reed (1999)).

Using a gross income taper – at least at the rate that we assume – would attenuate the 'second earner' problem. It would reduce the effective marginal deduction rate faced at incomes below the personal allowance, which would also mean that second earners in families currently on WFTC would keep more of their earnings even once they were liable for some tax. A gross taper of 37.4p in the pound would combine with income tax and National Insurance to achieve the same effective marginal rate of 69.4 per cent for a basic-rate taxpayer.<sup>b</sup> But if a second-earner parent entered work on wages low enough to pay no income tax or National Insurance, their effective marginal deduction rate would be only 37.4 per cent under a gross income taper in the integrated child credit rather than 55 per cent under WFTC. Of course, 37.4 per cent is higher than the withdrawal rate faced in the absence of any tax credits, but, for the second earner in couples already on WFTC, the improvement is unambiguous.

*Continued overleaf.*

Box 2.2 continued

The main disadvantage of using a gross taper is that the combination of taxes and credit withdrawal could produce marginal withdrawal rates of over 100 per cent (this is where an extra pound of income leads to more than a pound being lost in income tax, National Insurance and credit withdrawal).<sup>c</sup> It is not inevitable that a tax credit system based on gross income will produce marginal withdrawal rates of over 100 per cent. The earned income tax credit (EITC) in the USA, for example, depends upon gross income, and marginal deduction rates need not rise above 60 per cent (see Brewer (2001a)). But the government needs to take great care that marginal withdrawal rates remain below 100 per cent when changing taxes or taper rates. Whether the new tax credits produce any marginal withdrawal rates in excess of 100 per cent depends upon the taper rate chosen but it seems unlikely that they will on current plans.

<sup>a</sup>  $69.4\% = (22\%+10\%) + \{55\% \times [1 - (22\%+10\%)]\}$ ; basic-rate tax is 22 per cent and National Insurance is 10 per cent at the time of writing (October 2001).

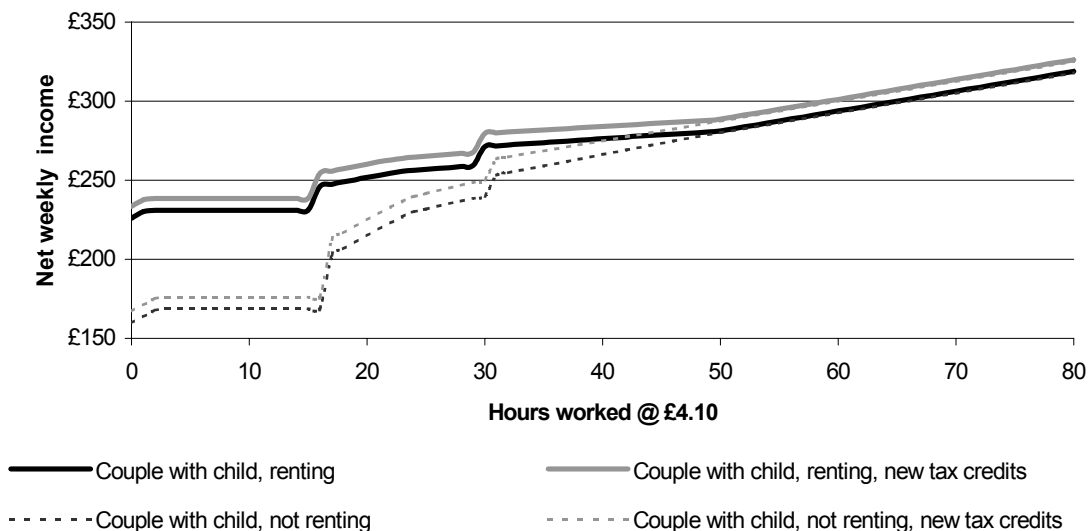
<sup>b</sup>  $37.4\% + 22\% + 10\% = 69.4\%$ .

<sup>c</sup> Indeed, this used to be the case with the old family income supplement scheme, which existed until 1988. On the other hand, there is no way that a tax credit or benefit that depends upon net income can produce a marginal withdrawal rate of more than 100 per cent, and this was one of the reasons why family credit and the WFTC depended upon net income.

### 2.3 Effects on work incentives

The introduction of the credits will alter families' budget constraints – the relationship between gross earnings and income after tax and benefits – as shown in Figure 2.5, and so may have some impact on people's financial incentives to work.

**Figure 2.5. Impact of the new tax credits on the budget constraint for families with children**



Notes: Assumes couple with two children and rent of £62.25 per week and that the tax credits are implemented immediately. The budget constraint for a lone parent with two children would look very similar. The graph does not illustrate the tapering away of the integrated child credit amongst high-income families.

Source: Authors' calculations using the IFS tax and benefit model, TAXBEN.

We present below several ways of looking at financial work incentives: marginal deduction rates, replacement rates and the cash gain from working. A marginal deduction rate describes how much of an extra pound of gross earnings is taken away in income tax, National Insurance payments and reduction in the payment of benefits or tax credits. This is a good way of measuring the incentive to increase work by, say, an extra hour. It is not a good way, though, of measuring the financial incentive to work at all. One way to assess this is to look at the replacement rate. This is the ratio of the income that someone's family would receive when that person is out of work to the income that they would receive when the individual is in work, with income in both cases calculated after all taxes and benefits. We also present the effect of the reforms on the cash gain from working, ignoring work-related costs.<sup>7</sup>

### *Marginal deduction rates*

The reforms will change the marginal deduction rates of about a third of parents: around 2.3 million will see their marginal deduction rates increase and 1.8 million will see them decrease. A small number of changes can explain most of the results:

- The integrated child credit will be more generous than the benefits it replaces. This will increase the number of families who are entitled to receive some means-tested support for their children, and will therefore increase the number of families who face some benefit withdrawal for each extra pound of income. These families were previously not receiving any means-tested support, so their marginal deduction rates will rise, typically from 32 per cent to 69.4 per cent for single-earner basic-rate taxpaying families or from 0 per cent to 37.4 per cent for the second potential earner in a single-earner couple.
- Using gross income rather than net income would mean that marginal deduction rates will fall for some low earners currently on WFTC. In particular, rates for some very low-paid parents and potential second earners in couples would fall – for example, from 55 per cent to 37.4 per cent (see Box 2.2 above).
- The increased generosity of the integrated child credit will mean that some families are no longer entitled to housing benefit or council tax benefit. This will reduce these families' marginal deduction rates to 69.4 per cent.

Table 2.1 offers a summary of the changes. By looking at bands of marginal deduction rates, it does not identify all of the changes, but it does focus on the group that we are most interested in – those with high marginal deduction rates. Even within this group, the story is complicated: although the number of parents with marginal deduction rates over 70 per cent falls, the number with rates between 60 and 70 per cent increases.

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<sup>7</sup> Our calculations also implicitly assume that everyone's circumstances are stable. People whose circumstances are changing will face different, short-term effects on work incentives, and the introduction of the credits will change these incentives. Chapter 4 offers some more discussion of these issues.

**Table 2.1. Effect of the new credits on marginal deduction rates of adults in families with children**

Marginal deduction rate	Before the reforms <sup>a</sup> (thousands)	After the reforms <sup>b</sup> (thousands)	Change (thousands)
0%	3,451	2,921	-531
0%–50%	6,396	7,217	+821
50%–60%	817	409	-408
60%–70%	1,033	1,194	+162
70%–80%	35	102	+67
80%–90%	304	216	-88
90%–100%	26	37	+11
100% or more	168	134	-34
<b>Total</b>	<b>12,231</b>	<b>12,231</b>	<b>0</b>

<sup>a</sup> Under the April 2001 tax and benefit system.

<sup>b</sup> If the integrated child credit and employment tax credit were introduced immediately.

*Note:* Calculations throughout involve assumptions about the parameters of the new credits, as shown in Box 2.1.

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

#### *Replacement rates and the cash gain from working*

The reforms will increase the gain from working for many low-wage lone parents. This occurs because the integrated child credit will increase incomes of people in work and out of work, but – at least for the examples shown in Table A.1 in the Appendix – the increase in in-work income is generally greater in cash terms. For example, a workless, non-renting lone parent with two children contemplating a minimum-wage job will find that her gain from working has increased by £2.04 for a part-time job or £1.01 for a full-time job. But, looked at in proportional terms, out-of-work incomes sometimes go up by more than in-work incomes as they were lower to start with (this generally occurs for lone parents with one child). This means that replacement rates can rise (i.e. worsen).

The reforms will have more complicated effects on couples with children. The cash gain from entering work for the first earner in a couple will increase for almost all our specimen families, for the same reasons as for lone parents (see Table A.2 in the Appendix). As for lone parents, there is a mixed effect on replacement rates, with some increasing and some falling (but generally by smaller amounts than for lone parents).

The effect on the second earner in a couple is more dramatic, though. The shift to gross income assessment means that, in most circumstances, the cash gain from working increases (see Table A.3 in the Appendix, and Box 2.2 above for more discussion of gross income). For example, in a couple with two children where one adult is in a full-time minimum-wage job, the financial gain to the second earner from taking a part-time minimum-wage job has increased by £11.54 – only slightly less than the gross pay for three hours' work. (It should be stressed that these results are very dependent on the assumptions made about wages and hours worked. There will be no effect on second earners, for example, in families where the first earner's income is high enough to deny entitlement to WFTC.)

