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Working Families Tax Credit and Family Credit

The Working Families Tax Credit is to be introduced from October 1999. It will replace Family Credit, and will be more generous. It will be administered by the Inland Revenue, and paid either directly by them or (from April 2000) through the wage packet.

This Research Paper compares the new tax credit with the existing provisions in Family Credit, discusses some of the issues raised, and presents some commentary from other organisations. Readers may also be interested in Library Research Paper 98/45, *The 1998 Budget and Work Incentives* (forthcoming).

Pat Strickland

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The Working Families Tax Credit (WFTC) is to replace Family Credit from October 1999. Family Credit is a means-tested social security benefit administered by the Benefits Agency and paid to people in families where at least one person works full-time (i.e. for 16 hours per week or more). The WFTC, as its name suggests, will be a tax credit administered by the Inland Revenue, also for people in full-time work. From April 2000 it will be payable either through the pay packet or directly by the Inland Revenue. Despite this difference in the method of payment, the structure is very similar to Family Credit. The main features of the two schemes can be tabulated as follows:

Family Credit	Working Families Tax Credit
• Administered and assessed by Benefits Agency's Family Credit Unit in Preston	• Administered and assessed by Inland Revenue
• Claimed by woman in couple	• Claimed by man or woman according to couple's choice
• Paid by direct debit or order book	• Paid through wage packet by employer or direct from the Inland Revenue
• Main earner must be working 16 hours per week or more	• Main earner must be working 16 hours per week or more
• Extra credit for those working 30 hours per week	• Extra credit for those working 30 hours per week
• Paid over six month period	• Paid over six month period
• Starts to be withdrawn once net income reaches £79	• Starts to be withdrawn once net income reaches £90
• Withdrawn at rate of 70p for each extra £1 earned over threshold	• Withdrawn at rate of 55p for each extra £1 earned over threshold
• One adult credit per household, plus age related credit for each child	• One adult credit per household, plus age related credit for each child
• Contains help with childcare costs	• More generous help with childcare costs
• Capital over £8,000 disqualifies from benefit; capital between £3,000 and £8,000 reduces benefit	• Will have a capital rule which "builds on" that of Family Credit - details not yet available

I Introduction

The Working Families Tax Credit is to replace Family Credit from October 1999. Family Credit is a means-tested social security benefit administered by the Benefits Agency and paid to people in families where at least one person works full-time (i.e. for 16 hours per week or more). The WFTC, as its name suggests, will be a tax credit administered by the Inland Revenue, again for people working full-time. From April 2000 it will be payable either through the pay packet or directly by the Inland Revenue.

Family Credit reached around 757,000 families[1] and cost around £2.35bn in 1997-98.[2] The WFTC is more generous than Family Credit in its higher earnings threshold, gentler taper and more generous help with childcare costs.[3] Consequently, it is expected to reach 1.4 million families, at a cost of around £5 billion a year.[4]

The Government sees the WFTC as a "step towards greater integration of the tax and benefits system".[5]

This Research Paper provides a brief history of Family Credit, and compares the structure of this benefit to that of the new WFTC. It summarises some of the issues raised, and provides some commentary from interested organisations.

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1 *Family Credit Statistics Quarterly Enquiry*, August 1997

2 Estimates for 1997/98. Source: DSS, *Departmental Report*, Cm 3913, April 1998, Tables 1 and 6

3 See pages 14 - 16 and Appendix 1

4 HM Treasury Press Release, "Government launches New Deal for Working Families: Making Work Pay", HMT 3, 17 March 1998

5 HM Treasury, *The Modernisation of Britain's Tax and Benefit System Number Three: The Working Families Tax Credit and Work Incentives*, 1998 p.7

II Background

A. A brief history of Family Credit

Family Credit was introduced in 1988. Its predecessor, family income supplement (FIS) had been originally brought in as a stopgap measure in 1971, in anticipation of a tax credit scheme, which was never actually introduced. It was intended to address the fact that low-wage families could be better off out of work than in work (a situation described as the "unemployment trap"). However, there were problems associated with FIS, the main ones being low take-up and the "poverty trap" - a term which describes a situation where combined tax and benefit rules mean that an increase in earnings can result in little increase - or even a reduction - in net income. Some families on FIS could lose £1.20 for each extra £1 of earnings after tax, national insurance and the effects on rent and rate rebates.[6]

In the mid 1980s the social security system was reviewed by the then Secretary of State Norman Fowler. The 1985 Green Paper which resulted originally proposed that the new Family Credit should operate as a tax credit, either offsetting tax or being paid through the pay packet, just as WFTC will be.[7] However, this was vigorously opposed, partly because it would involve a transfer of resources from men to women (or "wallet to purse", as this was termed), but also because of the burdens on employers.[8] In the event, elements of the 1985/6 Social Security Bill were defeated in the Lords and the then Government announced that Family Credit would be paid directly to recipients.[9]

The 1985 Green Paper set out several objectives for the new Family Credit. The main ones were:[10]

- providing extra support for low-income families
- ensuring that they were better off in work (i.e. addressing the unemployment trap)
- ensuring that they could achieve improvements in family income without losing all the benefit because of high marginal tax rates. (i.e. addressing the poverty trap).

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6 Marsh and McKay, *Families Work and Benefits*, 1993 p.4
7 DHSS, *Reform of Social Security*, Volume 1, Cmnd 9517, June 1985 p.29
8 For debate see SC B Deb 18 March 1986 cc 933-85
9 HL Deb 23 June 1986 cc 40-43
10 DHSS, *Reform of Social Security*, Volume 1, June 1985, Cmnd 9517 p.29

Benefit levels were more generous than for FIS, and greater alignment with other means-tested benefits was designed to ease the unemployment trap. The poverty trap was also alleviated, partly by this alignment and partly because entitlement to all means-tested benefits was now based on net income.[11]

A number of improvements were made to Family Credit after its introduction. These included:

- the reduction in the hours threshold from 24 to 16 in 1992
- the introduction of a bonus for people working more than 30 hours per week from July 1995
- a new disregard from October 1994 to help with the costs of certain forms of childcare.[12]

While FIS was only taken up by around half of those entitled to it,[13] by 1995/96 Family Credit was taken up by approximately 70% of those entitled.[14] Around 45% of these families were headed by a lone parent.[15] Expenditure on Family Credit has risen from £626 million in 1991-92 to around £2.35 billion in 1997-98.[16]

B. The review of the tax/benefit system

In May 1997, the Chancellor, Gordon Brown, set up a task force under Martin Taylor, the chief executive of Barclays. The terms of reference as set out in the Labour Manifesto were to "examine the interaction of the tax and benefits system so that they can be streamlined and modernised, so as to fulfil our objectives of promoting work incentives, reducing poverty and welfare dependency and strengthening community and family life."[17]

