

# THE NEW TAX CREDITS

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# The new tax credits

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The child tax credit and working tax credit were introduced in April 2003. When fully operational, the child tax credit will represent the majority of government financial support for children. It is designed to simplify the system of financial support for parents, and provides support that is means-tested against family income. The working tax credit is designed to make work more financially attractive. It means that people with or without children in work and on a low income may receive extra help from the State.

This Briefing Note looks at:<sup>1</sup>

- the changes to tax credits that happened in April 2003;
- why the new tax credits have been introduced;
- how they work;
- the cost and distributional impact;
- the impact on work incentives;
- what levels of take-up we might expect.

## The structure of tax credits in April 2003

In Budget 2002, the government confirmed that it would be introducing two new tax credits in April 2003: the child tax credit and the working tax credit.

The child tax credit effectively merges together several parts of the existing tax and benefit system that support families with children. Separately, the working tax credit supports adults with or without children in low-paid work, as well as providing subsidies for certain childcare expenditure for some working parents.

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## **What is being abolished?**

The *children's tax credit* reduces the income tax bills of around 5 million income-tax-paying families with children under 16. It was introduced in April 2001 and is subsumed within the child tax credit from April 2003.

The *working families' tax credit (WFTC)* provides support to 1.34 million low-paid families with dependent children<sup>2</sup> working 16 or more hours a week.<sup>3</sup> It is subsumed within the child tax credit and the working tax credit from April 2003.

The *childcare tax credit* subsidises some eligible childcare costs of 167,000 families that also receive the WFTC.<sup>4</sup> It was introduced in October 1999 as part of the WFTC and is subsumed within the working tax credit from April 2003.

*Child allowances and the family premium in income support (IS) or income-related jobseeker's allowance (JSA)* provide extra money to 1.18 million families with dependent children claiming IS or income-related JSA.<sup>5</sup> These will be subsumed within the child tax credit in April 2004.

*Child additions to some National Insurance benefits* provide extra money to around 170,000 families that have dependent children and receive the retirement pension, incapacity benefit, severe disablement allowance, bereavement benefits or invalid care allowance. These additions are being abolished for new claimants only, meaning that no one currently receiving the additions will lose out, but this does represent a long-run cut in the generosity of these benefits.<sup>6</sup>

## **What is new?**

The *child tax credit* provides income-related support to the main carer. By April 2004, around 90% of families with dependent children should be entitled to it.<sup>7</sup>

The *working tax credit* provides in-work support to around 1 million single people and couples with or without children in low-paid work.<sup>8</sup>

Both credits were introduced in April 2003. As described above, families will continue to be entitled to child allowances and family premium in IS or income-related JSA during 2003–04, unless they have already claimed the child tax credit. The rates of IS were altered in October 2002 to ensure that these families did not lose out during this transition period.

## **What is staying?**

*Child benefit* is a universal, non-means-tested payment. All 7 million families with dependent children in the UK are entitled to receive it. It is unaffected by the reforms.

## Why are tax credits being reformed again?

The new tax credits are a much more important and far-reaching reform than the previous changes made by this government to the personal tax and benefit system. The child tax credit changes the entire system of child-related support, and the working tax credit represents the first substantial policy to help those without children when they are working.

The stated aim of the child tax credit is to simplify support for families with children, so that parents have a clearer idea of how much they can expect to receive in respect of their children, and so that families do not need to claim different benefits or tax credits when their circumstances change.

The system in 2002–03 was complicated because there were four main ways by which financial support was directed to families for their children, and families were entitled to and had to claim up to three of these. When the child tax credit is fully phased in, there will be just two: child benefit and the child tax credit. It is true that the previous (2002–03) system was complicated in part because of this government's own reforms: the government argues that the children's tax credit and the WFTC were always intended to be interim steps between the 1996–97 system, which it inherited, and the radical reform of the new tax credits. Indeed, Treasury documents were outlining the case for and the possible structure of a child tax credit one month after the introduction of the WFTC, in November 1999.<sup>9</sup>

Given the existence of the child tax credit, something like the working tax credit for families with children was a necessary reform to ensure that families that would have been entitled to the WFTC were not worse off. Extending the working tax credit to those without children was a discretionary policy decision, though, and the stated aim is to reduce poverty and improve work incentives amongst those without children. There is little evidence, however, to support the introduction of an instrument such as the working tax credit to tackle these aims:

- Those without children who might be entitled to the working tax credit do not tend to be in poverty on standard government definitions (i.e. in households with income below 60% of the national median).
- There is no evidence that individuals without children are deterred from working by inadequate financial incentives. This contrasts strongly with the research findings for those with children that supported the introduction of the WFTC for families with children.<sup>10</sup>
- As shown later, the working tax credit has an ambiguous impact on work incentives, improving the reward to work for some but worsening it for others.

This suggests that the working tax credit may be aimed more at raising the income of those on low incomes in a way that does not create any disincentives to work.

## How will the tax credits work?

The child and working tax credits are both based on gross annual income, jointly assessed for a couple. Entitlement to them is not directly affected by a family's savings, as happens in means-tested benefits and the WFTC. Instead, non-earned income above the first £300 p.a. will be taken into account when calculating awards.