One shared feature of Tables A.1 and A.2 in the Appendix is the way in which incentives to work are currently worse for those families who rent their homes (because we assume they are entitled to housing benefit). So, for example, someone in a renting, workless couple with two children considering taking a 16-hour minimum-wage job faces a replacement rate of 97.5 per cent. But, strikingly, the credits do less to improve the gains from working for those claiming housing benefit than they do for those not on housing benefit. This is because we have assumed that, for families in work, some of the income gains from the new tax credits are clawed back by a reduction in housing benefit.<sup>8</sup>

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<sup>8</sup> This happened when the WFTC was first announced (see Blundell et al. (2000)).

### **3. The employment tax credit for families without children**

In this chapter, we examine the government's goals in extending the employment tax credit to families without children. We also consider the extent to which the reform is likely to succeed in achieving these and we look at the scale of the redistribution it is likely to produce.

#### **3.1 New support for working families without children**

As we saw in the previous chapter, the WFTC currently has two elements – adult and child credits. The integrated child credit will replace the child credits, so the government will need to introduce some new form of compensation if existing WFTC claimants are not to lose out as it is abolished. The employment tax credit will play this role. But the need to compensate those with children does not extend to those without children, as they cannot currently claim WFTC. The government has, then, made a clear policy choice to engage in redistribution to an entirely new group – low-wage workers without children.

Although the employment tax credit will be available to both families with and families without children, there will be two important differences:

- The government has said that the WFTC adult credit would provide the benchmark level of support for the employment tax credit for those with children, but that it will have a 'basic element payable at different rates for individuals and families (recognising the different levels of support needed to provide satisfactory gains to work for different groups)' (Inland Revenue, 2001b, para. 37). The implication is that it is likely that the system for people without children will have different rates for couples and single people, whereas lone parents and couples with children are entitled to the same rates of employment tax credit and integrated child credit.
- The work conditions will be stiffer for those without children. Whereas a weekly 16 hours of work is sufficient to make parents or those with disabilities eligible (with extra payment made if 30 hours are worked), 30 hours will be required for those without children to qualify.

#### **3.2 The rationale for redistribution**

The decision to extend the employment tax credit to cover people without children is clearly a discretionary policy choice on the part of the government. The reasons for this extension have been described as 'to increase work incentives' and 'to relieve in-work poverty in working households without children' (HM Treasury, 2000). These concerns parallel the issues motivating the introduction of the WFTC for families with children. But are these problems severe enough amongst those without children to indicate that extra support is needed? Is the employment tax credit the appropriate instrument? We now consider these questions.

### *Poverty alleviation*

In the absence of in-work benefits, we would expect working poverty amongst families with children to be far higher than it is amongst people of working age without children. This is because the call on a family's resources will certainly increase when they have children, but there is no reason to think that their wages will rise commensurately. This implies that, if there were no in-work benefits, then the priority for a government concerned about poverty would be to introduce them for those with children. But there already are in-work benefits for families, and the government directed large amounts of money to families with children in its first term (see Clark, Myck and Smith (2001)), with the integrated child credit set to continue this trend. So how do in-work poverty rates compare between families with and without children?

We measure poverty using an arbitrary but widely used standard – 60 per cent of median household income after taxes and benefits. We estimate that the overall poverty rate for working-age people without children (12.7 per cent) could well be very similar to that for non-pensioner families with children (12.8 per cent) after all the government's reforms implemented to date (see Table 3.1).<sup>9</sup> After the integrated child credit reform, the relative position of families with children will improve: we model that the new tax credits could reduce their poverty rate by 3 percentage points.

**Table 3.1. Poverty in families with and without children**

	All	(Both) working <16 hours per week	(Either) working 16–29 hours per week	(Either) working 30+ hours per week
<i>Working-age families without children (20.5 million people)</i>				
Proportion in groups	100%	23.7%	4.7%	71.6%
Poverty rate	12.7%	41.3%	21.7%	2.6%
<i>Families with children (26.0 million people)</i>				
Proportion in groups	100%	21.8%	5.8%	72.4%
Poverty rate	12.8%	42.1%	24.8%	3.1%

*Notes:* Excludes pensioners. Poverty line is defined as 60 per cent of median equivalised disposable household income. The hours thresholds were chosen to reflect possible lines of eligibility for the employment tax credit spelled out by the government.

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey, assuming the April 2001 fiscal system.

These poverty numbers might justify directing some support at poor households without children, perhaps with a new emphasis on increasing means-tested support for this group. The next question is whether the employment tax credit is the best way to deliver this. Amongst families without children, poverty is especially concentrated amongst those who are not working as much as 16 hours per week, over 40 per cent of whom are classed as poor by our measure. By contrast, workers without children are less likely to

<sup>9</sup> The results shown reveal poverty rates lower than those in the most recent set of official statistics (see Department for Work and Pensions (2001b)). This is because we model the effect of recent reforms not yet visible in survey data and because we assume all benefit entitlement is taken up and that the tax and benefit system responds instantaneously to changes in income. Our poverty rates are unadjusted for housing costs and will be lower as a result.



be poor than those with children. This suggests that working poverty remains more of a problem for those with children than for those without.

Still, the fact that working poverty is more acute for families with children than for those without does not mean that the government's expressed concern about the incomes of the working poor without children is ill-founded. But there is doubt whether the employment tax credit is well targeted if its aim is to have a direct impact on poverty. This is because of two proposed restrictions:

- The employment tax credit will not be available to the young: individuals under 25 or couples in which both partners are under 25 will be ineligible for the benefit. Yet poverty is unusually high amongst this group – they are more than twice as likely to be poor overall, and those of them who are in full-time work are twice as likely to be poor, as older workers without children (see Table 3.2).
- The employment tax credit will only be available to adults without children who work full time, defined as more than 30 hours a week. But Table 3.2 shows that poverty is far less of a problem for full-time than for part-time workers without children – just 2.5 per cent of those in the over-25 full-time group are below the poverty line. This is very much lower than the rate for over-25s without children working part time (21.4 per cent).

**Table 3.2. Poverty rates among working-age people without children**

	All	(Both) working <16 hours per week	(Either) working 16–29 hours per week	(Either) working 30+ hours per week
<i>All</i> (20.5 million people)				
Proportion in groups	100%	23.7%	4.7%	71.6%
Poverty rate	12.7%	41.3%	21.7%	2.6%
<i>Aged under 25<sup>a</sup></i> (1.6 million people)				
Proportion in groups	100%	35.0%	2.0%	63.1%
Poverty rate	28.9%	72.4%	29.7%	4.8%
<i>Aged 25 or over<sup>b</sup></i> (18.9 million people)				
Proportion in groups	100%	22.7%	4.9%	72.3%
Poverty rate	11.3%	37.2%	21.4%	2.5%

<sup>a</sup> For couples, means both partners under 25.

<sup>b</sup> For couples, means either partner 25 or over.

Notes: As Table 3.1.

Source: Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey, assuming the April 2001 fiscal system.

Given all this, the extension of the employment tax credit to families without children might be expected to have little direct impact on poverty. But it might be hoped that the overall effect will be greater than this. For poverty may also be reduced by improving the incentives for people to work full time, and perhaps the employment tax credit will do

just this. Indeed, the government has argued that ‘part-time employment, and not just low wages, is a factor in working poverty for households without children’ (HM Treasury, 2000). So the government hopes the employment tax credit will encourage people without children to work full time, and much of its effect on poverty may come through this route. With this in mind, we now turn to consider its effect on work incentives.

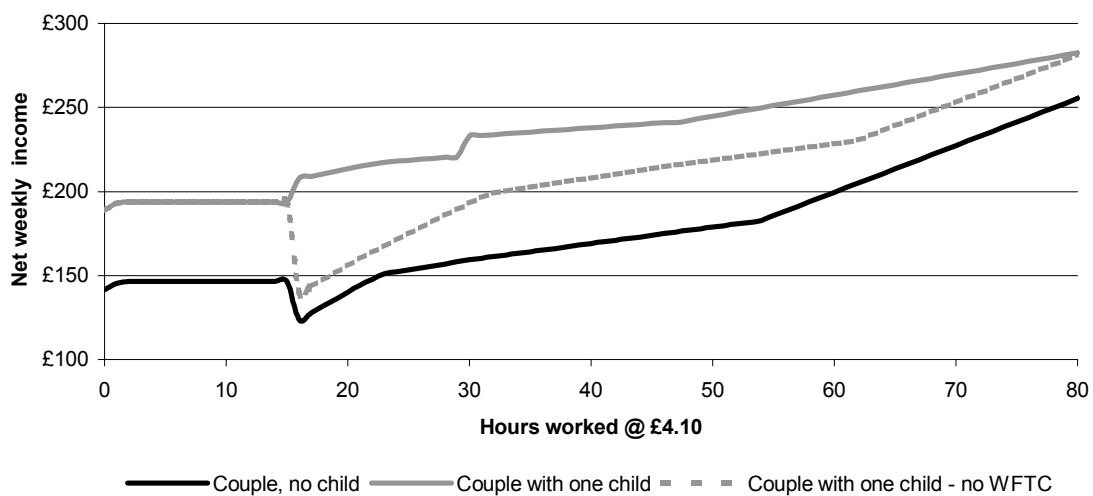
### *Work incentives*

The government justifies the proposed restriction of the employment tax credit to full-time workers without children by arguing that there is no reason why families without children should not work full time (unlike families with children). It may be true that full-time jobs offer higher hourly wages and more opportunities for training and advancement than part-time jobs. Introducing the hours minimum of 30 for those without children certainly reduces the cost of the policy very substantially (see Chapter 7 of Dilnot, Emmerson and Simpson (2001)). This structure also means that the employment tax credit will give a financial inducement to move into full-time work.