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11 Before the change, supplementary benefit was based on net income, while Housing Benefit and FIS were based on gross income.
12 See page 15 for details
13 DHSS, *Social Security Statistics*, various years
14 DSS, *Income Related Benefits: Estimates of Take-Up in 1995/96*, 1997 p.47
15 DSS, *Social Security Statistics 1997*, Table A1.01
16 DSS, *Social Security Departmental Report*, Cm 3913, April 1998 Table 1
17 Labour party, *New Labour because Britain deserves better*, 1997 p.13

In his July Budget, the Chancellor made it clear that the task force had been asked at an early stage to look at the advantages of introducing a tax credit drawing upon the American experience of the earned income tax credit.[18]

The earned income tax credit (EITC) is a credit on federal income tax available to poor working families. It was first adopted in 1975, although there have been many changes to it since then. The value of the credit is calculated on the basis of the family's annual earnings and whether the family has one child, or two or more children. The value of the credit rises with earnings, reaches a plateau when annual earnings are around $12,000 and then is withdrawn by a taper in the range of 16-21% for families with children. In the two-child case, the credit supplements earnings at the rate of 40 cents per dollar, up to a total annual earnings of $8,890 (i.e., a maximum credit of $3,556 is paid). Beyond earnings of $11,610 it is withdrawn at a rate of 21% until earnings reach $28,495.[19] The credit is refundable so that any credit due in excess of tax liability is given direct to the taxpayer. Further information on the EITC is given in Appendix 2.

Martin Taylor's report concluded that the EITC had much in its favour, although a UK tax credit would have to be different in a number of respects:

> I concluded that the US EITC had much to recommend it. Although the differences between the UK and US tax and benefit systems need to be recognised, there is no overriding reason why the UK should not have a tax credit payable though the pay packet to families in work. The advantages were clear:
>
> - As a tax credit rather than a welfare benefit, it would reduce the stigma currently associated with claiming in-work support;
> - It would prove more acceptable than social security benefits to most claimants and taxpayers as a whole;
> - Paid through the wage packet, it would reinforce the distinction between the rewards of work and remaining on welfare;
> - It could help lower marginal tax and benefit withdrawal rates. [20]

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[18] HC Deb 2 July 1997 c.210

[19] Robert Walker, Michael Wiseman "The possibility of a British EITC" *Fiscal Studies* 4, 1997 pp 401-425

[20] HM Treasury, *The Modernisation of Britain's Tax and Benefit System Number Two - Work Incentives: A Report by Martin Taylor*, 1998 p22

The report made it clear that "a number of design issues would have to be considered". These included:

- payment to the mother or father according to the choice of the couple
- mechanisms to avoid abolishing individual tax assessment
- reducing the burden on employers, possibly by the Inland Revenue calculating entitlement.

In the event, the new WFTC is obviously based on the same concept as the EITC, in that it is a tax credit - it either reduces the tax bill or is paid to the family if it exceeds the tax liability. However, it owes much more of its detailed structure to Family Credit than to the American system.

C. The announcement of Working Families Tax Credit

In his Pre-Budget Statement to the House on 25 November 1997, Mr Brown announced that a new tax credit for working families would be one element of the Government's welfare to work strategy. [21] Others would be a 10p rate of tax and a reform of benefit tapers to be introduced "when it is prudent to do so", a minimum wage and affordable childcare.

Further details were given in a Treasury paper on reforming tax and benefits published at the time. This stated that a WFTC had a number of advantages in principle:

- it could reinforce the effect of the minimum wage by making work pay
- it would boost work incentives, by increasing potential in-work incomes
- as a tax credit rather than a welfare benefit it should result in higher take up
- its clear link with the pay packet and the tax system should demonstrate the rewards of work over welfare
- it could prove a highly effective way of targeting help at low income families, thus reducing poverty and strengthening the family. [22]

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[21] HC Deb 25 November 1997 c.776

[22] HM Treasury, *The Modernisation of Britain's Tax and Benefits System: Employment Opportunity in a Changing Labour Market*, November 1997 p.43

The Chancellor's Budget Speech on 17 March 1998 described the new WFTC as follows:

> Under the present system of Family Credit there is, quite simply, a ceiling on aspirations for women and men wanting to work their way up. In Britain today there are nearly three quarters of a million working families who are held back by marginal tax rates in excess of 70 per cent. There are nearly half a million working families, with children, whose pay is so low that they receive in-work benefits and yet still are required to pay income tax.
>
> From October 1999, the Working Families Tax Credit will not only be a tax cut for hundreds of thousands of working men and women with children, but will abolish the grotesque distortion where some low-paid employees have had to pay back more than £1 for every extra £1 they earn.
>
> Instead of the state paying out benefit through the social security system to working families on lower incomes, in future they will receive cash directly through the tax system. Families will be able to choose to whom the credit is paid - either directly or through the pay packet.
>
> By tackling the unemployment trap and increasing the help available to families, the Working Families Tax Credit ensures that work will always pay more than benefits and by tackling the poverty trap - through cutting the rate at which help is withdrawn as incomes rise, the Working Families Tax Credit ensures that the more you earn, the more you take home.[23]

D. Related Budget changes and implementation dates[24]

From **November 1998**, the child credit for under 11s will be increased by £2.50 a week (initially through Family Credit). Currently the rates for under 11s are £8.10 less than for those aged 11-16. The rates for these older children will simply be indexed, so that the gap will narrow. The aim is to take more account of some of the high costs of early years. Similarly the personal allowances for children aged under 11 paid with Income Support, Jobseeker's Allowance, Housing Benefit, Council Tax Benefit and Disability Working Allowance will be increased by £2.50 at the same time.

From April 1999, Child Benefit will be increased by £2.50 per week for the eldest child. The family premium in Income Support, Housing Benefit, Council Tax Benefit and Jobseeker's Allowance will also be increased by £2.50. Those such as existing lone parent claimants who were protected from the cuts to Child Benefit for lone parents in June 1998 and to the lone parent premiums in April 1998, and who therefore get a higher rate of benefit than the new rate, will not receive the increases.

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[23] HC Deb 17 March 1998 c.1105

[24] Budget Statement, HC Deb 17 March 1998 cc 1104-6

Also from **April 1999**, national insurance contributions (NICs) are to be restructured. Employees will benefit from the abolition of the "entry fee" - £1.28 or 2% of the first £64 of earnings. For employers, the Lower Earnings Limit is to be raised to £81, to align it with tax personal allowances, and the 3%, 5% and 7% bands are to be replaced by a single rate of 12.2%. The changes to employers' NICs are revenue neutral, but the effect is broadly to decrease the burden on employers of lower paid employees at the expense of employers of those earning over £450 per week.[25]

From October 1999, the WFTC is due to be introduced, replacing Family Credit. At the same time, a new disabled person's tax credit will replace Disability Working Allowance. This will have a similar structure to the WFTC

From April 2000, the WFTC will be payable through the employee's wage packet.