Despite the impression created by the Inland Revenue's advertising, there is nothing that requires the child tax credit to be paid to the woman or the main carer in a couple. The notes to the claim form ask couples to indicate 'which one of you is mostly responsible for caring for the children', but this can be a different person from the one receiving child benefit for the children, and there is no indication that the Revenue will check the responses given.<sup>11</sup> In most practical terms, then, couples choose who will receive the child tax credit. Entitlement to the child tax credit does not depend on whether any adult in the family is working, nor do recipients face any obligations to look for work.

The working tax credit is paid through employers, with the self-employed receiving it direct from the Inland Revenue.

The government claims that the new tax credits, like the WFTC, do not violate the principle of independent taxation. The Inland Revenue has said that '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'.<sup>12</sup> Yet this seems hard to square with its further insistence that 'tax credits form an integral part of the income tax system' and 'entitlement to tax credits must take account of family, rather than individual, circumstances'.<sup>13</sup>

The new tax credits illustrate the government's frustration with both the income tax and the benefits system as ways of targeting financial support: presumably, income tax does not allow sufficiently accurate targeting, and traditional benefits seem to be unacceptably complicated and stigmatising, and not appropriate for a programme that covers 90% of families with children.

### The child tax credit

In 2003–04, the child tax credit consists of two components:

- a family element of £545 p.a. (approximately £10.45 a week), doubled in the financial year of a child's birth;
- an amount per dependent child of £1,445 p.a. (approximately £27.75 a week, and higher for disabled children).

Families with annual gross incomes below £13,230 are entitled to the full amount. Incomes above £13,230 reduce entitlement to the per-child elements at the rate of 37p in the pound until a family is left with just the family element (this happens at £17,135 p.a. for a one-child family and at £21,040 p.a. for a two-child family).<sup>14</sup> Incomes above £50,000 p.a. reduce entitlement to the family element at the rate of 6.7p in the pound, meaning that families with

children with incomes over £58,134 (or £66,269 if they have a child under 1) will be entitled to child benefit only.<sup>15</sup>

Together, this means that:

- around 90% of families with children are entitled to some child tax credit;
- around 50% of families are entitled to both the per-child element and the family element;
- around 40% of families are entitled to the family element only.<sup>16</sup>

The government has promised to increase the per-child element at least in line with average earnings growth until the end of this Parliament. This means that the rate from April 2004 will be around 2.3% higher in real terms than the rate in 2003 if earnings rise in line with their trend of recent years.<sup>17</sup> This, though, is a much smaller annual increase in child-related payments than families saw between 1996 and 2003, and equates to a real increase in incomes of only 0.7% for couples with two children on income support or income-related jobseeker's allowance (0.8% for a lone parent with two children).<sup>18</sup>

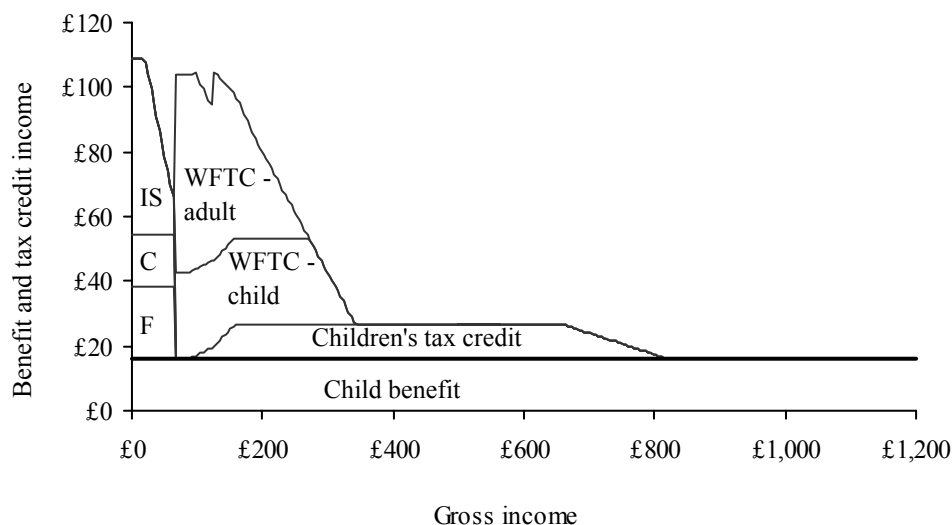
### **The working tax credit**

In 2003–04, the working tax credit consists of the following:

- Single people without children are entitled to a credit of £1,525 p.a. (approximately £29.30 a week).
- Couples with or without children and lone parents are entitled to a credit of £3,025 p.a. (approximately £58.15 a week).
- There is a bonus of £620 p.a. (approximately £11.90 a week) for those working 30 or more hours a week.
- Families with children where all adults are working, caring or disabled can receive help with approved childcare costs. This operates in the same way as the childcare tax credit under the WFTC, paying 70% of approved childcare costs below a generous maximum (£135 a week for those with one child under 16, £200 for others).<sup>19</sup>
- There are extra amounts for some adults with disabilities and for people over 50 returning to work.
- Families with children must work 16 or more hours a week to be entitled, and those without children must work 30 or more hours a week (and will therefore always be entitled to the bonus for working full-time).