But is there a financial work incentive problem for people without children? The budget constraints for one-earner couples and single people with one child and without children are shown in Figures 3.1 and 3.2. They are drawn for the worst-case scenarios: people on low wages and on housing benefit (the gains from working are much higher for those not receiving housing benefit). For people with children, we also show the budget constraint without the WFTC to show the difference it makes in terms of work incentives.

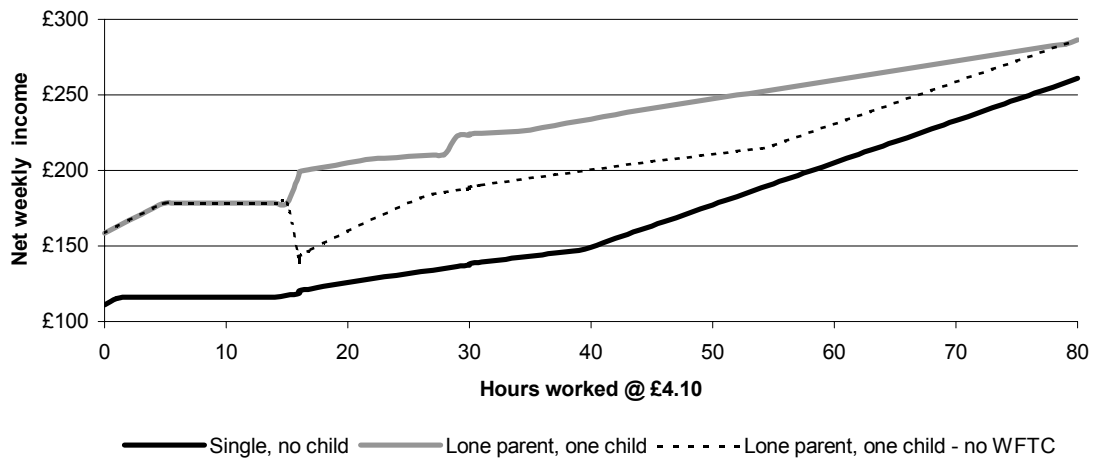
Looking first at couples, a striking feature is that the first person in a couple without children would be better off not working than working between 16 and 20 hours inclusive at the minimum wage. This is because income support receipt is limited to people working less than 16 hours per week. Even working full time at the minimum wage, a couple without children is only £17.90 better off per week when one of them

**Figure 3.1. Budget constraints for one-earner couples with and without children**



*Note:* Assumes rent of £58.10 per week and that the tax credits are implemented immediately.  
*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN.

**Figure 3.2. Budget constraints for single adults with and without children**



*Note:* Assumes rent of £58.10 per week and that the tax credits are implemented immediately.

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN.

works 30 hours a week (or £27.68 for 40 hours of work). This might suggest a real problem for those without children, but it is probably not a sensible statistic to look at. We would probably expect both adults in a couple without children to work if they were able to do so, and there is no financial work incentive problem when we compare income support for a couple with the net income of two earners.

Single people without children face a smaller unemployment trap than the first adult in a couple because their out-of-work benefits are lower. Minimum-wage work still pays little relative to staying on benefit, though: a single person over 25, without children, renting and earning £4.10 an hour receives £111.15 a week when out of work, £137.36 when working 30 hours and £149.32 when working 40 hours. Still, the lack of incentive to work is nothing like as bad as it would be for a lone parent without WFTC.

It is clear that the WFTC makes work much more attractive for people with children: without it, there would also be little or no financial reward to work on low wages. Without the WFTC, a single person with one child and renting would be only £30.54 better off in a 30-hour-a-week minimum-wage job (or £41.74 for 40 hours; these figures would be lower if the lone parent had more than one child). Given childcare, which adds to the cost of working, there is clearly a strong justification for having an in-work benefit for people with children, and, with WFTC, a single person with a child receives £65.40 more for working 30 hours relative to not working (or almost £75.50 for working 40 hours; see also Brewer (2000)). The case is simply not as strong for families with no children.

*The rationale for redistribution – conclusion*

From the discussion above, it seems rather unclear that either poverty alleviation or concerns over poor financial work incentives can justify the introduction of the

employment tax credit for those without children. The restriction to those over 25 and working full time means that the direct anti-poverty effect will be small.

Unlike for people with children, there does not seem to be a severe financial work incentive for those without children. The worst of the work incentive problems for those without children is for couples where one adult cannot work for some reason: in these cases, it is possible that the couple may be only slightly better off with one person in work than with neither. But if inability to work is the main cause of in-work poverty for couples without children, then extra support for the sick or disabled, or for carers, might be a more targeted and appropriate way to reduce poverty in this group than a generalised employment tax credit. For such cases, it is uncertain whether an improved financial reward to work would be effective.

There could be other rationales or justifications. One possibility is the view that fairness demands that full-time work should reward people more than it does at present. But the government has not stated that this is its motivation.

### **3.3 The cost and distributional impact of introducing the employment tax credit**

As with the integrated child credit, we do not know the generosity of the employment tax credit, the thresholds at which it will be tapered away or the rate at which it will be tapered, so we have had to make some guesses. All the parameters explained in Box 2.1 still apply. We highlight, though, that we chose a maximum value of £29.50 a week for single adults without children and that couples without children receive a maximum of £59 a week, the same as families with children.<sup>10</sup>

The impact of the employment tax credit on people without children is straightforward. All those entitled to the employment tax credit will see their incomes rise. The maximum theoretical gains are £59 a week for couples and £29.50 a week for single adults. But it is unlikely that many families will gain by this maximum amount because the value of the credit will start to be reduced for those with gross incomes above £94.35 a week/£4,906 a year. On our assumptions, a single adult working for 30 hours at the minimum wage (so earning £123 a week) – surely the lowest earnings that an employee could have and still qualify – could be entitled to only £18.78 a week in employment tax credit (£48.28 for a couple). At the rates that we have assumed, entitlement to the employment tax credit would be exhausted at annual incomes of around £9,000 for a single person and £13,000 for a couple. So the impact of the employment tax credit will be to increase the incomes only of single people and couples without children aged over 25 working at least 30 hours a week and earning less than £9,000 or £13,000 respectively (Figure 3.3 illustrates this for couples, although with weekly incomes).

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<sup>10</sup> The cash difference of £29.50 between our chosen rates is very similar to the cash difference in income support rates for a single adult and a couple (£30.20).

**Figure 3.3. Impact of the new tax credits on the budget constraint for families without children**



*Notes:* Assumes rent of £58.10 per week and that the tax credits are implemented immediately. The budget constraint for a single person would look very similar.

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN.

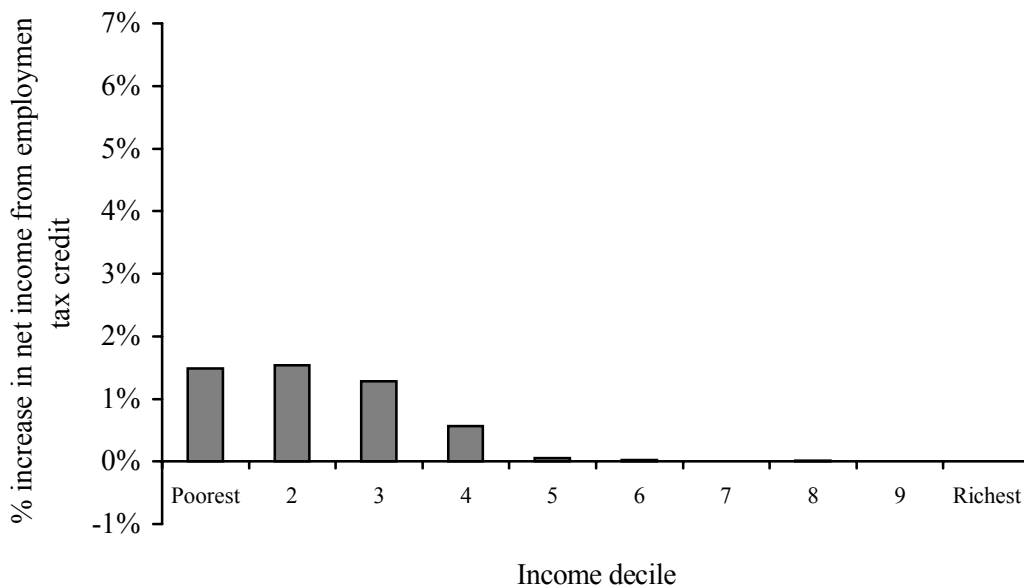
Extending the employment tax credit to those without children is much less expensive than the system for those with children, costing around £350 million a year on our assumptions. Only 250,000 single people and around 170,000 couples will be entitled. The effects and cost for this group are limited because the employment tax credit is

- not generous compared with the total amount of tax credits available to families with children;
- limited to those working full time;
- limited to those aged over 25.