[25] For details, including an explanation of current system, see HMT Budget Press Release 5, 17 March 1998

III Comparing the Working Families Tax Credit and Family Credit

All benefit rates quoted are for 1998/99.

A. The main features

Family Credit	Working Families Tax Credit
• Administered and assessed by Benefits Agency's Family Credit Unit in Preston	• Administered and assessed by Inland Revenue
• Claimed by woman in couple	• Claimed by man or woman according to couple's choice
• Paid by direct debit or order book	• Paid through wage packet by employer or direct from the Inland Revenue
• Main earner must be working 16 hours per week or more	• Main earner must be working 16 hours per week or more
• Extra credit for those working 30 hours per week	• Extra credit for those working 30 hours per week
• Paid over six month period	• Paid over six month period
• Starts to be withdrawn once net income reaches £79	• Starts to be withdrawn once net income reaches £90
• Withdrawn at rate of 70p for each extra £1 earned over threshold	• Withdrawn at rate of 55p for each extra £1 earned over threshold
• One adult credit per household, plus age related credit for each child	• One adult credit per household, plus age related credit for each child
• Contains help with childcare costs	• More generous help with childcare costs
• Capital over £8,000 disqualifies from benefit; capital between £3,000 and £8,000 reduces benefit	• Will have a capital rule which "builds on" that of Family Credit - details not yet available

Model calculations are given in Appendix 1. It can be seen from these that the WFTC is more generous than Family Credit because it has a higher threshold at which the credit is withdrawn (£90 instead of £79), and because the credit is withdrawn more gently (55% instead of 70%). The child credit rates for children under 11 are £2.50 more than they are under the current structure of Family Credit, although this will also apply to Family Credit from November 1998. Apart from help with childcare costs (see below), the structure is remarkably similar. However, the way the credit is paid will clearly be very different. Because it is a tax credit, it will either be deducted from income tax liability or (where it exceeds that liability) the excess will be paid either through the pay packet, or directly from the Inland Revenue.

B. The childcare tax credit

1. Provisions to help with childcare costs in Family Credit

In October 1994, the previous Government introduced a childcare disregard with Family Credit, and also with other means-tested benefits. This covers spending on children under 11 with registered childminders, day nurseries and out of school clubs, and certain other schools or establishments which are exempt from registration. Under the current rules, childcare costs of up to £60 can be disregarded from the family's income when the calculation is made. Because of the 70% taper, this means that the actual Family Credit award can be increased by up to £42.[26] The disregard is due to be increased to £100 - but only where there are two or more children - with effect from June 1998. At the same time, the maximum age will be raised from 11 to 12. However, the disregard cannot increase the maximum amount of Family Credit. Thus those families with incomes low enough to be receiving maximum Family Credit without the disregard cannot benefit. This has led to criticisms of the system.[27]

There have also been criticisms of the low numbers of people benefiting from the scheme. The original press release anticipated that the disregard would benefit 150,000 families, 50,000 of whom would be taking up work as a direct result of the change.[28] The most recent quarterly statistics on Family Credit show 32,000 people receive extra Family Credit through the disregard, of whom 30,500 are lone parents.[29]

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[26] It is possible to gain a further amount through Housing Benefit and Council Tax Benefit

[27] See for example Sally Holtermann, *The childcare disregard in family credit: Who gains?*, September 1997

[28] "Peter Lilley launches benefit help towards childcare charges'", DSS Press release 94/149, 3 October 1994

[29] *Family Credit Statistics Quarterly Enquiry*, August 1997

2. The new system

The new childcare tax credit will cover the same forms of childcare as the existing disregard. It will be worth 70% of eligible childcare costs, subject to an overall limit on these costs of £100 per week for one child and £150 per week for two or more children. Thus the maximum support will be £70 per week for a family with one child, and £105 per week for a family with two or more children. Unlike under the present system, this maximum will be available to those with low enough incomes to be on the maximum WFTC (before the childcare tax credit is calculated).

The childcare tax credit will be an integral part of the WFTC. It will be added to the adult and child credits, and withdrawn at the same rate - 55%.

As with the current childcare disregard, the childcare tax credit will be available to any lone parent working 16 hours per week or more, and to any couple where both partners are working 16 hours per week or more.

The Institute for Fiscal Studies has argued that the final cost of the childcare credit could rise to £4 bn if everyone who was entitled to it took it up, and particularly if people currently offering informal childcare (which would not qualify) registered as childminders.[30]

The Government responded to a PQ about this as follows:

> Mr. Gibb: To ask the Chancellor of the Exchequer what assessment he has made of the estimate by the Institute for Fiscal Studies relating to the cost of the proposed child care tax credit, assuming full take-up of the benefit.
>
> Dawn Primarolo [holding answer 24 March 1998]: A number of the Government's policies will make profound changes to the availability and affordability of child care over the next few years. The £300 million of extra resources for out-of-school child care provision, the child care tax credit and the rest of the Working Families Tax Credit, the New Deals to help people into work, and the rest of the National Childcare Strategy will all help to make quality childcare available and affordable for more parents. In this context, estimates of the cost of the childcare tax credit are subject to a wider degree of uncertainty than usual.
>
> The Exchequer cost arising from replacing Family Credit with the Working Families Tax Credit is shown in line 1 of Table C.1 of the Financial Statement and Budget Report (HC620). The share of that cost accounted for by the childcare tax credit is £50 million in 1999-2000 and £250 million in 2000-01 (the first full year of the tax credit). [31]

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[30] "Row brews over cost of childcare credit scheme", *Financial Times*, 19 March 1998 p.14

[31] HC Deb 1 April 1998 c.155W

C. Claims and payments

People will have to claim the new WFTC, just as they currently claim Family Credit. Claims will be made to the Inland Revenue who will assess entitlement. The working assumption is that Benefits Agency staff from the Family Credit Unit and the Disability Working Allowance Unit will join the Inland Revenue. This transfer recognises that these staff have all the skills and experience necessary to implement the new system successfully.[32]

In the first months after the introduction of the credit in October 1999, all payments will be made directly through the Inland Revenue. From April 2000, however, payments can be made through the pay packet for people on PAYE, although the Inland Revenue will still be determining entitlement rather than employers. Self-employed people and others not on PAYE will continue to get payments directly from the Inland Revenue.

