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Commons Library brief for Opposition Day Debate, Tax credits and support for working families, 1 July 2015

Summary

Tax credits – the Child Tax Credit and the Working Tax Credit – were introduced in April 2003 to "tackle child poverty and help to make work pay." They replaced Working Families Tax Credit and Disabled Persons Tax Credit, which had been introduced in 1999. At April 2015, 4.6 million families containing 7.6 million children were receiving tax credits. 3.3 million tax credit recipients (72% of the total) were in-work families, of whom 2.7 million had children. Total expenditure on tax credits in the UK is forecast to be £29.5 billion in 2015-16. Expenditure on tax credits increased significantly in real terms during Labour's term in office.

The Labour Government argued that tax credits would provide a secure stream of income for families with children, whether in or out of work, while tackling poor work incentives. A common framework based on annual assessment, it was argued, would result in a fairer and more transparent system, with less form-filling and simpler administration, while still being responsive to changing needs and circumstances. However, problems were encountered from the outset and in the first year nearly two million families were overpayed a total of £2.2 billion. Overpayments fell in subsequent years, but have increased again – in 2013-14, overpayments of £1.9 billion were incurred. HMRC's policy on recovering overpayments continues to cause controversy.

Studies of the impact of tax credits suggest they played an important role in reducing child poverty rates; and in helping to maintain low to middle income families' living standards, particularly with the stagnation of earnings in the mid-2000s. Studies also suggest a small but positive boost to employment levels (particularly for lone parents), although the increased number of families facing relatively high rates of withdrawal may have reduced incentives for increasing earnings for those already in work.

Tax credits – along with various means-tested benefits for families of working age – are being replaced by Universal Credit, although the new benefit is not expected to be fully phased in until 2020. The 2010 Government brought in a package of tax credit changes aimed at "controlling the costs of tax credits" in order to "provide a fair and affordable platform for the introduction of the Universal Credit." Savings of around £7 billion a year are expected by 2019-20.

There has been recent media speculation that the Government may be considering further cuts to tax credits, to help meet its target of an additional £12 billion a year in welfare savings. One option reportedly under consideration is reducing the child element of Child Tax Credit to its 2003-04 level (adjusted for inflation). It is estimated that this would save around £5 billion, but it would have a significant impact on low-income families, including those in work. In a speech on 22 June, the Prime Minister referred to the "merry-go-round" of people working on the minimum wage, paying tax and then receiving in-work benefits from the government; arguing instead for a move "from a low wage, high tax, high welfare society to a higher wage, lower tax, lower welfare society." Announcements on how the Government intends to make further welfare savings are expected in the forthcoming Budget on 8 July.

What are tax credits?

The new tax credits were introduced in April 2003 to replace the existing Working Families' Tax Credit (WFTC) and Disabled Person's Tax Credit (DPTC). Many people still refer to the Working Families' Tax Credit, but it no longer exists.

Tax credits comprise:

- **Child Tax Credit (CTC)**, payable to people with children. Along with Child Benefit, it provides a single system of financial support for families with children, whether in or out of work. It also replaces the additions for children that were payable with benefits such as Income Support and income-based Jobseeker's Allowance (although a small number of long-term benefit claimants may continue to receive amounts for their children along with their benefit payments rather than via tax credits).

- **Working Tax Credit (WTC)**, payable to people in low-paid work, including those without children. Those with children may be able to get help with childcare costs via the childcare element of the Working Tax Credit.

People may receive the CTC, or the WTC, or both. Tax credits are claimed on a family rather than an individual basis, so that for couples the incomes and circumstances of both partners will be taken into account.

How much a family receives from tax credits will depend on a number of factors including:

- The number and ages of the children, and whether any are disabled

- The number of hours worked by the adults, and whether they are disabled

- Whether the family is incurring childcare costs for eligible childcare

- The family's income from earnings and other sources

Tax credits are means-tested; i.e. the amount received depends on income, so that in general the amount received tapers away as income increases.

Tax credits are based on an annual cycle which coincides with the tax year (running from April to April). Awards are based initially on a family's income for the previous tax year, and their circumstances at the beginning of the tax year. Awards run for twelve months, after which the claim must be renewed. Claimants are asked to confirm their circumstances for the year that has just ended, and provide information on actual income received over the year. This is then used by the Revenue to "finalise" the award for the year ended: the family's actual tax credit entitlement for the period is determined and reconciled with what has actually been paid out over the course of the year. The income information also determines the initial award for the next year.