Changing any of these parameters will change the cost and the distributional impacts. For example, the costs could change by a factor of 9 if entitlement were extended to all those aged 18 or over without children working part time (see Chapter 7 of Dilnot, Emmerson and Simpson (2001)).

The distributional impact, shown in Figure 3.4, is unsurprising. The gains are limited to the lower deciles and are extremely small when averaged across the population of all working-age families without children: the mean gains are 34p a week for single people and 54p a week for couples. But the mean gain may be misleading because so few people are entitled: people entitled to the employment tax credit will see average gains of £13.04 and £19.71 a week for single people and couples respectively, or 11 per cent and 12 per cent respectively in percentage terms. There is a modest direct impact on poverty, in line with our discussion in Section 3.2: we calculate that the poverty rate amongst working-

**Figure 3.4. Distributional impact of the employment tax credit for families without children**



*Notes:* Income deciles are derived by dividing the total population into 10 equally sized groups according to family income adjusted for family size using the McClements equivalence scale. Decile 1 contains the poorest tenth of the population, decile 2 the second poorest and so on, up to the top decile (decile 10), which contains the richest tenth. This graph shows the effect on working-age families without children only, so the interpretation is that the employment tax credit will increase incomes of working-age families without children in the poorest tenth of the population by 1.5 per cent. The scale is the same as for Figure 2.4. For other assumptions, see Box 2.1 and the text.

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

age people without children will decline by just 0.4 of a percentage point (by contrast, we model that the poverty rate for those with children could decline by 3 percentage points).

As is usual when doing simulations of tax and benefit reforms, we have assumed that all those entitled to some employment tax credit will claim and receive it. But this may not be a sensible assumption to make for those without children. First, the employment tax credit will represent a new benefit for a group of people, many of whom are not currently entitled to state support. Evidence from reforms to family credit and the introduction of the WFTC suggests that such a 'newly entitled' group takes some time – a matter of years – to respond fully to the new benefit.<sup>11</sup> Secondly, evidence from family credit suggests that whether someone claims a benefit to which they are entitled depends heavily on how much it is worth. Offsetting this is the government's ambition that the new tax credits will be simple to claim and will not carry any of the negative connotations of receiving benefit. Which of the effects dominate is an open question.

<sup>11</sup> Blundell et al., 2001.

### 3.4 Work incentives

As in Chapter 2, we now present several ways of looking at financial work incentives: marginal deduction rates, replacement rates and the cash gain from working. As entitlement to the employment tax credit for those without children is limited, the effect on marginal deduction rates is correspondingly small.

#### *Marginal deduction rates*

The reforms will change the marginal deduction rates of rather more than half a million working-age adults without children: a small number (40,000) are modelled to see their rates decline, whereas 520,000 will see them increase. The changes here are simpler to explain than those for the integrated child credit:

- Anyone newly entitled to the employment tax credit will face a higher marginal deduction rate corresponding to the taper of the employment tax credit. This will increase marginal deduction rates by, we assume, 37.4 percentage points.
- The higher income enjoyed by recipients of the employment tax credit will mean that a very small number of them will no longer be entitled to housing benefit or council tax benefit, and this will reduce their marginal deduction rates.

Table 3.3 offers a summary of these changes. The number facing marginal rates over 70 per cent increases marginally, and there is a more substantial increase (269,000) in the number of adults facing marginal rates between 50 and 70 per cent.

**Table 3.3. Effect of the employment tax credit on marginal deduction rates for adults without children**

Marginal deduction rate	Before the reforms <sup>a</sup> (thousands)	After the reforms <sup>b</sup> (thousands)	Change (thousands)
0%	4,235	4,145	-90
0%–50%	12,821	12,624	-197
50%–60%	19	72	+53
60%–70%	43	260	+216
70%–80%	102	101	-1
80%–90%	80	74	-5
90%–100%	3	25	+22
100% or more	129	131	+1
Total	17,431	17,431	0

<sup>a</sup> Under the April 2001 tax and benefit system.

<sup>b</sup> If the employment tax credit were introduced immediately.

*Notes:* Calculations throughout involve assumptions about the parameters of the new credits, as shown in Box 2.1. The table includes all adults in non-pensioner families without children where there is at least one person aged 25 or over.

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

#### *Replacement rates and the cash gain from working*

The impact of the employment tax credit will be very different for the main earner in a family (or a single person) and the second earner. For single people and the first earner in

a family, the employment tax credit may increase in-work incomes, but out-of-work incomes will be unaffected. This will improve the gain from working and mean that, where replacement rates are affected, they will fall (i.e. improve). For example, a single, non-renting adult on the minimum wage will see the gain from working improve by £18.78 or £3.45 for jobs doing 30 or 40 hours a week (see Table A.4 in the Appendix). The effect is larger for the main earner in a couple than for single adults, as we have assumed that the employment tax credit is more generous to couples than to single adults. As with families with children, the improvement in work incentives is dulled for those on housing benefit.<sup>12</sup> Of course, the vast majority of single adults – those earning more than £9,000 a year – will earn too much to be affected by the credit.

For some second potential earners in couples, though, the incentive to work will be reduced. These will be in one-earner couples who receive some employment tax credit. Any earnings from the second person will then face the taper of the employment tax credit at, we assume, 37.4 per cent. So, for example, a non-renting adult with a partner working 30 hours at the minimum wage will find the gain from part-time minimum-wage work fall by £14.87 (see Table A.6 in the Appendix). The replacement rates also worsen (rise). Of course, couples where one adult earns enough to deny entitlement to the employment tax credit (£13,000 a year) will be unaffected.

So, in low-income couples entitled to the employment tax credit, the gain from working improves for the first earner but declines for the second earner.<sup>13</sup> One could infer that the government is more concerned that someone in a couple works, and that the number of workless households falls, than it is that all people in couples are in employment.

Another feature of Tables A.4–A.6 in the Appendix is that the smallest improvements in the gains from working occur for the people who currently face the worst work incentives: those on housing benefit. As for families with children, then, we find the reform does least to tackle the worst financial work incentive problems.

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<sup>12</sup> These results are very dependent on the assumptions made about wages and hours worked. We have assumed the minimum wage throughout, which reflects the fact that the employment tax credit for people without children does not look likely to be very generous.

<sup>13</sup> These results are similar to those predicted for families with children when the WFTC was first announced (see Blundell et al. (2000)).



#### 4. Design issues: how the new credits will work

So far, we have focused only on the main *structural* features of the credits, such as the entitlement available to families on different incomes and the conditions of receipt. These features have enabled us to model the redistribution the credits would effect on a static population. But we have not yet discussed a number of crucial *administrative* details. These determine the extent and nature of engagement that is required between claimants and the State. Importantly, they also determine how transfer payments respond to claimants whose circumstances change. Amongst the most important details determining how a policy is administered are:

- the period over which income is assessed;
- the period for which the entitlement is fixed after assessment;
- the extent to which claimants are obliged to inform the authorities of changes in circumstances, and the time taken for any such change to affect entitlement;
- the method of payment and the recipient within the family.

Getting such details right is vital if the credits are to succeed. First, they will directly determine whether the reform manages to introduce targeted support that is less intrusive than traditional means-tested benefits. Secondly, through their influence on the take-up rate of the new credits, these decisions will determine the extent to which the credits succeed in securing their other goals of reducing poverty and making work pay. Finally, these decisions will determine the degree of responsiveness built into the new credits, and this affects their ability to secure a number of other goals of tax and benefit policy, such as the preservation of the income safety net and the efficient targeting of resources. The government clarified some details in the recent consultation document (Inland Revenue, 2001b), and we consider a few of these aspects in greater detail below.<sup>14</sup>

To summarise, claimants should find the new credits very different from existing means-tested benefits, with the government hoping that an annual system will be simpler to understand and administer, and less intrusive for claimants. But the conflicting aim of targeting the credits effectively has forced the government to compromise on simplicity and predictability for families whose composition or income changes significantly during a year. Many families will surely find themselves in this position. The need for claimants to monitor their annual income, average hours of work and, if appropriate, childcare costs means that the government's desire to provide a flexible and well-targeted system may be increasing the risk of non-compliance.

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<sup>14</sup> We are not attempting to summarise all that is contained in the consultation document, ignoring, for example, the New Deal credit for workers over 50, the interaction of the credits with the pension credit and the changes in employers' responsibilities.

#### 4.1 The assessment period and responsiveness to changing circumstances

As we have seen, the government's major aim in introducing the integrated child credit is to reduce the burden that the means test imposes on both administrators and claimants. One way that it is hoping to deliver this is through moving towards less frequent assessment – proposing to move away from the weekly means test, used in benefits such as income support, towards an annual system. Credit entitlement is typically to be calculated annually on the basis of the preceding year's income, and then held fixed for a year (Inland Revenue, 2001b, paras 124–6). The crucial question is whether this simplification can be achieved without compromising unacceptably on targeting.

##### *Annual assessment*

Targeting resources – in the sense of paying different amounts of financial assistance to families with different levels of income – almost defines means-tested support, and lies at the heart of many of this government's social security reforms (see Brewer (2001b)). If claimants' circumstances were stable, then the government could target resources effectively through a one-off means test. In practice, though, family and financial circumstances change, so effective benefit entitlement has to respond to these changes if the targeting of resources is to be achieved over time. We will call this dynamic aspect of targeting 'responsiveness'. Responsiveness is partly needed, like targeting in general, to ensure cost-effectiveness. But, more importantly, we need a responsive system to ensure that the income safety net is preserved for those who suddenly fall on hard times.