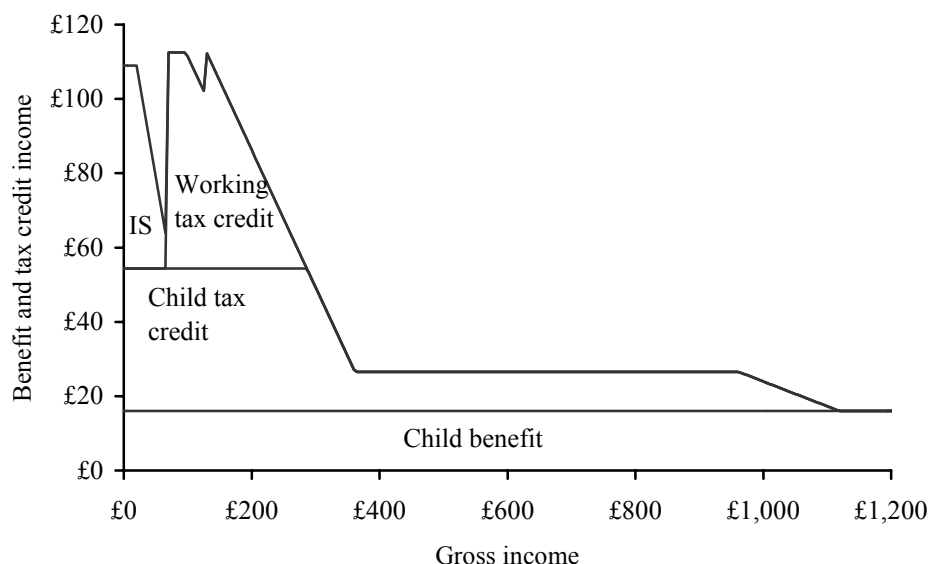
Families with annual incomes below £5,060 are entitled to the full amount. Incomes above this level reduce entitlement at the rate of 37p in the pound. Entitlement is exhausted at around £10,857 p.a. for a single person without children, £13,230 for a lone parent or a couple with children working part-time, and £14,911 for a lone parent or a couple with or without children working full-time. It is theoretically possible for a family with children spending the maximum allowed on childcare (£10,430 a year) to be entitled to the working tax credit at incomes of £34,586.

**Figure 1. Financial support for a family with one child under the outgoing system (£ per week)**



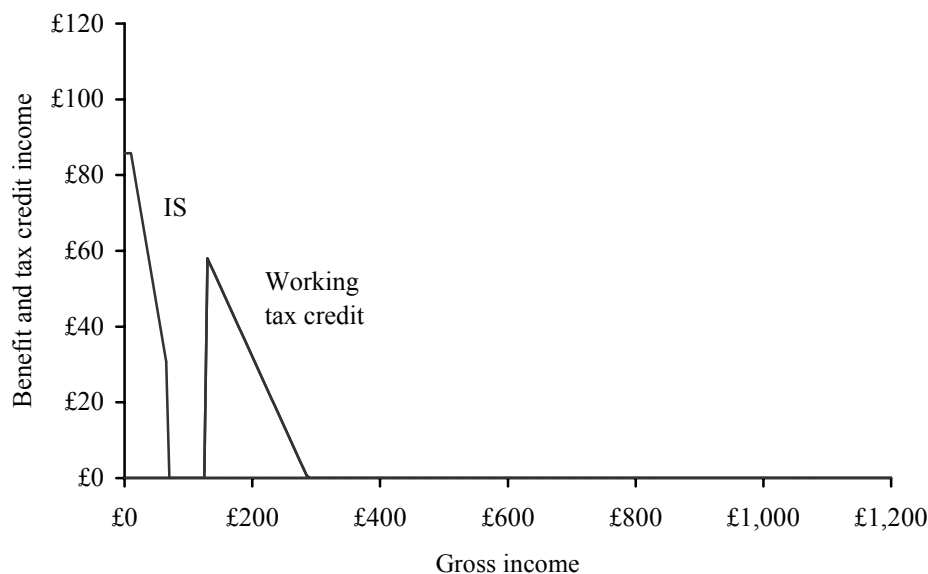
*Notes:* IS is adult allowance, F is the family premium and C is the child allowance in income support or income-related JSA. The graph uses hypothetical April 2003 rates for the WFTC and the children's tax credit assuming the usual uprating rules. It does not show the childcare tax credit, housing benefit or council tax benefit, and it ignores extra support paid in the first year of a child's life.

**Figure 2. Financial support for a family with one child under the new tax credits (£ per week)**



*Notes:* The new tax credits are annual systems but this graph treats them as weekly. It also assumes that the new tax credits are implemented fully in April 2003 and that a family qualifies for working tax credit at 16 hours of minimum-wage work (£67.20 p.w.) and for the 30-hour premium at £126 p.w. It does not show the childcare tax credit, housing benefit or council tax benefit, and it ignores extra support paid in the first year of a child's life.

**Figure 3. Financial support for a couple without children under the new tax credits (£ per week)**



*Notes:* The working tax credit is an annual system but this graph treats it as weekly. It also assumes that a family loses entitlement to income support at 16 hours of minimum-wage work (£67.20 p.w.) and qualifies for working tax credit at 30 hours of minimum-wage work (£126 p.w.). It does not show housing benefit or council tax benefit.

The structures of the new tax credits and the systems they replace are illustrated in Figures 1, 2 and 3.