Some changes in circumstances during the year must be reported to the Revenue as they occur, and the award is adjusted accordingly. Other changes do not need to be reported in-year, but it may be in the claimant's interests to do so.

Further information:

Library briefing Constituency casework: tax credits

“What are tax credits?” in HMRC’s Child and Working Tax Credit Statistics - Finalised annual awards 2013-14

Why were tax credits introduced?

Tax Credits were introduced by the Labour Government in April 2003 to “tackle child poverty and help to make work pay.” WTC would be payable to low income working people, including those without children; while CTC along with Child Benefit, would constitute a “single, seamless system of support for families with children, payable irrespective of the work status of the adults in the household.” The Government believed that this would ease the transition from welfare to work for families with children, and create a more inclusive system of support for children that did not stigmatise poorer families.

In response to a PQ in January 2006, the then Paymaster General, Dawn Primarolo, set out the principles underpinning the Labour Government’s policy towards providing financial support for families with children:

> “The Government's system of financial support for families with children is built on the principle of progressive universalism, delivering help for all families and more help for those who need it most. Universal child benefit forms the foundation of this system, recognising the extra costs and responsibilities associated with bringing up a child. The Government believe it is right that society should recognise the importance of family life by providing financial support for every family with a dependent child, and will not tax child benefit. Child benefit is complemented by child tax credit, which delivers greatest support to those who need it most, including families on lower incomes, those with children under one, and parents of disabled children.”

Further information:

HM Treasury, The Child and Working Tax Credits: The Modernisation of Britain’s Tax and Benefit System: Number Ten, April 2002

What was the impact of tax credits?

A recent Institute for Fiscal Studies working paper covering trends in child poverty since the 1990s, by far the most significant factor in explaining the reduction in measured child poverty over the period was the “substantial increase in spending on means-tested cash transfer entitlements for low-income families with children.” This included, but was not limited to, the introduction and subsequent expansion of the tax credit system. Total expenditure on tax credits in the UK increased from £17.6 billion in 2003-04 to £31.4 billion in 2010-11 (figures in real terms, at 2015-16 prices). Expenditure increased further – to £31.9 billion – in 2011-12, but subsequently fell back slightly. Nevertheless, expenditure on tax credits is still forecast to be £30.0 billion in 2019-20 (at 2015-16 prices).

A 2012 report by the Resolution Foundation assessed the impact of the tax credit systems in place between 1999 and 2008 across five areas: child poverty reduction; supporting incomes among low paid in-work households; boosting employment; the interaction with wages; and patterns of family formation. The authors found-

> “…evidence of several successes in relation to poverty reduction, income support and overall employment, along with a predictably negative impact on work incentives for recipients subject to the tapering of their award. However, we find little sign of any unintended negative consequences.”

The main findings included:

- There was a "clear inverse link" between spending on tax credits (and cash transfers more generally) and child poverty rates.

- For low to middle income working households, tax credits helped compensate for stagnating pay from the mid-2000s; and had provided some insulation from the sharp decline in earnings from 2008 onwards.

- A number of studies of Working Families' Tax Credit had identified a "small but direct boost to employment," particularly for single parents; but an inevitable consequence of increasing means-tested support had been to increase the numbers affected by relatively high marginal effective tax rates, reducing incentives to increase earnings.

- In relation to the "couple penalty," overall a range of studies had suggested the impact on family formation had been "very small."

The authors also looked at whether tax credits had depressed wage growth in the lower part of the earnings distribution. However, the analysis found "no evidence to support the hypothesis that tax credits have put downward pressure on wage growth." The authors added:

> "An often repeated concern is that tax credits produce behavioural responses among firms and claimants which depress wage growth at the lower end of the earnings distribution in general and among intended beneficiaries in particular, resulting in direct transfers of money from government to employers. The findings in this report refute this accusation – at least in relation to the current generation of tax credits."