Couples will be able to choose which of them will get the credit. If the partner the couple has chosen to get the credit is not in PAYE employment, then they will get it directly through the Inland Revenue. See pages 22-24 for the procedure in cases of dispute.

[32] Source: Treasury

IV Issues raised by the Working Families Tax Credit

A. Work incentives

The effect of the Budget on work incentives is considered in detail in Library Research Paper 98/45. The purpose of this section is to explain the fundamental issues involved and to look in broad terms at the effects of the WFTC upon these.

An explicit aim of the WFTC is to improve work incentives by easing the unemployment and poverty traps.[33] This is the same aim that the Conservative Government had for Family Credit in the mid-1980s.[34] The unemployment trap describes a situation where the unemployed can be better off out of work than in work. The poverty trap describes a situation where very high marginal tax rates caused by combinations of tax, national insurance and benefit withdrawal means that earning an additional £1 in gross income can result in little extra net income (or in extreme cases, less net income).

It is important to realise that these problems are fundamental ones in a system which gives means-tested help. Martin Taylor, in his report, explains this as follows:

> The low financial returns from work reflected in the unemployment and poverty traps result from providing a benefit safety net for those who have few resources of their own. Once such a safety net is provided, it has to be reduced at higher income levels either directly through the withdrawal of benefits or indirectly through the taxes needed to pay for these benefits. The trade-off between incentives and support for those without resources of their own cannot be avoided. The issue is how fast the safety net should be reduced. If withdrawn rapidly, it will mean a relatively small number of people face very high marginal rates; if withdrawn more slowly, a larger number of people will be affected by moderately high rates. There are also trade-offs between measures to help the unemployment trap and those that help the poverty trap.
>
> These are essentially structural problems, to which no miraculous solution can be advanced, short of paying benefit to everybody or nobody. As long as benefits are paid and then withdrawn, there will be high effective "tax" rates at certain points.[35]

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33 HM Treasury, *Budget '98 New Ambitions for Britain, Financial Statement and Budget Report*, HC 620, 1997-98, March 1998 paragraph 3.37

34 DHSS, *Reform of Social Security Programme for Change*, Volume 2, June 1985, Cmnd 9518 para 4.48

35 HM Treasury, *The Modernisation of Britain's Tax and Benefits System, Number Two, Work incentives: a Report by Martin Taylor*, 1998 paragraphs 1.13 and 1.14

The IFS also points out the trade-off between the unemployment trap and the poverty trap:

> Increased spending on in-work support cannot evade the trade-off between unemployment and poverty traps. If we make work relatively more attractive than unemployment, by increasing in-work support (reducing the unemployment trap), we will increase the numbers in work facing withdrawal of benefit as incomes rise (worsening the poverty trap). This is particularly a concern for two-earner couples, where the incentive of the second earner to work at all could be much reduced. [36]

1. The poverty trap

One cannot hope to eliminate the poverty trap altogether by altering the details of a means-tested system. There is a fundamental trade-off between the depth of the poverty trap and the numbers caught within it. If benefit is withdrawn less sharply, the benefit levels will go further up the income scale and more people will be caught within it. It is a matter of judgement as to which forms of work disincentive are the least damaging. As Professor John Hills of the London School of Economics puts it, "The poverty trap has evolved as a way of keeping down the marginal tax rates of most earners at the expense of very high marginal tax rates on a very small number."[37]

A detailed examination of the effect of the Budget changes on the poverty trap is provided in Library Research Paper 98/45. Broadly, however, the effects are to decrease the numbers facing very high marginal tax rates at the expense of increasing the numbers of people in the poverty trap. Table 3.3 in the Red Book shows that marginal tax rates over 100%, which are currently estimated to affect 5,000 people, should be eliminated by the Budget changes. However, while the numbers of people facing marginal deduction rates of 90% or more are to be reduced from 130,000 to 20,000 the numbers of people facing deduction rates of 60% or more are increasing from 760,000 to 1,010,000.[38]

The Government accepts that it is inevitable that those brought into entitlement by the increased generosity of the WFTC will face higher marginal tax rates than at present, but it points out that those people will be better off than they are now. It also counters the IFS criticisms about reduced incentives for second earner couples (see above) by pointing out that:

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[36] IFS, *Green Budget Press Release*, 21 January 1998.

[37] John Hills, *Changing Tax*, CPAG, 1988, p.32

[38] HM Treasury, *Budget '98 New Ambitions for Britain, Financial Statement and Budget Report*, HC 620, March 1998

- where one in five households are workless, the priority must be to get one member of such families into work
- the childcare credit will benefit second earners
- only a minority of families floated onto WFTC will be two earner couples.[39]

The effect of changes including the introduction of Family Credit in 1988 and subsequent improvements to it was to decrease the numbers facing the most extreme forms of the poverty trap (reducing the numbers facing marginal tax rates of more than 100% from 70,000 in 1985 to 5,000 in 1996-97). However, the changes increased the numbers facing marginal tax rates over 70% from 290,000 in 1985 to 645,000 in 1996-97.[40] The WFTC and associated Budget changes consequently move further in the direction started by the Fowler reforms in the mid 1980s.

2. The unemployment trap

The DSS has argued that introduction and expansion of Family Credit has been a significant factor in reducing the numbers of people in the unemployment trap.[41] There is quite a lot of agreement in the research literature that Family Credit is structured in such a way that it provides incentives to leave unemployment, and that people on the margins of unemployment will be better off on Family Credit than they were on Income Support.[42] However, ignorance of the income that in-work benefits can provide can still prove to be a barrier in moving from unemployment, as can fear of delays and uncertainties about the outcomes of claims.[43]

There is also evidence that, while Family Credit is structured to persuade people to move into jobs from unemployment, this is not actually how the majority of claimants use it. This was demonstrated in a Policy Studies Institute study of families who had left Family Credit. The study showed that the vast majority of these had had their job for some time before claiming, and were responding to a drop in earnings caused by loss of overtime, shortened hours or the loss of a partner's job.[44] Marsh and McKay provide similar evidence of families using the

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[39] HM Treasury, *The Modernisation of Britain's Tax and Benefit System Number Three: The Working Families Tax Credit and Work Incentives*, 1998, paragraph 4.10

[40] Source: DSS, *Departmental Report*, Cm 3613, March 1997, Figure 34, p.57

[41] DSS Departmental Report 1997, Cm 917, para 5.17

[42] See Marsh and McKay, *Families, Work and Benefits* 1993 and Martin Evans, *Giving Credit Where it's Due? The success of Family Credit reassessed*, STICERD, WSP/121, May 1996

[43] See Corden and Craig, *Perceptions of Family Credit*, SPRU 1991 pp 7 and 78, and Shaw et al, *Moving off Income Support: Barriers and Bridges*, DSS, 1996 pp 3 and 9

[44] Bryson and Marsh, *Leaving Family Credit*, DSS Research Report No 48, 1996 pp 1-2

benefit as a "parachute", preventing or delaying a fall into unemployment, although in their study this group was in a minority.[45]

The WFTC has the effect of easing the unemployment trap because of its increased generosity over Family Credit. Thus families need lower wages than they would otherwise to be better off in work than on Income Support - their "replacement ratio" will be lower.