Some of the novel and most complicated aspects of the new tax credits concern how they react to changes in families' circumstances (the Appendix contains some worked examples):

- Formally, the tax credits depend on income in the current tax year. From 2004 onwards, most families will apply for or renew an award in the summer, at which point an award will be made based on annual income in the previous tax year (there are different arrangements for 2003–04: families should already have applied, and the awards are initially based on income in 2001–02).
- After the end of the tax year, though, the Revenue will recalculate awards based on people's actual income in the tax year. Families whose income has fallen and that are therefore entitled to more tax credit will receive the balance due to them. Families whose income has risen and that have been paid too much tax credit may have to pay some of the extra back, although the first £2,500 of income changes will be disregarded when performing this calculation. These corrections will be made either by adjusting future awards or by one-off payments.
- People can apply for the tax credits in mid-year and can ask for their awards to be recalculated at any point. In these cases, awards will be based on an estimate of their current-year income. To prevent manipulation of



the system, in these cases, payments will be recalculated at the end of the year, as above, but there will be no disregard for income rises.

- In addition to this, families claiming help with childcare costs need to inform the Inland Revenue if their weekly spending on childcare (averaged over four weeks) changes by more than £10. This could mean that families have to reapply several times a year if childcare arrangements change substantially during school holidays.

These features mean that the tax credits are not a pure annual system, such as the earned income tax credit in the USA. There is a danger that this will cause uncertainty amongst families, as people cannot be sure that they will not have to pay back credit they are currently receiving. It also means that the amount of tax credit being received by families in a given month may bear little relationship to their circumstances in that month.

The government estimates that in 2004–05 and later years, 1 million families will be entitled to extra tax credit and a further 750,000 families will face the possibility of having to pay back credit to the Revenue because they experience a rise in income of over £2,500. These 1.75 million families (a quarter of families in Britain) do not include those whose award may change when children enter or leave the household, nor those who experience changes in marital or relationship status; these families will have to reapply for the tax credits when such an event occurs.<sup>20</sup>

This problem will be worse in 2003–04, because awards were based on income data that were two years out of date rather than one. Around 1 million families (rather than 750,000) face the possibility of having to pay back credit to the Revenue.<sup>21</sup> This means that Summer 2004 – when families' awards for 2003–04 will be finally reconciled and awards for 2004–05 set to recover the overpayments – will see a crucial test of the popularity of the new tax credits.

### **The implications for employers**

The Inland Revenue's own regulatory impact assessment suggests that employers should save £11 million a year in compliance costs compared with the WFTC.<sup>22</sup> This is mainly because the Revenue has simplified the administrative process (for example, employers will not have to stop and start awards every six months, nor do anything extra when an employee leaves). These savings may, though, be offset by increases in compliance costs or administrative costs for individuals or the Revenue, neither of which have been quantified by the Revenue.

There will be a gain to employers because some people receiving the child tax credit – which is paid direct to parents – will previously have received the WFTC via their employers. However, the extension of the working tax credit – which is always paid through employers – to those without children means that the overall number of employers paying tax credits remains around 300,000.<sup>23</sup>

## The cost and distributional impacts

The Treasury estimates that the new tax credits will cost £2.7 billion in 2003–04, and slightly less in 2004–05 (see Table 1).

**Table 1. The cost of the new tax credits**

New tax credits	2003–04 (£m)	2004–05 (£m)
For families with children	2,450	2,300
For families without children	250	300

Source: Table A.1 in Budget 2002.

However, this cost should be seen in the context of the increases in benefits and tax credits for families with children seen so far under Labour. The total level of central government financial support that is conditional on having children has risen from £13.7 billion in 1997, to £19.2 billion in 2002 and £21.2 billion in 2003.<sup>24</sup> The government estimates that £13 billion of support will be channelled through the child tax credit,<sup>25</sup> which means that it will replace child benefit as the most important programme for supporting families with children.

Amongst the 7 million families with children in Great Britain, around 4.1 million will gain and 300,000 will lose from the new tax credits (changes of less than 50p a week have been ignored, and numbers are rounded to the nearest 100,000).<sup>26</sup> The majority of the gainers are families that would have been eligible for either income support or the WFTC.

The main explanations for the changes are:

- Families with incomes below £8,000 a year paid insufficient income tax to benefit fully from the children's tax credit. In addition, everyone on the WFTC taper and receiving the children's tax credit saw the tax cut that the old credit represented partially offset by a reduction in WFTC awards. The children's tax credit is now the family element of the child tax credit, and so these two sets of families gain by up to £545 a year.
- WFTC awards used to be reduced by 55p for every pound of income in excess of some threshold *after* deducting income tax and National Insurance (NI). The new tax credits will be reduced by 37p for every pound of income in excess of some threshold *before* deducting income tax and NI. The new taper rate of 37p in the pound was chosen so that these two calculations give the same reduction at the margin for an individual who pays basic-rate income tax and NI. But the change will be of benefit for almost all families that are on the first taper of the new tax credits, and particularly for those individuals who earn too little to pay income tax or NI.
- Some well-off two-earner couples are worse off because the child tax credit begins to be withdrawn when joint income exceeds £50,000, whereas the children's tax credit began to be withdrawn when the higher income exceeded £34,000 regardless of the size of joint incomes. For example, a couple with joint incomes above £50,000 but where neither