#### **Box 4.1. Changes in family circumstances**

There is no perfect data source that can tell us about the dynamics of incomes and family status, particularly about the short-term dynamics, such as changes within the year. The most reliable information on socio-economic dynamics comes from surveys that reinterview the same people repeatedly. For example, the Labour Force Survey (LFS) interviews the same households in five successive quarters and asks them (amongst other things) about their employment status, and the British Household Panel Survey reinterviews a sample of individuals annually.

Evidence from the LFS helps us quantify the extent to which the loss of responsiveness implied by an annual means test is likely to be a problem. For example, it suggests that:

- at least 360,000 adults in couples with children and 90,000 lone parents (or 3 per cent and 5 per cent respectively) change employment status within three months;
- at least 840,000 adults in couples with children and 180,000 lone parents (or 7 per cent and 11 per cent respectively) change employment status within 12 months;
- at least 225,000 couples with children break up and at least 200,000 lone parents start to cohabit within 12 months (4 per cent and 12 per cent of families respectively).

In addition, administrative data tell us that around 45 per cent of family credit claims last for six months only.

*Sources:* Labour Force Survey data analysed in Brewer, Myck and Reed (2001, Appendix); Department of Social Security, *Family Credit Quarterly Statistical Enquiry*, various years.

A means test entirely based on the previous year's income would achieve simplicity by ignoring all changes in circumstances within the present year. The downside of such simplicity would be unresponsiveness. For example, in any given week, some families would receive large payments in spite of recent pay rises meaning that they were now enjoying a high income; others, whose earnings had recently dropped to a low level or ceased, would be left with low entitlement for the rest of the year. This unresponsiveness could also see resources diverted to unintended groups. Someone – say a new graduate – who had no income for most of the previous year and then got a well-paid job at its end could receive some employment tax credit. Such people are unlikely to be classified as the government's target group for financial support (although the restriction of the employment tax credit to over-25s should attenuate this problem).

The central point here is that family circumstances can and do change within years, sometimes quite dramatically, suggesting that such unresponsiveness could significantly compromise targeting. Some examples of the scale of changes in family circumstances are shown in Box 4.1.

#### *Responding to changes in circumstances*

Recognising the dangers of an unresponsive system, the government has decided that the new credits should surrender some simplicity by allowing some response to within-year changes in circumstances. Clearly, if a family's circumstances do not change significantly, then payments will stay at the same level for the full year. But there will be four ways in which people's tax credit will respond to within-year changes:

- Families with children who start claiming income support or jobseeker's allowance will automatically receive the maximum amount of integrated child credit regardless of their previous income. This is the way that the government will retain the safety net for families with children.
- Changes in family composition: a change in the number of children will lead to immediate recalculation of integrated child credit entitlement; the formation or break-up of a couple will immediately affect both integrated child credit and employment tax credit entitlement.
- Families whose current-year income differs 'significantly' from their income over the previous tax year will have their current-year credit entitlement adjusted. The Inland Revenue will define the 'significance' of a change by comparing the whole of present-tax-year income with the whole of last year's income. This means that dramatic changes in income that occur near the end of the tax year may have little immediate impact on entitlement.
- For the employment tax credit, changes in 'average' hours of work and childcare costs may also lead to change in entitlement.

Changes in eligibility due to changes in family circumstances will be simple to compute, usually leading to changes in entitlement from the time of the change in family composition. Such changes should also certainly be easy for families to recognise. In addition, changes to the number of children should be easy for the Inland Revenue to

verify (although the same cannot be said for the formation or break-up of a couple). But it is in varying entitlement in respect of income changes that most complexities will arise. The government has said that it will ignore small changes in income, but it wants to adjust levels of entitlement if there is a significant change in annual income (Inland Revenue, 2001b, paras 130–8).

There are two ways the government could do this, but it is not clear which it will pursue. One possibility is that claimants could be obliged to inform the Inland Revenue if they thought that their income in the current tax year would be significantly different from what it was in the previous year. Alternatively, claimants could have the *option* of informing the Inland Revenue when they thought that their current-year income would diverge significantly from their last year's income. Families who informed the Inland Revenue would have their award recalculated immediately. Others would, presumably, have their current-year award recalculated at the end of the tax year. This could be done on the basis of their actual income over the current tax year, which, at this stage, the Inland Revenue would know for certain. Where 'significant' changes were deemed to have occurred, the families affected would be liable for any overpayment and entitled to claim any underpayment.

Whichever route is pursued, families reporting a 'significant' income change will be asked to forecast their income for the current tax year. Credit entitlement will be based on this estimate, rather than on last year's actual income. Estimates will be checked at the end of the tax year, and families will be due any underpayment, but also liable for any overpayment, arising because of discrepancies between estimated and actual income (Inland Revenue, 2001b, paras 135–6).

So the system will treat differently those who do and do not experience significant income changes within a year. Families not experiencing significant changes should always be paid the right amount: small changes in income will not affect entitlement and so cannot lead to a liability to repay overpaid credit nor to entitlement to a refund. But families who report that their circumstances have changed significantly (or who first claim mid-year) and who forecast their income inaccurately will end up repaying overpaid credit or being refunded for underpayment. Financial uncertainty and hassle will also both be higher for this second group of families. The success of the new credits will therefore partially depend on how many families experience these changes and on how good families are at estimating current-year income.

This principle of within-year responsiveness relies crucially on people volunteering information to the Inland Revenue within the year, and therefore introduces the risk of substantial (intentional or accidental) non-compliance. One way to reduce non-compliance would be to introduce and vigorously enforce obligations to report information, backed up by surveillance and, in extreme cases, by fines or penalties. This would clearly compromise the aim of an unobtrusive means test.

The risk of non-compliance is important because where income estimates prove dramatically wrong – or if claimants do not inform the Inland Revenue of dramatic changes – overpayments could be extremely large. For example, a lone parent working 30 hours a week on the minimum wage with several children and childcare costs could well have total credit entitlement of several thousand pounds per year. If she moved into

a new job on an above-average wage near the start of the tax year, or began to cohabit with a working partner, she could be liable to repay almost all of this money. It would not be possible to reclaim it by reducing her credit entitlement for the next year, because entitlement is likely to be low, leaving the Inland Revenue with a significant debt to chase. Widespread occurrence of these sorts of large-scale overpayments would clearly pose major difficulties for the Inland Revenue and for claimants.

*What is a 'significant income change'?*

The government has not yet said, though, what it considers to be a 'significant income change'. In other words, how large should a change in annual income be before a recalculation of tax credits is triggered? Or, what magnitude of annual income changes should the Inland Revenue ignore? The concept of having a threshold below which income changes within the year are ignored is a new one: currently, income support reacts in full to income changes in any week, WFTC responds to all income changes within assessment periods and none outside them, and the income tax system eventually responds to all income changes on an annual basis. Determining the appropriate level of this threshold will be one of the most crucial elements of the reform. There is a clear trade-off between targeting/responsiveness and simplicity of administration of the new system:

- narrow thresholds improve the targeting/responsiveness of the system but increase compliance and administrative costs;
- broad thresholds could mean that the government would continue to pay tax credits to families whose circumstances have improved dramatically, and leave families whose circumstances deteriorate going without, but would be simpler for all to operate.

The width of the threshold could also affect work incentives. If a family reports a 'significant' income change, only change *in excess of the threshold* will affect their tax credit award. For example, if the threshold were set at £1,000 a year and the withdrawal rate at 37.4 per cent, a family whose income rose by £1,500 a year would see their annual tax credits fall by only  $(£1,500 - £1,000) \times 37.4\% = £187$ . This is not pointed out in the consultation document (Inland Revenue, 2001b), but the system would have to operate in this way to avoid substantial inequities and inefficiencies.<sup>15</sup> Consequently, the threshold effectively defines a band within which within-year income changes are ignored by the credits. This means high marginal deduction rates typically associated with means-tested benefit withdrawal will not have immediate effect on claimants undergoing 'small' income changes – entitlement only being affected from the start of the next tax year. Working more hours – up to the point where the resulting income change becomes 'significant' – will become more financially attractive as a result. The empirical

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<sup>15</sup> To see this, assume that all income was considered if an income change exceeded the threshold of, say, £1,000. Then, a family on the tax credits taper whose income rose by £995 would not need to report this change and would not see a change in the tax credit award. But another family on the tax credits taper whose income rose by £1,005 would see its tax credits fall by  $£1,005 \times 37.4\% = £375.87$ . It would have lost £375.87 a year in tax credits in response to an income increase of £10 a year, a marginal tax rate of 3,758.7 per cent.