3. Work incentives and the real world

There is some doubt about whether the work disincentives, which are perceived by academics and policy makers, actually affect people's decisions. Research shows that people are confused by the rules, and may not be at all clear about what their benefit entitlement will be in work, or if they increase their income.[46] This cuts both ways in relation to the poverty and unemployment traps. Although Family Credit is structured to encourage people to leave unemployment, ignorance about entitlement to in-work benefits might prevent them from doing so. Conversely, if people do not realise that they will face high marginal deduction rates if they increase their earnings, this may not interfere with them doing so. Marsh and McKay argue that people might not actually behave any differently if the rate of withdrawal of Family Credit were increased from 70% to 100%:

> Few families, even present recipients, have any idea what the rate of withdrawal of FC really is. Many believe it *is* 100%. As the DSS is always keen to point out for other very good reasons, the likely disincentive effects of withdrawal are anyway heavily cushioned by the six months rule. 'Increasing your labour supply' usually means doing overtime. Does anyone really turn down overtime because they are on Family Credit? …Overtime is usually done to oblige (or simply obey) an employer. Other forms of advancement such as accepting promotion or looking for a better job seem equally poorly attached to people's perception of Family Credit withdrawal rates. [47]

Similarly Bryson and Marsh found that "the supposed disincentive effect of the tapered withdrawal of benefit against new earnings discourages few from seeking them where they can."[48]

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45 Marsh and McKay, *Families, Work and Benefits*, 1993 p.189

46 See Corden and Craig, *Perceptions of Family credit,* SPRU, 1991 p.78 and Shaw et al, *Moving off Income Support: Barriers and Bridges*, DSS p.3

47 Marsh and McKay, *Families Work and Benefits* 1993 p 188

48 Bryson and Marsh, *Leaving Family credit,* DSS Research Report No 48, pp 1-2 p 3.

B. The problem of housing costs

Housing costs are central to the problem of work incentives. Unemployed tenants receiving Income Support and income-based Jobseeker's Allowance can get 100% of their eligible rent met through Housing Benefit, subject to certain restrictions. Housing Benefit and Council Tax Benefit can also be paid to tenants in work, but tapers on income over Income Support levels of 65% for Housing Benefit and 20% for Council Tax Benefit apply. Unemployed owner occupiers on Income Support and income-based Jobseeker's Allowance can get help with mortgage costs, again subject to limitations. However, there is no help with these for people who work 16 hours per week or more. Around half of those entitled to the WFTC are expected to be owner-occupiers.[49] Research shows that concern about how housing costs and council tax will be met in work are major barriers to coming off Income Support, with only worries about wages being too low being more significant.[50] Ignorance about help with rent and council tax for people in work, together with fact that there is no help with mortgage costs with in-work benefits contribute to this.

The interaction of Family Credit and Housing Benefit is largely responsible for the worst excesses of the poverty trap. This is because Family Credit is counted as income for Housing Benefit purposes, and subject to a taper of 65%. The WFTC will be treated as income for Housing Benefit and Council Tax Benefit purposes, although any child care tax credit will be disregarded, so that people will not lose the value of this element because of Housing Benefit and Council Tax Benefit withdrawal.

Under the current system, it is possible for a person paying national insurance contributions and lower rate income tax, and receiving Family Credit, Housing Benefit and Council Tax Benefit to lose 97p out of every additional £1 of net income earned. The reduction in the taper from 70% for Family Credit to 55% in the working family's tax credit will only reduce this to 95p in the £1. Although the numbers facing marginal tax rates of over 90% should be reduced very considerably as a result of budget changes (see above), Housing Benefit still plays a very important role in the high marginal tax rates which persist.

The Social Security Committee in its recent pre-Budget report on tax and benefits made the following comments about the role of Housing Benefit:

> Whatever the outcome of the Government's changes to the tapers for the Working Families Tax Credit and other alterations to taxes and benefits, a major concern will remain through the interaction with the tapers in Housing Benefit and Council Tax Benefit. The role of Housing

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[49] HC Deb 6 April 1998 c.41W

[50] Shaw et al, *Moving off Income Support: Barriers and Bridges*, DSS p.126

> Benefit in the poverty and unemployment traps is well known and longstanding. We were told that the current Housing Benefit system is failing: fear of losing all Housing Benefit deters people from taking work and leaving social security benefits. The complexity of the scheme, the frequently poor administration by local authorities and the lack of awareness of in-work Housing Benefit combine to produce a powerful disincentive to give up the 'security' of full Housing Benefit. There are particular problems for people receiving help with mortgage costs who are unable to receive any in-work benefits. The purpose of this Report is not to analyse the many and varied problems and proposed solutions relating to Housing Benefit. The Department of Environment is currently reviewing all aspects of Housing Benefit. The evidence about Housing Benefit we have taken during both phases of our inquiry makes a compelling case that Housing Benefit is central to problems of welfare dependency, workless households and the poverty and unemployment traps. Yet Housing Benefit is often regarded as an adjunct to the main debate; to be grafted on when the other tax and benefits models are complete. There are two broad issues: the structure of the Housing Benefit system in the way that it assesses help for housing costs and the administration and delivery of that help. At present, both issues need urgent attention and the outcomes desired by the Government's reforms of tax and benefits might be jeopardised unless Housing Benefit is fully taken into account. **We recommend that the Government places high priority on Housing Benefit as part of its strategy of welfare to work and the reform of social security**. [51]

In his report, Martin Taylor stated that he had concluded that he did not need to consider Housing Benefit in detail because of the Comprehensive Spending Review which is being conducted into Housing Benefit.[52]

Similarly, there is little discussion of Housing Benefit in the Red Book or in the document which sets out the detailed proposals for the WFTC. The latter makes some points of detail about changes in the interaction between the new credit and Housing Benefit. It promises that these will end the anomaly whereby the 30 hour premium in Family Credit could give rise to marginal tax rates of over 100% for a small number of families with Family Credit entitlement of less than £10.80 per week. It also points out that, because of its increased generosity, WFTC will float around 50,000 families off Housing Benefit.[53]

The Government's Green Paper on Welfare Reform makes it clear that the problems posed by Housing Benefit reform are still the subject of a review:

> Reforming housing and Housing Benefit policy raises many difficult questions which have defeated successive governments in the past. In the immediate term, we are taking steps to

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[51] Social Security Committee, *Tax and Benefits: Pre-Budget Report*, Third Report, HC 423, 4 March 1998 para 18.