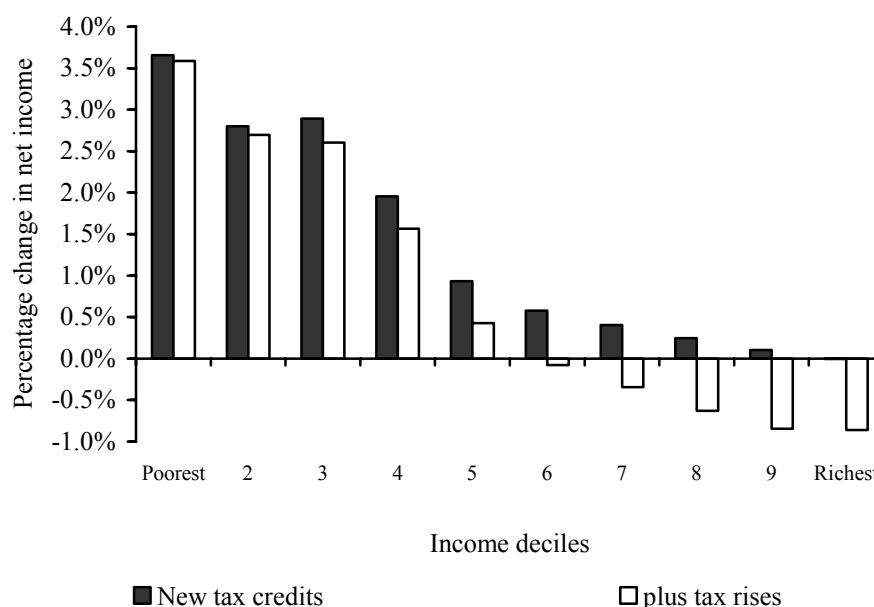
partner earns more than £34,000 is £545 a year worse off. We estimate that around 200,000 well-off couples will lose by at least 50p a week through this change.

- For the same reason, some well-off couples are better off under the child tax credit than under the children’s tax credit. For example, a couple where the higher earner earns at least £42,000 but joint income is less than £50,000 is £545 a year better off. We estimate that around 600,000 well-off families will gain by at least 50p a week through this change.

Other changes affecting a small number of families are as follows:

- Families with new-born children and low incomes gain from the extra child tax credit for children under 1, previously only available to those qualifying for the children’s tax credit.
- Families with only dependent children aged 16–19 may gain as they will be entitled to the child tax credit whereas previously they could not claim the children’s tax credit.
- Child additions to some non-means-tested benefits (e.g. incapacity benefit) have been abolished for new claimants.
- The definition of income for the new tax credits is different from that used when calculating IS/JSA and WFTC, and this will lead to a few small changes in tax credit awards.

**Figure 4. Distributional effects of the new tax credits and the tax rises in April 2003**



*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.

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

The impact of the working tax credit on those without children is straightforward: people working full-time but on a sufficiently low income to qualify for some tax credit will see their income rise. No one will lose from the reform. The size of the gain depends upon the incomes of the family as long as they work at least 30 hours a week: the gains are larger for poorer households.

The distribution of income changes as a result of the new tax credits is shown in Figure 4, which assumes full take-up of all benefits and tax credits. The gains decline as income rises, fully in keeping with the pattern of Labour's reforms to date.<sup>27</sup>

This pattern is emphasised if we include the impact of the rise in employee and self-employed NI and income tax due in April 2003: the bottom five deciles gain on average, but the richest five deciles lose on average.<sup>28</sup>

## **Will the credits improve work incentives?**

Although improving the financial incentives to work is not the main aim of the new tax credits for families with children, there are some important changes in this area:

- Compared with previous tax and benefit systems, low-earning families with children generally receive higher incomes both in and out of work. This improves the financial gain to working compared with not working for some and reduces it for others. Most of these changes, though, are relatively small in magnitude.
- The effective tax rates of about a third of parents (including those not working) will change. Around 1.6 million will face a higher effective marginal tax rate because of the new tax credits. These are mostly people who previously earned too much to be entitled to the WFTC, but who are now on the first taper of the child tax credit. For every extra pound they earn, they now get to keep less. Conversely, 2.4 million will see their effective marginal tax rates fall, mostly because the credits will be assessed against gross income, which particularly benefits those who earn too little to pay basic-rate income tax.
- Another important set of changes occur because the old children's tax credit, which was withdrawn based on the income of the higher earner in a two-earner family, is being replaced by the child tax credit, which is based on joint income. The change means that both individuals in a couple whose joint income places them on the second taper of the child tax credit now face an increase of 6.7 percentage points in their effective marginal rate. Under the children's tax credit, though, only the higher earner faced this addition to his or her effective marginal rate. We estimate that the number of individuals whose effective marginal tax rate is 6.7 percentage points higher thanks to the child tax credit (600,000) is therefore higher than the number affected similarly by the children's tax credit (400,000).

- In general, those whose marginal rates fall tend to have high marginal rates to start with, and those whose rates rise tend to have low marginal rates to start with.

However, there are more substantial changes to financial work incentives amongst those without children affected by the working tax credit. The government has said that:

The Working Tax Credit will provide support for working households which have neither dependent children nor a worker with a disability or illness, provided the applicant is in full-time employment. This will increase work incentives for all low-income households ... Specifically, the Working Tax Credit will help tackle the unemployment trap that arises when the difference between in and out of work incomes is too small to provide an incentive for those currently out of work to take a job. The new tax credits will also help tackle the poverty trap which discourages those already in work, or with working partners, from working longer hours, moving to a better paid job or entering work, because higher in-work income is offset by reduced in-work support and higher tax and National Insurance Contributions.<sup>29</sup>

This only tells half the story, as there are both negative and positive effects:

- The working tax credit will improve the financial reward from moving into work for some (single people and the primary earner in a couple) but worsen it for others (some second earners in couples). This is very similar to the impact of introducing the WFTC.
- It is difficult to see how the working tax credit will 'help tackle the poverty trap' (cited above), because, on our estimates, if all those who are entitled to the credit were to claim it, around 800,000 people without children would see their effective marginal tax rate increase and around 50,000 would see it fall. Overall, the number of adults without children facing marginal deduction rates between 50% and 70% would increase by around 490,000.