**Table 4.1. Changes in circumstances and end-of-year reconciliation**

Case	End of year 1, start of year 2	During year 2: step 1	During year 2: step 2	During year 2: step 3	End of year 2, start of year 3
1.	Declare year 1's income of £15,000; tax credit of £2,000 set for year 2.	Annual income rises by £500.	No further action as income change less than threshold.		Actual income in year 2 (£15,500) compared with income in year 1 (£15,000), but no reconciliation needed as income change less than threshold. Tax credit for year 3 set at £1,813, i.e. £2,000-(£500×37.4%).
2.	Declare year 1's income of £15,000; tax credit of £2,000 set for year 2.	Annual income rises by £2,000. Report change to Inland Revenue.	Provide correct estimate of annual income change (£2,000) in tax year 2 to Inland Revenue.	Award set on basis of estimate. Changes up to size of threshold ignored. Award falls by (£2,000-£1,000)×37.4%, i.e. to £1,626.	Actual income in year 2 (£17,000) compared with estimate of income in year 2 (£17,000), but no further reconciliation needed as estimate was correct. Tax credit for year 3 set at £1,252, i.e. £2,000-(£2,000×37.4%).
3.	Declare year 1's income of £15,000; tax credit of £2,000 set for year 2.	Annual income rises by £2,000. Report change to Inland Revenue.	Provide incorrect estimate of annual income change (£1,500) in tax year 2 to Inland Revenue.	Award set on basis of estimate. Changes up to size of threshold ignored. Award falls by (£1,500-£1,000)×37.4%, i.e. to £1,813.	Actual income in year 2 (£17,000) compared with estimate of income in year 2 (£16,500). £187 of tax credits must be repaid to Inland Revenue, i.e. £500×37.4%. Tax credit for year 3 set at £1,252, i.e. £2,000-(£2,000×37.4%).
4.	Declare year 1's income of £15,000; tax credit of £2,000 set for year 2.	Annual income rises by £2,000. Omit to report change to Inland Revenue.	No further action.		Actual income in year 2 (£17,000) compared with income in year 1 (£15,000). £374 of tax credits must be repaid to Inland Revenue, i.e. (£2,000-£1,000)×37.4%. Tax credit for year 3 set at £1,252, i.e. £2,000-(£2,000×37.4%).

*Notes:* We assume – purely for illustrative purposes – that: a family with an income of £15,000 a year would receive a tax credit award of £2,000 a year; the threshold is £1,000 a year; the withdrawal rate at this point of the credit is 37.4 per cent. ‘Reconciliation’ means that all overpaid tax credits are recovered and underpaid tax credits refunded.

*Source:* Authors’ interpretations of Inland Revenue (2001b).

significance of this effect is clearly likely to depend on how wide the thresholds are.<sup>16</sup> Table 4.1 summarises how we think the system will respond to within-year changes in incomes.

The government says that it ‘would welcome views on the appropriate threshold for changes in income to which the new tax credits should respond’ (Inland Revenue, 2001b, para. 138). But it is very difficult to say anything more about it with the information released by the government so far. These decisions should ideally be based on information on how many families experience income changes in excess of various potential thresholds over the year. Although some evidence on this can be gathered from surveys (of the type we used to summarise the dynamics of family and labour market circumstances in Box 4.1), the government has not shared any of the conclusions it has drawn from looking at this, despite having access to at least as many sources of information as us.

Finally, the annual income test in combination with the rules allowing more frequent calculation of entitlement where circumstances change significantly could lead to undesirable incentive effects. For example, consider the automatic eligibility of those with children to maximum integrated child credit awards if they become eligible for income support. This might mean that if, say, a lone parent lost her job close to the end of the tax year – having earned enough to make her ineligible for any support on the basis of annual assessment – she could have little financial incentive to move to low-paid work, as the income earned earlier in the year might make her ineligible for any employment tax credit whilst in low-paid work but she could continue to receive support on income support if she stopped working.

## **4.2 Administering the hours rule in the employment tax credit**

At present, families need to have someone working at least 16 hours a week to claim the WFTC. The government wants to preserve hours rules in the new employment tax credit, with a minimum weekly hours requirement and, for families with children, a bonus for full-time work (30 or more hours). But it is not at all clear how monitoring weekly hours of work fits into an annual tax credit system. There will clearly need to be a system of averaging, as currently operates for the WFTC, but there will also be a responsibility on people claiming the employment tax credit to monitor their (average) hours of work, as payment of the employment tax credit is conditional on being in work and working sufficient hours. The calculation to determine ‘average’ hours of work will need to be simple if the Inland Revenue expects people to be able to monitor it themselves. It is also not clear how the Inland Revenue will verify hours of work.

The system proposed is different from that for the WFTC, where claimants have to be and expect to be working 16 or more hours when they apply (verified by employers), but then payment of WFTC continues for six months regardless of changes in hours worked. The new system risks producing a situation where people whose hours of work fluctuate

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<sup>16</sup> The effect will also be strengthened if claimants either discount future years’ entitlement heavily or are unaware of the link between ‘small’ income changes now and next year’s entitlement.

between above and below the required level might have to make repeated claims for the employment tax credit within the year.

A weekly hours-of-work requirement seems to sit oddly with an annual system. The obvious response would be to abolish the hours-of-work requirement, as is done for the earned income tax credit (EITC) in the USA (this just depends on having some earned income in the year). Following the EITC, though, would mean that the government might end up paying tax credits to people who work for only part of the year at relatively high wages, or to people who have a low income because they work very few hours a week. It does not seem to want to do the former, because that does not seem to be a well-targeted system, and it does not want to do the latter, because it does not want to subsidise people without children or disabilities to do part-time work. But if the government wants to maintain an hours rule, the challenge is to find a definition of average hours worked that is easy for all to understand and implement.

The uncertain application of the hours rule combines with the possible complexity of the income test and the need for end-of-year payment reconciliation to risk making the new system less than transparent. The resulting uncertainty (over the amount of one's entitlement) and hassle (flowing from the need to monitor and report changes in one's annual income, to reapply when hours change and to pay back any overpaid credit) may discourage people from making claims and moving into work as a result of government support. Two alternative options for implementation of the employment tax credit that could be considered for the reform were presented in Brewer, Myck and Reed (2001). All designs will have flaws; which is the best depends upon the weight attached to different priorities.

### **4.3 Payment methods**

The new credits will alter how different bits of state support are paid out and who within couples receives them. The elements of the tax and benefit system that they will replace currently have different rules regarding payment. Out-of-work benefits are received as benefit cheques or direct transfer by whichever partner in a couple claims them. The children's tax credit tends to be paid to the higher earner – it has to be where couples contain a higher-rate taxpayer or where only one partner pays income tax. The WFTC is paid to whoever a couple nominates; if that person is in work, then it is paid through the pay packet, but if that person is a carer, then it is paid direct.<sup>17</sup>

Under the new system, it is proposed that

- The integrated child credit will be paid direct to the main carer – the woman in most couples – hopefully direct into bank accounts, as part of the government's drive to pay all benefits electronically (Inland Revenue, 2001b, paras 150–1). This will involve a redistribution from the main earner to the main carer in working couples where the former had previously received either the children's tax credit or WFTC. There will also be a redistribution to the principal carer in workless couples where the non-caring parent claims income support or jobseeker's allowance.

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<sup>17</sup> There is more detail in Section 7.2 of Brewer, Myck and Reed (2001).



- The employment tax credit will be paid through the wage packet direct to earners. As the employment tax credit replaces the WFTC's adult credit, this will involve a redistribution from principal carer to principal earner for some couples who currently elect to have the WFTC paid direct to the caring parent.

The decision to pay the integrated child credit direct to the main carer will mean that, from 2003, all government financial support to families in respect of their children is paid to the main carer. It will represent the culmination of a long-running process of reforms to how financial support for children is delivered. The trend towards paying financial support to the carer began in 1977, with the replacement of tax allowances (which went to the man in a couple family) with child benefit (which went to the main carer), and continued through the payment of family credit to the main carer. In fact, the only reform since 1977 that has gone in the opposite direction was the introduction of the WFTC, where couples can now choose to whom it is paid, so representing a shift (albeit small) from 'purse' to 'wallet'. The rationale for paying the integrated child credit direct to the main carer is the oft-cited evidence (Lundberg, Pollak and Wales, 1997) that directing money for children to the main carer rather than to the main earner means that it is more likely to be spent on things that will benefit children. This action also seems to be supported by public attitude.<sup>18</sup>

The reasons given by the government for paying the employment tax credit through the wage packet was that '[it] is a key element in reinforcing the message that work pays in demonstrating the link between receiving employment tax credit and being in employment' (Inland Revenue, 2001b, para. 60). It also hoped that 'as a tax credit rather than a welfare benefit, it should reduce the stigma associated with claiming in-work support, and encourage higher take-up' (HM Treasury, 2000, para. 2.8). There is no evidence, though, that payment in this way improves work incentives or reduces stigma: the WFTC evaluation programme has not yet produced estimates of WFTC take-up or of the impact on employment. Qualitative evidence collected by Citizens' Advice Bureaux (see Wheatley (2001)) suggests that payment through the wage packet caused substantial difficulties for some WFTC recipients, such as the following:

- in extreme cases, some employers refused to pay the WFTC, so they sacked or would not employ people wishing to claim it;
- in less extreme cases, employees were forced to work fewer than 16 hours to prevent them from becoming eligible for the WFTC;
- the system depends on employers completing forms quickly when people apply or renew their award, or where they change jobs midway through a WFTC six-month award; if this is not done, claimants can be forced to go without the WFTC for some weeks.

These findings suggest to us that, for some, payment through the wage packet has been perhaps more stigmatising and certainly more hassle than direct payment. It has also been criticised by small-business organisations.

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<sup>18</sup> Section 7.2 of Brewer, Myck and Reed (2001) shows some illustrative calculations of how the integrated child credit will alter individuals' own incomes within couple families with children.