[52] HM Treasury, *The Modernisation of Britain's Tax and Benefits System, Number Two, Work incentives: a Report by Martin Taylor*, 1998 paragraph 1.35

[53] HM Treasury, *The Modernisation of Britain's Tax and Benefit System Number Three: The Working Families Tax Credit and Work Incentives*, 1998 paragraph 4.08

> tackle Housing Benefit fraud. The Working Families Tax Credit and other changes announced in the Budget will reduce the disincentive effects caused by the combination of Housing Benefit and Family Credit. For the longer term, the Government is reviewing the underlying relationship between housing policy and Housing Benefit, to address the weaknesses of the current regime. We aim to develop stable and sustainable policies, in line with the overall objectives of welfare reform, striking a better balance between tenants' rights and responsibilities. [54]

During the Budget debate, the Secretary of State for Social Security, Harriet Harman, made the following comments on this point:

> We are concerned about the way in which Housing Benefit is operating, as we do not believe it is contributing to housing policy in the way that it should. One of its problems is that it does not fit with our commitment to ensure that every part of the benefits system contains no disincentives to work - and, indeed, provides incentives. Together with the Department of Environment, Transport and the Regions, we are reviewing the interaction of housing policy and Housing Benefit and we will bring forward proposals for consultation shortly. We are well aware of the evidence to the Select Committee - and the Committee's report - which suggests that this matter needs further action. [55]

C. Transfers from wallet to purse

Family Credit is currently claimed by the woman in a couple, unless the Secretary of State considers it reasonable that this should be done by the man.[56] This would happen in rare cases and would cover, for example, the mental incapacity of the mother. However, where there is a couple, both partners have to sign the claim form. Where there is an order book and both partners have signed the form, the male partner's name would appear as an alternative payee.

According to a recent PQ, of the 757,000 families currently on Family Credit, 351,000 are lone parents and 406,000 are couples.[57] In the majority of these families - 431,000 - the main earner is a woman, largely because 90% of lone parents are women. However, in the remaining 326,000 families, the main earner is the man.

Since the Government first announced that it was considering the introduction of a WFTC payable through the pay packet, there has been considerable concern that this would mean

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[54] *New ambitions for our county: a new contract for welfare*, Cm 3805, March 1998 paragraph 35
[55] HC Deb 19 March 1998 c.1436
[56] Regulation 4(2) of the *Social Security (Claims and Payments) Regulations, SI 1987/1968*
[57] HC Deb 12 February 1998, c 392W

that money would be transferred from women to men in the family. The result of this might be that less would be spent on the children. There is a body of research which shows that men in a fairly large proportion of couples have greater access to personal spending money than women, and that women in couples generally suffer a higher level of financial deprivation than their partners.[58]

The Government has stressed that there will be no compulsory transfer of resources from women to men because couples will have the right to elect to whom the credit is paid, the man or the woman.[59]

Professor Ruth Lister, one of the authors of a forthcoming qualitative study of the distribution of income within families on social security,[60] made the following remarks about a system which allowed choice about who received the WFTC in her evidence to the Social Security Select Committee:

> You have put your finger on a key issue, which is who decides and how that decision is made. Again, in our families the men themselves did not want it (i.e. Family Credit) through the pay packet, partly because they mistrusted employers. They did not trust employers to pay them the right amount. They felt their system was working well. Some of the women would recount what had happened in earlier partnerships where it might have been rather different, where the man was much more powerful and it might have been much harder for the woman even to exercise that choice. I am all for choice and giving families choice, but then I suspect that in many cases they would opt to have it separately and then that undermines the whole purpose of what the Government is trying to achieve.[61]

The question of what happens where there is an open dispute over which partner should receive the credit is dealt with in the following PQ:

> Mrs. Fyfe: To ask the Chancellor of the Exchequer what steps the Inland Revenue takes in circumstances where (a) a husband and wife cannot agree who should receive the Working Families Tax Credit and (b) one spouse claims the other is receiving the tax credit but keeping it to him or herself.

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58 See for example Carolyn Vogler, "Money in the household", from *The Social and Political Economy of the Household* ed. A Anderson, S Bechhofer, J Gerschuny, 1994, and Jan Pahl, *Money in Marriage*, 1989

59 HM Treasury, *The Modernisation of Britain's Tax and Benefit System Number Three: The Working Families Tax Credit and Work Incentives*, 1998 paragraph 2.13

60 J Goode, C Callander and R Lister, *Purse or Wallet? Gender inequalities and the distribution of income within families on benefits*, PSI 1998 (forthcoming). The report highlights the unequal distribution of income within families, and the importance of money being paid to the main carer.

61 Social Security Committee, Third Report, *Tax and Benefits: Pre-Budget Report*, HC 423 1997-98, 4 March 1998 p.45

> Dawn Primarolo: From April 2000 the Working Families Tax Credit will generally be paid through the wage packet. Couples will be able to choose which partner should receive the credit. The details of the new scheme, including the rules for dealing with particular situations, such as disagreements between partners, will be developed by the Inland Revenue over the coming months. Although the resolution of particular disagreements would, of course, depend on the specific facts of the case, the present presumption is that, where the couple disagree about which of them is to receive the credit, it would normally be paid to the partner who mainly cared for the children. [62]

D. Independent taxation

There was considerable speculation before the publication of the Government's plans for the WFTC that it would mean the end of independent taxation for men and women.

The Government has made it very clear that the WFTC poses no threat to independent taxation:

> The WFTC will be assessed and paid over a six month period, on the basis of an initial assessment of household income. In this respect, it will be similar to FC which it replaces. It therefore poses no threat to the principle of independent taxation. As the Chancellor has made clear, the Government has not intention of reverting to the system which existed before 1990 whereby women were treated effectively as their husband's chattels for tax purposes. [63]

E. Take-up

Levels of take-up for Family Credit are currently 70% by caseload (i.e. 70% of those entitled claim) and 82% by expenditure (i.e. 82% of the money which should be spent on Family Credit is actually paid).[64]

The Government makes the following comments on take-up for the WFTC:

> The WFTC is designed to make work pay for families, guaranteeing them a minimum income, above and beyond the level of the minimum wage. Its clear link with employment should demonstrate the rewards of work over welfare and help ensure that people move off welfare

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[62] HC Deb 31 March 1998 c. 452W

[63] HM Treasury, *The Modernisation of Britain's Tax and Benefit System Number Three: The Working Families Tax Credit and Work incentives*, 1998 paragraph 2.14

[64] *Family Credit Statistics Quarterly Enquiry*, August 1997

> into work. 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. FC has only ever been taken up by around 70% of those in work who are entitled to it. With the WFTC, the onus will be on the Government to seek to ensure that as many families as are entitled receive the credit.[65]

However, as people will still have to claim the credit, any increased take-up would presumably come from better publicity, the increased generosity of the benefit and what the Government hopes will be the decreased stigma, rather than from the fact that it is a tax credit.