It must, however, be stressed that government estimates of how many families will claim the working tax credit are lower than ours; the most obvious explanation is that the government has assumed a more realistic take-up rate than our assumption of 100%. If fewer families claim, though, then fewer individuals will see their marginal rates (and their incomes) increase.

## **Take-up of the new tax credits**

The new tax credits confirm the Labour government's belief in targeted support assessed against joint family income. A practical disadvantage of means-tested benefits and income-related tax credits is that people have to apply for them and not everyone does, either because they do not know they are eligible or because they decide not to apply. By contrast, income tax cuts affect income-tax-payers automatically, and most universal benefits are claimed by virtually all who are entitled.

The WFTC take-up rate has been estimated at 62–65%, lower than that for family credit (72% in Summer 1999) and much lower than the estimated take-up rates for income support and housing benefit (over 95% in 1999–2000). People who do not claim benefits or tax credits tend to be entitled to small

amounts; even so, non-take-up of the WFTC, for example, saved the government around £1.4 billion a year in 2000–01.<sup>30</sup>

The government's estimate of the take-up rate for the child tax credit is around 90%, as it has claimed that 90% of families with children will be eligible for the new tax credits and that 5.75 million will receive them, and as there are around 7.25 million families with children in the UK. This implies that around 775,000 families with children will not claim the child tax credit despite being entitled, slightly more families than did not claim the WFTC in 2000–01 despite being entitled.<sup>31</sup> There are several ways that the introduction of the child tax credit and the working tax credit might change take-up behaviour compared with that for the existing tax credits and benefits:

- The child tax credit will go to the vast majority of families with children, with all save the richest 10% entitled to something. This should reduce the likelihood that families do not claim because they think that they will not be entitled or that they will only be entitled for a short time.
- Although precise figures are not known, the government is almost certainly spending more money advertising the new tax credits than it did on advertising the WFTC and the children's tax credit, and so awareness may be higher.
- However, experience from family credit and the WFTC suggests that take-up will probably take a couple of years to rise to its new long-run level, as awareness of the reform spreads amongst the population.
- The nature of the means test and the administration of the credits will be different from those of the old tax credits. The claim form requires more information than for the children's tax credit but less than for the WFTC or income support. Also, as discussed earlier, the tax credits will require an end-of-year reconciliation which may involve people paying money back to the Inland Revenue. These changes may make families more or less likely to claim compared with the 2002–03 system.

We estimate that average entitlements to working tax credit for those without children are less than £20 a week, with around 650,000 families entitled. It is not clear what take-up rate is being assumed by the government for the working tax credit for people without children. Our estimates of the total cost of the working tax credit for people without children assuming full take-up are over twice those of the government, although it is unclear whether all other assumptions are the same in both models. Given related reforms in the past, it is perfectly plausible that the take-up rate for working tax credit for people without children could be below 50%.<sup>32</sup>

## Conclusion

The new tax credits are a substantial reform, affecting nearly 7 million families in Britain. Their distributional impact is fully in keeping with that of past Labour reforms, with the largest gains going to the poorest families, and with households with children gaining far more, on average, than those without.

Those who are entitled to the tax credits may find that both their financial reward to work and their effective marginal rates of tax change slightly. For those with children, the changes are relatively small, and the overall impact is ambiguous. For those without children, their reward to full-time work increases but their effective marginal tax rates also increase.

Labour's previous reforms to the personal tax and benefit system have merely involved changing the generosity of existing programmes. But the success or failure of the new tax credits depends as much on the practicalities of administration and delivery as on calculations of the precise amounts of money involved. This makes it hard to predict whether the government will manage to persuade the vast majority of those who are entitled to claim the tax credits actually to do so, and whether people will understand the complicated way in which the credits react to changes in family circumstances.

The new tax credits underline the government's frustration with individual taxation and the Pay-As-You-Earn (PAYE) mechanism as ways to target resources on the basis of household need. They also show that the government is happy to increase the administrative responsibilities of basic-rate taxpayers with children, many of whom will now complete a form similar to the annual tax return completed by those who undergo self-assessment (those earning more than £34,000, the self-employed and those with complicated tax affairs). Both of these changes may point to the way Labour would ultimately like to see the income tax system structured.

## **Appendix: How the tax credits might respond to changes in incomes**

The table in this appendix gives some worked examples of how the new tax credits react to changes in financial circumstances for a single-earner couple in full-time work with two children and no childcare costs, earning £15,000 in Year 1, leading to an initial Year 2 award of £3,402 based on income in Year 1. It also assumes April 2003 tax credit rates for all three years.

In cases 2a–2c, the income change and the eventual award for Year 2 are the same, but the timings of the payments differ.