Further information:

Paul Gregg, Alex Hurrell and Matthew Whittaker, Creditworthy: Assessing the impact of tax credits in the last decade and considering what this means for Universal Credit, Resolution Foundation, 27 June 2012

Robert Joyce, Child poverty in Britain: recent trends and future prospects, IFS Working Paper W15/07, October 2014

Robert Joyce and Luke Sibieta, "An assessment of Labour's record on income inequality and poverty," Oxford Review of Economic Policy, June 2013

What changes did the 2010 Government make to tax credits?

The 2010 Government announced a package of changes to tax credits in the June 2010 Budget and October 2010 Spending Review aimed at "controlling the costs of tax credits" in order to "provide a fair and affordable platform for the introduction of the Universal Credit." Further measures were announced in Autumn Statement 2011 (including not going ahead with the above-indexation increase in the CTC child element that was to have taken effect from April 2012), and the freezing of certain WTC elements. Further measures were announced subsequently aimed at reducing tax credit and fraud, and increasing recovery of tax credit debt. Tax credits have also been affected by changes to uprating rules, including the switch to Consumer Price Index (CPI) uprating from April 2011, and 1% uprating of certain elements for three years from 2013-14 (as a result of the Welfare Benefits Uprating Act 2013).

For some of the tax credit changes – such as the changes the thresholds and taper rates and to individual elements – the effects on families are fairly straightforward to illustrate. For

other measures – such as the changes to the rules on backdating and to in-year income change disregards – the impacts are less obvious but given the savings expected as a result will have a significant effect on families receiving tax credits.

As regards the changes affecting the structure of tax credits, the main impact has been to reduce the number of middle income working families entitled to tax credits, focusing support on families at lower income levels. Between April 2011 and April 2015, the number of families in receipt of tax credits fell from 6.4 million to 4.6 million. The biggest fall was in the number of working families with children receiving tax credits (1.6 million fewer by April 2015). Working families still constitute the majority of tax credit claimants however - at April 2015, 3.3 million tax credit recipients (72% of the total) were in-work families, of whom 2.7 million had children.

The changes introduced by the 2010 Government are also expected to deliver significant savings. The tax credit measures (including uprating changes) are expected to yield savings of over £7 billion a year by 2019-20, not taking into account the effect of behavioural changes (source: House of Commons Library analysis of the OBR Policy Measures Database, April 2015 edition).

Further information:

Library briefing Constituency casework: tax credits, section 3

HMRC, Child and Working Tax Credits Statistics: April 2015, Table 1.1

What impact will Universal Credit have?

Tax credits – along with various means-tested benefits for families of working age – are being replaced by UC, although the new benefit is not expected to be fully phased in until 2020.

The aims of UC are to simplify and streamline the benefits system for claimants, making it easier for people to understand; to reduce the financial and administrative barriers to work; to tackle in-work poverty; and to bear down on fraud and error. Around 7.7 million individuals and families are expected to receive UC when it is fully introduced.

Universal Credit is means-tested and is payable both in and out of work. A key feature is the "single taper" for the withdrawal of UC for those in work. As earnings rise, UC is withdrawn at a constant rate of 65 pence for each pound of net earnings (although an initial slice of earnings – the "work allowance" – is ignored before the taper is applied). For employees paid through PAYE, Universal Credit payments are to be calculated and adjusted automatically using a new system giving "real time" information on earnings from employers.

The financial support provided by Universal Credit is underpinned by a new "conditionality" framework setting out the responsibilities claimants may be required to meet. The level of requirements will depend on the claimants' circumstances. People in work but earning below a certain amount may be expected to seek more or better paid work as a condition of receiving UC. The conditionality framework is backed up by a new "strong and clear" sanctions regime for non-compliance.

Universal Credit was introduced for a small subset of simpler claimant types in selected "pathfinder" areas starting from April 2013, and is gradually being extended to further areas and to new groups. A detailed timetable for the full introduction of UC is yet to be

announced, under the most optimistic scenario some claimants will still be in receipt of "legacy benefits" (the benefits UC is to replace) in 2020.

Financial incentives to work are key to Universal Credit. UC is expected to encourage more people into work, but for those already in work the incentive to work and earn more may be little different than under the current benefits and tax credits system, or even weaker. There is concern that under UC, people without children, single parents with housing costs and second earners in households in particular could be incentivised to work only a few only a few hours a week, reduce their hours or even stop working completely. In-work conditionality is intended to counter this, but it is not yet clear how this will work.