F. Administration and the burden on employers

Much of the effectiveness of the WFTC will rest on the administrative arrangements made for delivering the service. The same is true of the burden on employers. Whilst it is clear that they will not have to assess entitlement, the precise details of the partnership with the Inland Revenue will make a great deal of difference in determining how easy it will be to make payments through the wage packet.

The Government has made the following comments on this aspect of the new credit:

> The WFTC will be payable through the wage packet from April 2000. This mechanism is important in order to reinforce the link between receipt of the credit and rewards of work. However, the Government is determined to minimise burdens on employers. It is important here to look at the effect of the Budget as a whole: the national insurance contribution reform in particular is likely to ease administrative burdens in the medium term.
>
> Another important priority will be to ensure that the WFTC gets to recipients quickly and efficiently: uncertainty about in work support can be a big disincentive to returning to work. The design of the WFTC - whether paid through employers or direct from the Inland Revenue - will aim to deliver the tax credit to individuals reliably and on time.
>
> In the months ahead, work will continue on the administrative arrangements for WFTC:
>
> - efficient and effective delivery of the WFTC to those entitled to it will be a key objective;
>
> - the Inland Revenue will be consulting employer organisations about the arrangements for paying WFTC through the pay packet. The aim will be to minimise extra work while ensuring successful delivery of the new credit. (A regulatory assessment will be published when detailed administrative arrangements have been settled).[66]

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65 HM Treasury, *The Modernisation of Britain's Tax and Benefit System Number Three: The Working Families Tax Credit and Work incentives*, 1998 paragraph 2.09

66 *Ibid*, paragraph 2.13

V Commentary

The Conservative Party's comments on the WFTC are as follows:

> 'The Conservative party support the principle of in-work benefits and of reducing dependency. That is why we introduced Family Credit in the mid-1980s. By his own admission the Chancellor wants to build on Family Credit, with his new Working Family Tax Credit (WFTC).
>
> However, this reform makes some significant changes. The WFTC by changing the threshold and benefit tapers will make more people benefit recipients and will make more people pay high marginal deduction rates of 60 per cent or more. The WFTC will be paid through the wage packet which means employers will be involved in the payment of the tax credit. This will increase the burdens on employers. The move from Family Credit payable to the mother as a benefit in the Post Office to a Working Family Tax Credit payable to the father would shift income from half a million women to their husbands.
>
> To soften this the Chancellor has given couples the right to choose to have the benefit paid to the mother. This could create a source of discord in low income households. The Chancellor has finally admitted that if couples cannot agree the woman has the final choice to receive the benefit directly just as under Family Credit. Once known this could well become the norm, rendering the whole exercise of creating a WFTC largely nugatory.
>
> The Government claims it would reduce the social security budget, reduce welfare dependency and reduce the numbers of people paying high marginal deduction rates, yet this will undermine all three objectives. It will increase the cost of welfare by at least £1.35 billion a year. It will bring nearly ½ a million people into dependency on welfare. And it will increase those facing marginal deduction rates above 60% by ¼ of a million.[67]

Conservative MP David Willetts has recently produced a critique of the WFTC. In this he makes the following comments:

> If the Chancellor had had the courage of his convictions he would have moved entirely to a working families tax credit which was firmly and exclusively part of the tax system. He would have looked at individuals' incomes, and introduced some special tapering of personal tax allowance which could be delivered entirely through the pay packet. Instead we have a muddled compromise. The basis of entitlement will still be family income. Employers do not and cannot know about family income. The Inland Revenue has no means of adding together the incomes of different members of a family. Assessment will therefore still be done via the benefits system. Payment can be by the employer but equally, if both partners agree, it can be as a benefit paid to non-working partner. If a benefit is paid by the employer it appears to count as a negative PAYE payment. If it is paid to the partner it appears to be a conventional social security payment through the order book (but perhaps as a bold new innovation, an Inland Revenue order book). This seems to involve two bureaucracies handling one measure.

[67] Source: Shadow Chancellor, Rt Hon Peter Lilley MP

> The complex interactions between the Inland Revenue, the benefits system, the employer and the claimant will massively increase administrative costs. Instead of a system that was reasonably well understood and doing a useful job we are now going to have a muddle. It is a wasted opportunity.[68]

The Liberal Democrats welcome the extra support to low paid workers which the WFTC will bring. However, they are concerned about the lack of integration of housing costs into the Credit. Another concern is the basis of the costings of the childcare tax credit (see above for discussion of this). The Liberal Democrats are not wholly convinced about the efficacy of measures like this in getting people back into work, as they neglect the demand side of the economy. They argue that in large parts of the country people are not working because the jobs are not there rather than because of problems with work incentives. Neither are they convinced about the benefits of delivery through the tax system, particularly with regard to the issue of "wallet to purse" transfers.[69]

The Institute for Fiscal Studies have made the following comments about the WFTC:

> The centrepiece of the Budget, the Working Families Tax Credit, aims not just at redistribution but also at encouraging employment. In truth, the credit is not new, and is more accurately described as a re-badging of Family Credit, the existing state benefit for poor working families. But the Working Families Tax Credit will be much more generous than Family Credit - £1.5 billion (or 75%) more generous in fact. It will not only benefit current Family Credit recipients but also 400,000 families who are not entitled to Family Credit but will be eligible for the new credit.
>
> Working Families Tax Credit should be successful in helping some people get into employment because it will reward work more than the current tax and benefit system. But no respectable research has ever shown that tax or benefit incentives can transform the labour market. Reducing the rate at which the Working Families Tax Credit is withdrawn might also mitigate the disincentive for those currently on Family Credit to increase their incomes. The reduction for most recipients will be from 79% to 68%, which will marginally improve the return to increased earnings. But this has so far only considered the up side of the reform. As ever, there is also a downside. As the Working Families Tax Credit is more generous than Family Credit, many people will find that they will be able to reduce the number of hours they work per week and still be better off than before. If they do not particularly enjoy their job, they will do this, and the Government will find it loses tax revenue when people reduce the number of hours in employment. This might apply particularly to the 400,000 families newly entitled to the WFTC because of its increased generosity. If even more people decide to do less work, and spend more time with their families, it could get very expensive for Gordon Brown in a few years.
>
> So Gordon Brown has achieved the first Budget to redistribute to the poor for many years. But it is still too early to conclude whether he has also significantly improved incentives in the labour market.[70]