	Year 2		Year 3	
1.	Annual income rises by £1,000 to £16,000	No change to award	Actual income in Year 2 (£16,000) compared with income in Year 1 (£15,000); no action as income change less than £2,500	Tax credit for Year 3 set at £3,032 based on Year 2 income of £16,000
2a.	Annual income rises by £4,000 to £19,000; provide correct estimate of annual income in Year 2 to Inland Revenue	Award falls by 37% of estimated change ignoring first £2,500 of changes (i.e. £555)	Actual income in Year 2 (£19,000) compared with estimate of income in Year 2 (£19,000); no reconciliation needed	Tax credit for Year 3 set at £1,922 based on Year 2 income of £19,000
2b.	Annual income rises by £4,000 to £19,000; provide incorrect estimate of annual income (£18,000) in Year 2 to Inland Revenue	Award falls by 37% of estimated change ignoring first £2,500 of changes (i.e. £185)	Actual income in Year 2 (£19,000) compared with estimate of income in Year 2 (£18,000); family must repay 37% of the difference to Inland Revenue (i.e. £370)	Tax credit for Year 3 set at £1,922 based on Year 2 income of £19,000
2c.	Annual income rises by £4,000 to £19,000; do not inform Inland Revenue	No change to award	Actual income in Year 2 (£19,000) compared with income in Year 1 (£15,000); family must repay 37% of the difference ignoring first £2,500 to Inland Revenue (i.e. £555)	Tax credit for Year 3 set at £1,922 based on Year 2 income of £19,000
3.	Annual income falls by £1,000 to £14,000; do not inform Inland Revenue	No change to award	Actual income in Year 2 (£14,000) compared with income in Year 1 (£15,000); family entitled to 37% of the income fall from Inland Revenue (i.e. £370)	Tax credit for Year 3 set at £3,772 based on Year 2 income of £14,000

## Notes

1. It draws on and updates previous work by researchers at IFS, including: chapter 4 of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, IFS Commentary 92, London, 2003 ([www.ifs.org.uk/gb2003/ch4.pdf](http://www.ifs.org.uk/gb2003/ch4.pdf)); M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, IFS Commentary 86, London, 2001 ([www.ifs.org.uk/taxben/taxcred.pdf](http://www.ifs.org.uk/taxben/taxcred.pdf)); and chapter 5 of A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2002*, IFS Commentary 87, London, 2002 ([www.ifs.org.uk/gb2002/chap5.pdf](http://www.ifs.org.uk/gb2002/chap5.pdf)). The main government source is HM Treasury, *The Child and Working Tax Credits, The Modernisation of Britain's Tax and Benefit System 10*, London, 2002 ([www.hm-treasury.gov.uk/mediastore/otherfiles/new\\_tax\\_credits.pdf](http://www.hm-treasury.gov.uk/mediastore/otherfiles/new_tax_credits.pdf)). A more detailed explanation of how the credits work can be found in D. Thurley, 'Tax credits and income changes', *Welfare Rights Bulletin*, 169, Child Poverty Action Group, August 2002.
2. In all of this, a dependent child is one under 16, or under 19 and in full-time education.



3. Inland Revenue, *Working Families' Tax Credit Statistics: Quarterly Enquiry, May 2002*, London, 2002 ([www.inlandrevenue.gov.uk/wftctables/wftc\\_may\\_02.pdf](http://www.inlandrevenue.gov.uk/wftctables/wftc_may_02.pdf)).
4. See note 3.
5. Department for Work and Pensions, *Income Support: Quarterly Statistical Enquiry, August 2002*, London, 2002 ([www.dwp.gov.uk/asd/asd1/qse/aug2002/is\\_aug2002\\_pub.pdf](http://www.dwp.gov.uk/asd/asd1/qse/aug2002/is_aug2002_pub.pdf)).
6. It is difficult to obtain comparable figures on how many parents gain from each of these benefits separately: what follow are from different sources, but all relate to 2002, with the month in parentheses: 2,832 families received child additions through ICA (May); 53,700 parents received child additions through bereavement benefits (March); 96,700 families received child additions through IB or SDA (August); and 23,000 pensioners were receiving child additions to the state pension (May).
7. HM Treasury, *The Child and Working Tax Credits*, The Modernisation of Britain's Tax and Benefit System 10, London, 2002 ([www.hm-treasury.gov.uk/mediastore/otherfiles/new\\_tax\\_credits.pdf](http://www.hm-treasury.gov.uk/mediastore/otherfiles/new_tax_credits.pdf)).
8. See note 7.
9. See HM Treasury, *Supporting Children through the Tax and Benefit System*, The Modernisation of Britain's Tax and Benefit System 5, London, 1999 ([www.hm-treasury.gov.uk/media/F174F/children.pdf](http://www.hm-treasury.gov.uk/media/F174F/children.pdf)).
10. HM Treasury, *Work Incentives: A Report by Martin Taylor*, The Modernisation of Britain's Tax and Benefit System 2, London, 1998 ([www.hm-treasury.gov.uk/media/6A702/taylor.pdf](http://www.hm-treasury.gov.uk/media/6A702/taylor.pdf)).
11. See page 35 of Inland Revenue form 'TC600 notes', entitled 'How to complete your tax credits claim form for 2003'.
12. Paragraph 11 of Inland Revenue, *New Tax Credits*, London, 2001 ([www.inlandrevenue.gov.uk/consult\\_new/new\\_tax\\_credits.pdf](http://www.inlandrevenue.gov.uk/consult_new/new_tax_credits.pdf)).
13. Paragraphs 9 and 14 respectively of Inland Revenue, *New Tax Credits*, London, 2001 ([www.inlandrevenue.gov.uk/consult\\_new/new\\_tax\\_credits.pdf](http://www.inlandrevenue.gov.uk/consult_new/new_tax_credits.pdf)).
14. These three annual thresholds are higher if a family qualifies for extra credits for working at least 30 hours a week or for having disabled adults or children, or receives help for childcare costs.
15. The formula used by the Inland Revenue to calculate awards is more complicated than suggested here due to errors introduced by rounding the results of intermediate calculations. The overall impact is that actual annual awards will be slightly higher than those implied by the numbers here. For the precise details of how awards are calculated, see [www.legislation.hmso.gov.uk/si/si2002/20022008.htm](http://www.legislation.hmso.gov.uk/si/si2002/20022008.htm).
16. Author's calculations based on the IFS tax and benefit model, TAXBEN, using data from the 2000–01 Family Resources Survey.
17. The average annual growth in nominal earnings between 1998 and 2001 was 4.74%. This would imply a per-child element of £1,515 in April 2004. The inflation rate averaged over the same period is 2.43%, implying that the annual real rise would be just £35.
18. Total income defined as income support, child benefit and the child tax credit.
19. 'Approved' childcare is broadly comparable to formal childcare and includes childminders, nurseries and playgroups registered with a local authority, and some out-of-school clubs run by schools. It does not include informal arrangements made between family and friends. See chapter 7 of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, IFS Commentary 92, London, 2003 ([www.ifs.org.uk/gb2003/ch7.pdf](http://www.ifs.org.uk/gb2003/ch7.pdf)).