Further information:

"Universal Credit: work in progress?" in Key Issues for the 2015 Parliament, House of Commons Library, May 2015

Making the most of UC: Final report of the Resolution Foundation review of Universal Credit, 8 June 2015

GOV.UK, Universal Credit and tax credits, last updated February 2015

Child Poverty Action Group, Tax credits - moving on to universal credit, last updated 1 August 2014

Low Incomes Tax Reform Group, Universal Credit

Will there be further changes to tax credits?

The current Government has pledged to make additional welfare savings of £12 billion a year. The Institute for Fiscal Studies (IFS) estimates that three measures already announced by the Government – a reduction of the household benefits cap to £23,000 a year, cutting Housing Benefit for under 21s on Jobseeker's Allowance, and freeze most working-age benefits for two years – would only result in savings of around £1.2 billion a year.

There has been recent media speculation that the Government may be considering further cuts to tax credits, to help meet the £12 billion target. One option reportedly under consideration is reducing the child element of Child Tax Credit to its 2003-04 level (adjusted for inflation). In a note published on 26 May, the IFS commented:

> "Returning the per-child element of child tax credit to its real (CPI-adjusted) 2003–04 level would reduce entitlements for about 3.7 million low-income families with children by an average of £1,400 per year, and would cut spending by about £5bn. For the poorest families it would mean a takeaway of £845 per child per year. Taking as an example a 2-child family where at least one parent works full-time, it would mean tax credit entitlement running out at £28,847 of gross earnings rather than £32,969.We estimate that this would increase relative child poverty by about 300,000 (or 2.5 percentage points) so, in the absence of much-needed clarity from the government on its child poverty strategy (and in particular its attitude towards the supposedly legally-binding 2020 child poverty targets) it is difficult to assess the coherence of such a policy. While about two thirds of families with children on tax credits are in work, like most cuts to means-tested benefits this policy would tend to strengthen work incentives – families would have less tax credit income to lose by increasing their earnings or to gain by reducing their earnings."

Further analysis of the impact of this option is given in a note by David Finch of the Resolution Foundation published on 14 June. Key findings included:

> "over two-thirds of the families affected would be in-work;
>
> families with two children would lose up £1,690 a year;
>
> almost two-thirds of the cut would be borne by the poorest 30 per cent of households; and
>
> almost none of the cut would fall upon the richest 40 per cent of households"

In a speech given on 22 June, the Prime Minister criticised previous governments for "papering over the cracks" by redistributing money through the tax and benefit system instead of dealing with the causes of poverty. There was, he said, a "similar complacency" in how governments had approached the crucial issue of low pay, adding-

> "There is what I would call a merry-go-round. People working on the minimum wage having that money taxed by the government and then the government giving them that money back – and more – in welfare. Again, it's dealing with the symptoms of the problem: topping up low pay rather than extending the drivers of opportunity – helping to create well paid jobs in the first place.
>
> So this is the change we need. We need to move from a low wage, high tax, high welfare society to a higher wage, lower tax, lower welfare society. Indeed, across the spectrum, as a country we have been too busy picking up the pieces of failure that has gone before. Dealing with anti-social behaviour rather than strengthening families. Managing youth unemployment rather than boldly reforming education. We all know why.
>
> Extending the drivers of opportunity is difficult. It means taking on vested interests – like teaching unions or poorly performing local education authorities and it means talking about things and concepts some people feel uncomfortable about – families, behaviour, the link between effort and reward. Put another way, it's easier just to sign off another benefit cheque than it is to get people ready for work or discuss the importance of stable family life."

Further information:

Stuart Adam , Andrew Hood and Robert Joyce, The search for further benefit cuts, IFS Observations, 27 March 2015

James Browne and Andrew Hood, "Options for reducing spending on social security," IFS Green Budget, February 2015

Robert Joyce, Benefit cuts: where might they come from? IFS Observations, 26 May 2015

"George Osborne considering £5bn cuts to child tax credits," BBC News, 11 June 2015

David Finch, Assessing the proposal to cut £5 billion from Child Tax Credit, Resolution foundation, 14 June 2015

GOV.UK, PM speech on opportunity: David Cameron discusses plans to help working families and extend opportunities to all, 22 June 2015