

Supplementary note submitted by the Institute for Fiscal Studies (CP 19b)

CHILD POVERTY AND TAX CREDIT CHANGES

Previous IFS work has confirmed the intuition that, for a given level of expenditure, increasing the per-child element of the child tax credit will have a larger direct impact on poverty than increasing the family element or increasing child benefit.^[9] In a recent note, we built on this by estimating the number of children that would be taken out of poverty by five hypothetical policy reforms:^[10]

- increases in the per-child element of the child tax credit of £3/week.
- increasing all adult allowances in income support by £2.50 a week.
- introducing a new premium into the child tax credit which is paid to families with three or more children. The premium would be worth £845 a year to all families with three or more children with joint annual incomes below £50,000.
- Increasing the working tax credit for all families with children by £11.75 a week.

To allow for a fair comparison, the policies cost roughly the same: £1 billion a year. For all changes except those to the working tax credit, we increase allowances or premia in HB and CTB to ensure that families receiving these benefits gain by the full amount.

Following a request from the chairman of the Work and Pensions Select Committee, we have now modelled the impact of an increase in the working tax credit that would apply only to couples with children (at present, there is no difference in the rate for lone parents and couples with children). We estimate that an increase of roughly £16.80 a week (£875 a year) would cost around £1,060 million, and would therefore be of comparable cost to the policy changes modelled in IFS Briefing Note 41. This would make the working tax credit for a couple equal to £3,900.^[11] The working tax credit for a lone parent would then be equal to around 78% of the value for a couple with children ($£3,025/£3,900 = 78\%$), which would still be higher than the relativities implicit in the McClements equivalence scale (61%), the modified OECD scale (67%), or in income support (64%).

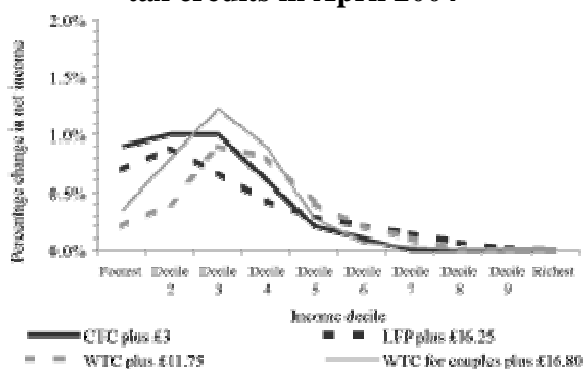
This new policy reform, as well as those first modelled in IFS Briefing Note 41, would largely benefit families with children in the poorest half of society: Figure 1 shows the distributional effect (across all families, not just those with children). It also reveals that:

- The bottom decile gains less than the second and third deciles under all the reforms: this is because there are relatively few families with children in the first decile.
- The reform which benefits the richer half of society the most is the premium for families with three or more children: this is because we have assumed that families with annual incomes up to £50,000 could gain. However, this measure is still relatively effective at reducing child poverty because so many children in families with three or more children are poor.

— Increasing the working tax credit for couples is better targeted on reducing child poverty than increasing the working tax credit for lone parents. This reflects the fact that, under present policies, an otherwise-identical couple and lone parent family will receive the same level of tax credits if they have the same gross earnings, but the use of the McClements equivalence scale means that the HBAI methodology will ascribe a higher standard of living to the lone parent family, and so will be less likely to be counted as poor.

— The gains from increasing the working tax credit are lower in the first two deciles than increases in the child tax credit. This is because the poorest children tend to have parents who are not working 16 or more hours, and therefore cannot benefit from the working tax credit. The per child element of the child tax credit helps all children in poverty, whereas increases in the working tax credit—if limited to couples with children—are more closely focused on children who are just below the poverty line.

Figure 1. Distributional effects of different increases in child-related benefits and tax credits in April 2004



Notes: The figure shows gains in addition to the increase to the per-child element of the child tax credit in line with earnings growth in April 2004 to which the government is already committed. 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 decile 10, which contains the richest tenth. CTC: per child element of child tax credit; IS: income support; LFP: a new child tax credit premium for families with three or more children; WTC: working tax credit for people with children. See text for details of changes.

Source: IFS tax and benefit model, TAXBEN, based on 2000-01 Family Resources Survey

Table 1, which repeats the analysis in IFS Briefing Note 41, shows the impact of these reforms on child poverty. The bottom row shows that an increase in the working tax credit for couples with children would lift around 200,000 children out of poverty if the poverty line is set at 60% of median income measured after housing costs (AHC). This means that this reform is nearly as effective at reducing poverty as increases in the per child element of the child tax credit, or a new premium for families with three or more children; in fact, the difference between the impact of these two measures is not statistically significant, and would not be captured by official HBAI estimates, which round to the nearest 100,000 children.

Table 1 also includes new estimates of the number of children lifted out of poverty if incomes are measured before housing costs (BHC). This shows that increases in the

working tax credit are more effective at reducing poverty AHC than BHC, whereas increases in the child tax credit are more effective at reducing poverty BHC than AHC. Although we have not examined this issue in detail, it probably reflects the fact that measuring poverty BHC leads to a smaller proportion of poor children having working parents; an IFS report due to be published on 30 March will show how the change in the definition of poverty has altered the composition of who is judged to be poor.

Table 1. Effect of possible increases in per-child element of the child tax credit in April 2004

<i>Increase in per-child element of child tax credit in April 2004</i>	<i>Annual per-child credit rate,</i>	<i>Number of children taken out of poverty (60% median income AHC)</i>	<i>Number of children taken out of poverty (60% median income BHC)</i>	<i>Cost per year, 2004 prices (£ million)</i>
Average earnings growth +£155 (£3/week)	£1,650	240,000	320,000	1,040
<i>Other possible changes in April 2004</i>				
Income support adult allowances increased by £2.50/wk.	£1,495	55,000	60,000	1,040
Child tax credit premium of £845 for families with three or more children (£16.25/week)	£1,495	210,000	270,000	1,010
Working tax credit for families with children increased by £610 /year (£11.75/week)	£1,495	150,000	100,000	1,040
<i>Policy reform proposed by CARE</i>				
Working tax credit for couples with children increased by £875 /year (£16.83/week)	£1,495	200,000	190,000	1,060

Notes: "Number of children taken out of poverty" is rounded to the nearest 5,000 and "Cost per year" is rounded to the nearest £10 million, but these should not be interpreted as measures of accuracy. Changes are based on unrounded numbers. The poverty line was allowed to move if the reform altered median household income. Except for the increase in the working tax credit, housing benefit and council tax benefit allowances and premia are adjusted so that families on these benefits gain by the full amount stated. Uses the McClements' equivalence scale.

Source: Authors' calculations from IFS tax and benefit model, TAXBEN, using 2001-02 Family Resources Survey.

There are, of course, other considerations than the impact on child poverty to consider. For example, increases in the per child element of the child tax credit will reduce the financial incentive to work at all and reduce the financial gains to progression, whereas increases in the working tax credit increase the financial incentive for one person in a family to work, but still reduce the financial gains to progression.

Mike Brewer

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9 See Section 4.4 in M. Brewer and G. Kaplan (2003), "What do the child poverty targets mean for the child tax credit?", in *IFS Green Budget 2003*, www.ifs.org.uk/budgetindex.shtml.

10 See M. Brewer (2003). *What do the child poverty targets mean for the child tax credit? An update*, IFS Briefing Note 41.

11 These figures all assume the change took place in April 2003, and are expressed in 2003 prices.