20. Chapter 4 of HM Treasury, *The Child and Working Tax Credits*, The Modernisation of Britain's Tax and Benefit System 10, London, 2002 ([www.hm-treasury.gov.uk/mediastore/otherfiles/new\\_tax\\_credits.pdf](http://www.hm-treasury.gov.uk/mediastore/otherfiles/new_tax_credits.pdf)).
21. See note 20.
22. Inland Revenue, *The New Tax Credits: A Regulatory Impact Assessment*, London, 2002 ([www.inlandrevenue.gov.uk/ria/ntcria.pdf](http://www.inlandrevenue.gov.uk/ria/ntcria.pdf)).
23. See note 22.
24. In January 2003 prices. Author's calculations as part of ongoing work funded by the Joseph Rowntree Foundation, updating S. Adam, M. Brewer and H. Reed, *The Benefits of Parenting: Government Financial Support for Families with Children Since 1975*, IFS Commentary 91, London, 2002 ([www.ifs.org.uk/taxben/c91.pdf](http://www.ifs.org.uk/taxben/c91.pdf)).
25. Annex A of HM Treasury, *The Child and Working Tax Credits*, The Modernisation of Britain's Tax and Benefit System 10, London, 2002 ([www.hm-treasury.gov.uk/mediastore/otherfiles/new\\_tax\\_credits.pdf](http://www.hm-treasury.gov.uk/mediastore/otherfiles/new_tax_credits.pdf)).
26. Our estimates in this section come from the IFS tax and benefit model, TAXBEN, based on the 2000–01 Family Resources Survey.
27. See chapter 9 of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, IFS Commentary 92, London, 2003 ([www.ifs.org.uk/gb2003/ch9.pdf](http://www.ifs.org.uk/gb2003/ch9.pdf)).
28. See appendix B of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, IFS Commentary 92, London, 2003 ([www.ifs.org.uk/gb2003/appb.pdf](http://www.ifs.org.uk/gb2003/appb.pdf)) for a full analysis of the changes announced in Budget 2002 and due in 2003–04.
29. Paragraph 2.5 and footnote 3 of Inland Revenue, *The New Tax Credits: A Regulatory Impact Assessment*, London, 2002 ([www.inlandrevenue.gov.uk/ria/ntcria.pdf](http://www.inlandrevenue.gov.uk/ria/ntcria.pdf)).
30. WFTC take-up rates from Inland Revenue, *Working Families' Tax Credit: Estimates of Take-Up Rates in 2000–01*, London, 2002 ([www.inlandrevenue.gov.uk/stats/wftc/wftc\\_takeup.pdf](http://www.inlandrevenue.gov.uk/stats/wftc/wftc_takeup.pdf)). Family credit take-up rates from A. Marsh, S. McKay, A. Smith and A. Stephenson, *Low-Income Families in Britain*, DSS Research Report 138, Corporate Document Services, Leeds, 2001. Take-up rates for other means-tested benefits from Department for Work and Pensions, *Income Related Benefits: Estimates of Take-Up in 1999–2000*, London, 2001 ([www.dwp.gov.uk/asd/income\\_analysis/tu9900f.pdf](http://www.dwp.gov.uk/asd/income_analysis/tu9900f.pdf)).
31. The take-up rate for the children's tax credit is not known, unfortunately.
32. The take-up rate for WFTC amongst couples with children is around 50%, and this is a group whose mean entitlement is £53 a week – far in excess of the £20 a week mean entitlement to the working tax credit for those without children. In the late 1990s, a policy called Earnings Top-Up was piloted in a number of areas. Its design was similar to that of the working tax credit for those without children, although it was less generous. Its take-up rate was very low – less than a quarter – although the benefit was only publicised during its first six months, after which word of mouth was the only means by which people could find out about it. One point from the evaluation of this pilot is that word of mouth is an important way by which people hear about benefits and tax credits and that there is a critical mass below which awareness fails to spread (A. Marsh, *Earnings Top-Up Evaluation: Synthesis Report*, DSS Research Report 135, Corporate Document Services, Leeds, 2001).