Several changes have been proposed for the new tax credits that are designed to lessen the burden on employers and which should tackle some – but not all – of the problems above. These include not requiring employers to certify earnings, and only paying the employment tax credit when someone is in work. By reducing the cost to employers, the government must be hoping that the number of cases where people are not hired because employers think they will claim a tax credit will be reduced. The government also estimates that the new tax credits will not increase the burden on business as the total number of people being paid tax credits through the wage packet should not increase.<sup>19</sup> But the Inland Revenue seems committed to the principle of paying employment-related support through employers.

#### **4.4 Support for childcare**

The government will continue to provide support for people using formal childcare under the new tax credits. Details are, in general, limited (and non-existent on the possible generosity of support), but one thing that is stressed is the government's hope to reduce the administrative burden on childcare providers and parents (Inland Revenue, 2001b, paras 74–80).

Another decision to be taken is how support for childcare should be paid. At present, families who are eligible for the WFTC can claim a 70 per cent credit on formal childcare costs, and this is paid to whichever adult in a family is receiving the WFTC. As discussed above, under the new tax credits, the part of the WFTC that corresponds to support for children will be paid to the main carer, and any additional amounts – the basic employment tax credit – will be paid to an adult in work. The government is suggesting that support for childcare should be paid by employers to the adult in work, rather than direct to the main carer (Inland Revenue, 2001b, paras 76–7). The justification rests on the fact that the government sees help for childcare costs as being help with work-related costs. It acknowledges, though, that there are arguments for paying the money to the main carer because they typically arrange childcare, and so it is consulting on which option it should pursue. The decision, though, is little more than symbolic, as, at present, only 14,000 couples are receiving help with childcare costs (Inland Revenue, 2001a).

More importantly, the government has not said explicitly what would happen to parents receiving support for childcare if their job ended suddenly or they fell below the minimum hours rule for receiving the employment tax credit. As eligibility for childcare costs is linked to being in work, our inference is that support for childcare costs would stop immediately if a job ended or they worked fewer than 16 hours a week. This would be different from the current arrangement, where support for childcare costs, like the rest of the WFTC, is fixed for six-month periods. It does not seem particularly desirable either: although it would prevent families claiming support for childcare while the adults are not working (something that the government does not want to subsidise), it could leave some families unable to pay childcare costs if a job ended or they dropped below 16 hours of work a week and they were locked into longer-term childcare contracts. This

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<sup>19</sup> See Inland Revenue (2001b, para. 5.1.2); this is because it thinks that the number of people without children newly entitled to the employment tax credit will be approximately equal to the number of families with children who will receive the integrated child credit only rather than the WFTC. This estimate, though, is based on unpublished assumptions on the eligibility conditions and generosity of the employment tax credit.

could cause them substantial short-term hardship. An alternative system would be to give families a period of grace after losing a job during which they would still receive support for childcare, giving them an opportunity either to find a new job or to renegotiate childcare arrangements.

#### 4.5 The use of joint income assessment

The tax credits will look at the combined income of couples throughout, in (slight) contrast to the current system, where the children's tax credit depends upon the higher income in the couple. Much of the debate around joint assessment focuses on whether taxation is joint or individual. Before the introduction of individual taxation in 1990, the income of a woman in a couple was treated and taxed as if it were her husband's. Since that date, women have been taxed as individuals in their own right. The Inland Revenue maintains that the new tax credits do not violate the government's (limited) definition of individual taxation.<sup>20</sup> But whether we have joint or individual taxation is a narrow debate; a wider question is whether tax payments or benefit entitlement should depend upon an individual's income or upon the combined income of a couple. We use the phrase 'joint assessment' (rather than 'joint taxation') to refer to the latter.

Whether one is in favour of joint assessment depends partly on how couples share their income. Individual assessment is more appropriate if governments are concerned with individuals' own income, but joint assessment is more appropriate if the combined income of a couple is more closely related to their actual standard of living. The government's view is that 'a key objective of the new system [is] to target support to families on the basis of need. That means that entitlement to tax credits must take account of family, rather than individual, circumstances' (Inland Revenue, 2001b, para. 14). The alternative to using joint income would be to pay tax credits on the basis of individual income. Such an approach, though, would be substantially – and no doubt prohibitively – more expensive than using joint incomes, because there are many individuals with low personal incomes with partners with high personal incomes who would benefit from a system based on individual income.

But there are concerns with joint assessment. If couples do not share their income, then joint income will be a bad measure of the well-being of the two individuals. It means that families have to provide government agencies with details of their relationships and be prepared to have these investigated. It also means that individuals in a couple have to share information on their incomes with each other. Sociologists argue that this can exacerbate existing gender imbalances of power within a relationship. Depending on the precise way in which joint assessment is implemented, it can affect the incentives for two single people to cohabit, and it could potentially lead to a situation where the second earner faces a higher effective tax rate than the first earner.

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<sup>20</sup> For example, 'What individuals pay in income tax depends, broadly, on their income in the tax year. Their tax bill is based on the principles of independent taxation – that each person should be taxed on their own income and have their own tax allowance and rate bands. None of that will change on the introduction of new tax credits' (Inland Revenue, 2001b, para. 11). We will let the reader evaluate this claim, given that the same document states that 'tax credits form an integral part of the tax system' and 'entitlement to tax credits must take account of family, rather than individual, circumstances' (paras 9 and 14 respectively in Inland Revenue (2001b)).

Under our assumptions, around 4 million couples with children might be entitled to the integrated child credit. But this will not represent a dramatic increase in joint assessment: around 1.3 million of these are already jointly assessed through the benefit system or WFTC, and almost all of the remainder are entitled to the children's tax credit. For these reasons, the integrated child credit should not drastically change the financial incentives to cohabit. The employment tax credit for people without children, though, will represent an extension of joint assessment to the 175,000 couple families who might be eligible, slightly increasing the (small) financial disincentive to cohabit for low-income people without children. So, assessing the tax credits against joint income will not represent much of a change from the current situation – it merely makes transparent what has been the result of successive government reforms since 1997 (see Brewer (2001b)).

#### **4.6 Are the new tax credits means-tested benefits or tax credits?**

It is not always clear how tax credits should be classified in the public finances or National Accounts. The introduction of WFTC was accompanied by some controversy, as the Treasury classified WFTC in a different way from the European System of Accounts (ESA), used by the Office for National Statistics.<sup>21</sup> Although Chapter C of recent Budget documents allows one to calculate the tax burden using either definition, the government's preferred measure of the tax burden counts all WFTC awards as negative tax revenues. This is despite the fact that a considerable proportion of families have WFTC awards that are greater than their income tax bills so that only a fifth of WFTC awards are actually refunding income tax payments. This is a different approach from that used by the previous government, which counted all of family credit as social security spending (these issues are discussed further in Appendix B of Dilnot, Emmerson and Simpson (2001)).

These arguments will apply to the new tax credits as well. Under the ESA classification, some of the component parts of the integrated child credit currently count as government spending and some count as forgone revenue. A small amount of the employment tax credit to people without children will also be effectively refunding income tax payments, and this will count as forgone revenue, with the remainder being counted as spending under the ESA system. It is not known yet, though, how the Treasury will prefer to classify the credits. Its decision should make no difference to how people respond to the payments, but it will make a difference to the estimates of the aggregate tax burden. But this is not a number of any real economic significance – what matters is the degree of redistribution that the tax and benefit system achieves and its effect on incentives, neither of which should be affected by the decision to label a transfer as a tax credit rather than as expenditure.

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<sup>21</sup> Some tax credits are classified as spending: the former mortgage interest tax relief (MIRAS) and the new research and development (R&D) tax credits.

## 5. So will the new tax credits work?

The introduction of the integrated child credit and the employment tax credit from 2003 will represent a major reform of the tax and benefit system, and certainly one of the largest attempted by this government.

The high-level aims of the credits are simple enough. The integrated child credit is intended to simplify and streamline existing financial support to families with children, surely a laudable goal. The employment tax credit, though, extends financial support to a new group: full-time working families without children. The first stated aim here is to reduce poverty. But poverty amongst families without children is concentrated amongst those not working full time and amongst the young, and neither of these groups will be eligible for the new credit. The immediate impact on poverty must therefore be small.

The government also hopes that the employment tax credit will improve the financial reward to work for people without children and so encourage non-working individuals and part-time employees to work full time. In practice, though, these groups do not face particularly poor financial work incentives at present. It is perhaps the case that non-financial factors are preventing non-working people without children from working full time, and so it might be more efficient to tackle these factors directly. Furthermore, under our assumptions, the employment tax credit will do little to help those who face the worst work incentives (those receiving housing benefit), and it will also reduce the incentive to work for potential second earners in couples without children receiving the employment tax credit.

The new credits will be operated by the Inland Revenue. This move should help ensure that they really will operate very differently from existing means-tested benefits. The intention is that the new credits will be easier to understand and administer, and less intrusive for claimants. One of the ways the government hopes to achieve this is by moving to an annual system for assessing tax credits. But the conflicting aim of targeting the credits effectively means that the government has compromised on simplicity and predictability for families whose composition or income changes significantly during a year. Many families will find themselves in this position. The need for claimants to monitor annual income, average hours of work and, if appropriate, childcare costs will lead to a less certain and more complicated system for some families, with the associated risk of non-compliance.

The government has not stated how many families might receive the new credits, nor how much they would cost, nor allowed for them in the public finances. Given this, we have had to make some assumptions about the main parameters – how much each credit will be worth, at what income level it will start to be tapered away and at what rate. Our main assumption has been that the new system will ensure that no low-income families lose during the transition. On this basis, the integrated child credit would cost around £1.8 billion a year to introduce (£0.6 billion more if there are to be no losers amongst better-off families). Around 5.7 million families would be entitled to the credit. On our assumptions, around 1.1 million better-off families with children will lose, but 3.3 million low-income families with children will be better off.

The employment tax credit could go to around 400,000 families without children at an approximate cost of £350 million. However, these figures are very sensitive to the restrictions on eligibility. The reforms to the way that changes in circumstances are treated mean, though, that these snapshot calculations underestimate how many families will be treated differently under the new regime compared with the current system. In particular, low-income families with children who experience a drop in earnings may find themselves temporarily worse off than under current rules.

The effect of the reforms on the work incentives of families with children is complicated and something that deserves greater attention. In general, the cash gain from working will increase for those parents currently out of work. But those in work could see either increases or decreases in their marginal deduction rates. The most important reason for these changes is the decision to base the credits on gross income rather than net income, particularly for potential second earners in couples receiving the WFTC.

The aggregate impact of both reforms on labour supply is also complicated. Some people may well be induced to enter work but – like the introduction of the WFTC – the extension of the employment tax credit to those without children may mean some people in couples decide not to work, because the credit gives their family extra income and increases the marginal deduction rate they face.

Finally, to introduce these credits on time, legislation will be needed later this year and final decisions will have to be made early in 2002. Despite this, there is still a great deal to be decided on, or at least announced, by the government. A recent consultation document provided some detail of how the credits would work, but it said little or nothing on the most important features. Although the government invited views on some key issues, it provided no quantitative evidence on which one might base a sensible response. Until the government provides substantially more detail on the operation and structure of the credits, it will be impossible to evaluate conclusively whether they will be effective in their stated aims of tackling poverty and making work pay. In particular, we await the evidence to show that the government's desire to target these credits precisely will not lead to a more complicated and less popular system than the one being replaced.

## Appendix

### Impact of the credits on the financial gain from working

*Families with children*

**Table A.1. Effect of the new credits on the financial return from working for lone parents**

Hours of work	Number of children	Hourly wage	Old replacement rate	Change in replacement rate (percentage points)	Change in cash gain from working
<i>Not renting</i>					
16 hours	1	£4.10	66.3%	+2.5	+£4.76
40 hours	1	£4.10	47.6%	0.0	+£4.41
16 hours	1	£5.55	58.9%	+2.7	+£5.79
40 hours	1	£5.55	43.9%	-1.7	+£3.37
16 hours	2	£4.10	73.3%	-0.5	+£2.04
40 hours	2	£4.10	55.4%	-3.3	+£1.01
16 hours	2	£5.55	66.2%	-0.9	+£2.39
40 hours	2	£5.55	51.6%	-4.7	-£0.03
<i>Renting</i>					
16 hours	1	£4.10	86.1%	+0.1	+£0.89
40 hours	1	£4.10	75.6%	+1.2	+£3.41
16 hours	1	£5.55	84.0%	+0.7	+£2.03
40 hours	1	£5.55	70.0%	+1.0	+£3.37
16 hours	2	£4.10	89.8%	-0.2	+£0.38
40 hours	2	£4.10	79.7%	-0.4	+£1.01
16 hours	2	£5.55	87.7%	-0.1	+£0.84
40 hours	2	£5.55	85.5%	-0.6	-£0.03

*Notes:* The replacement rate is the ratio of net out-of-work income to net in-work income. 'Old replacement rate' is that under the April 2001 tax and benefit system. The change in the rate is what would happen if the integrated child credit and employment tax credit were introduced immediately. Calculations throughout involve assumptions about the parameters of the new credits, as shown in Box 2.1. For renters, we assume rent of the mean weekly rent for all those with children in the 1998/99 Family Resources Survey modelled as entitled to either the WFTC or income support / jobseeker's allowance. The difference between the renting and non-renting cases arises because we assume that anyone renting can claim housing benefit (subject to their income being low enough).

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

**Table A.2. Effect of the new credits on the financial return from working for the first earner in couples with children**

Hours of work	Number of children	Hourly wage	Old replacement rate	Change in replacement rate (percentage points)	Change in cash gain from working
<i>Not renting</i>					
16 hours	1	£4.10	83.8%	-2.0	+£4.76
40 hours	1	£4.10	62.4%	-0.5	+£4.41
16 hours	1	£5.55	75.2%	-1.3	+£4.63
40 hours	1	£5.55	57.4%	-0.1	+£3.37
16 hours	2	£4.10	87.5%	-0.4	+£2.04
40 hours	2	£4.10	68.2%	+0.6	+£1.01
16 hours	2	£5.55	80.0%	0.0	+£1.91
40 hours	2	£5.55	63.4%	+1.0	-£0.13
<i>Renting</i>					
16 hours	1	£4.10	95.4%	-0.3	+£0.89
40 hours	1	£4.10	86.9%	-0.4	+£1.55
16 hours	1	£5.55	93.8%	-0.3	+£0.87
40 hours	1	£5.55	84.0%	-0.9	+£3.37
16 hours	2	£4.10	97.5%	-0.1	+£0.38
40 hours	2	£4.10	89.7%	+0.2	+£0.36
16 hours	2	£5.55	96.4%	-0.3	+£0.96
40 hours	2	£5.55	86.4%	+0.4	-£0.03

Notes: As Table A.1.

Source: Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998-99 Family Resources Survey.

**Table A.3. Effect of the new credits on the financial return from working for the second earner in couples with children**

Hours of work	Number of children	Hourly wage	Old replacement rate	Change in replacement rate (percentage points)	Change in cash gain from working
16 hours	1	£4.10	88.0%	-3.4	+£11.54
40 hours	1	£4.10	72.5%	+0.6	+£0.61
16 hours	1	£5.55	84.4%	-4.2	+£15.37
40 hours	1	£5.55	64.1%	+2.5	-£8.46
16 hours	2	£4.10	89.5%	-3.1	+£11.54
40 hours	2	£4.10	79.3%	-3.3	+£16.68
16 hours	2	£5.55	86.4%	-3.8	+£15.37
40 hours	2	£5.55	72.6%	-0.3	+£4.91

Notes: As for Table A.1 except for the following. The replacement rate is the ratio of net income when both partners work to net income when one partner works 40 hours on the minimum wage. Rent is irrelevant to these results, as the first earner's net pay is already sufficient to have exhausted housing benefit entitlement on the typical rent that we assumed in Tables A.1 and A.2.

Source: Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998-99 Family Resources Survey.



**Table A.4. Effect of the new credits on the financial return from working for single people**

Hours of work	Old replacement rate	Change in replacement rate (percentage points)	Old cash gain from working	Change in cash gain from working
<i>Not renting</i>				
30 hours	50.8%	-7.7	£51.42	+£18.78
40 hours	40.1%	-1.0	£79.34	+£3.45
<i>Renting</i>				
30 hours	88.9%	-4.4	£13.87	+£6.57
40 hours	82.5%	-0.6	£23.64	+£1.05

*Notes:* The replacement rate is the ratio of net in-work income to net out-of-work income. 'Old replacement rate' is that under the April 2001 tax and benefit system. The change in the rate is what would happen if the employment tax credit were introduced immediately. Calculations throughout involve assumptions about the parameters of the new credits, as shown in Box 2.1. Minimum wage assumed throughout. Rent is assumed to be the average household rent for adults in the 1998–99 Family Resources Survey who are: without children, non-pensioners, aged 25 or over, and *either* on income support / jobseeker's allowance *or* in work and being paid at a wage of less than £5 per hour.

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

**Table A.5. Effect of the new credits on the financial return from working for the first earner in couples without children**

Hours of work	Old replacement rate	Change in replacement rate (percentage points)	Old cash gain from working	Change in cash gain from working
<i>Not renting</i>				
30 hours	74.8%	-19.3	£28.06	+£38.62
40 hours	62.3%	-10.8	£50.40	+£27.91
<i>Renting</i>				
30 hours	91.3%	-4.1	£13.39	+£7.24
40 hours	88.9%	-3.5	£17.57	+£6.50

*Notes:* As for Table A.4.

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

**Table A.6. Effect of the new credits on the financial return from working for the second earner in couples without children**

Hours of work	Old replacement rate	Change in replacement rate (percentage points)	Old cash gain from working	Change in cash gain from working
<i>Not renting</i>				
16 hours	66.9%	+12.0	£54.97	-£14.87
30 hours	51.4%	+17.1	£105.19	-£36.33
40 hours	45.5%	+15.8	£133.12	-£38.62
<i>Renting</i>				
16 hours	93.1%	-7.8	£11.54	+£16.51
30 hours	71.5%	+2.6	£61.76	-£4.95
40 hours	63.3%	+3.0	£89.69	-£7.24

*Notes:* As for Table A.4 except that the replacement rate is the ratio of net income when both partners work to net income when one partner works 30 hours on the minimum wage.

*Source:* Authors' calculations using the IFS tax and benefit model, TAXBEN, based on 1998-99 Family Resources Survey.

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