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68 David Willetts, *The Benefit of Experience*, Centre for Policy Studies, 3 March 1998

69 Source: Liberal Democrat Social Security Spokesman, Steve Webb MP

70 *The Distributional Effect of the 1998 Budget*, IFS, 1998

The Low Pay Unit has welcomed the proposals, although they point to some remaining concerns:

> The Low Pay Unit today welcomed the Chancellor's Budget which will begin to address the inequality that has disfigured Britain for the last decade.
>
> "His announcement that a new Working Families Tax Credit will mean those earning less than half average earnings will pay no tax is a real step towards redistributing economic gains and putting fairness back in the tax system. The LPU has consistently argued that those on such low pay should not pay tax. We would urge the Chancellor to extend this to all low paid taxpayers, including those without children," *commented LPU director Bharti Patel.*
>
> The LPU also welcomed the large increase in Child Benefit on top of indexation but were concerned that it may be taxed in the future.
>
> The Chancellor pledged that under the WFTC no family on half-average earnings should pay tax. This promises real increases in living standards for low paid families.
>
> The WFTC childcare tax credit will also tackle one of the greatest barriers to work facing low income families - child care costs - and could be the crucial element in making work pay.
>
> There are still concerns over the administration and flexibility of the new system. The low paid labour market is more flexible and insecure than ever and unless the new system can deal with this, work disincentives will persist.[71]

The Daycare Trust made the following comments:

> Colette Kelleher, Director of Daycare Trust, said: "For the first time the Budget will make work pay for low income parents and give their children the services they need. It will put money into parents' pockets and make a realistic contribution towards the cost of childcare. The Budget will help unlock potential and transform the lives of millions of people in Britain.
>
> "Daycare Trust has been pressing the Government to make childcare more affordable. More than 40 per cent of the calls to Daycare Trust's childcare helpline are from parents who cannot find childcare they can afford. Daycare Trust is very pleased that the Chancellor has listened to the voices of parents across the country.
>
> "Childcare provides choices and opportunities for parents and children. For too long many parents and children in Britain have missed out because of the cost of childcare. Children whose parents cannot afford childcare are excluded from early learning opportunities and their parents are excluded from education, training and employment opportunities.
>
> "Less than 30,000 families currently get help with childcare costs through the benefits system. The Budget provides both generous and well-targeted help paying for childcare to many more families.

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[71] Low Pay Unit Press Release, 17 March 1998

"Making childcare more affordable has many benefits. It will underpin the success of the welfare to work programme; it will help tackle social exclusion; it will improve the quality of childcare services; and it will sustain the Government's expansion in childcare places.

"The Budget offers a new deal for families who want to move from welfare to work. It will help to close the still growing gap between 'work rich' and 'work poor' families in the UK.

"The childcare subsidy within the working families tax credit is the first much needed step towards making childcare more affordable in the UK. With increasing numbers of mothers with young children choosing to return to work, parents, children and employers all need an effective childcare infrastructure. The Government should also look at start-up grants to kick-start new childcare services in disadvantaged areas, particularly for younger children, and incentives for employers to share the costs of childcare."[72]

[72] Daycare Trust Press Release, 17 March 1998

Appendix I Model calculations

1998-99 rates of benefit/tax credit have been used throughout these calculations. However, the WFTC will be introduced in 1999-2000, when the structure of National Insurance contributions (NICs) will change and the 2% “entry fee”, which costs workers £1.28 per week in 1998-99, will be abolished. Consequently the 1999-2000 structure of NICs has been used both in the Family Credit and the WFTC calculations. Similarly, the 1999-2000 structure of tax has been used (with the reduction in the married couples' allowance), again both for Family Credit and WFTC. This is consistent with the model calculations used for WFTC in the Government document, *Working Families Tax Credit and Work Incentives.* The aim here is to highlight effects achieved through the WFTC as compared to those produced by Family Credit, rather than the effects of the whole Budget package.

Family Credit calculation

<u>Rates</u>

Adult credit	(one per family)	£48.80 **(a)**
Child credits	0-11	£12.35 **(b)**
	11-16	£20.45 **(c)**
	16-18	£25.40
Credit for adult working 30 hours or more		£10.80 **(d)**

The maximum Family Credit is paid until net income reaches £79 per week. After that, for each £1 they will lose 70p in benefit (i.e. a 70% taper).

<u>Example</u>

Two parent family with two children aged 10 and 12. Only one adult works (for more than 30 hours per week), earning £200 per week gross.

Maximum Family Credit **(a + b + c + d)** =	£92.40 **(e)**
Gross income	£200.00
less tax	£21.31
less NICs	£13.60
Net income	£165.09
threshold	-£79.00
Net income over threshold	£86.09
70% of excess income	£60.26 **(f)**
Family Credit **(e - f)**	£32.14

Working Families Tax Credit

Rates

Basic tax credit	(one per family)	£48.80 **(a)**
Tax credit for child aged	0-11	£14.85 **(b)**
	11-16	£20.45 **(c)**
	16-18	£25.40
Credit for adult working 30 hours or more		£10.80 **(d)**

The maximum tax credit would be paid or credited until net income exceeds £90 per week. After that, for each extra £1 the tax credit is reduced by 55p -–a 55% "taper".

Example

As above – Two parent family with two children aged 10 and 12, one adult working (for 30 hours per week) earning £200 per week gross.

Maximum tax credit **(a + b + c + d)** =	£94.90 **(e)**
Gross income	£200.00
less tax	£21.31
less NICs	£13.60
Net income	£165.09
threshold	-£90.00
Net income over threshold	£75.09
55% of excess income	£41.30 **(f)**
Working Families Tax Credit **(e - f)**	£53.60

As this is a tax credit, it will be deducted from income tax liability as follows:

Income tax due	£21.31
Minus Working Families Tax Credit	-£53.60
Net income tax	-£32.29

The family would owe a negative amount of income tax, and would therefore get £32.29 either directly from the Inland Revenue or through the pay packet. Overall they would be £21.46 better off than they would have been on Family Credit.

Appendix II Tax credits for working families in the USA

This Section was prepared by Antony Seely, from the Library's Business and Transport Section.

The inspiration for paying a tax credit to working families comes from the United States of America and its system of earned income tax credits (EITCs). The EITC is a credit on federal income tax available to poor working families with children, introduced in 1975. Since then it has become a central part of the federal government's antipoverty strategy. In 1975, approximately 6.2 million families received credits totalling $1.25 billion. In 1996, over 18 million families received credits totalling around $25 billion. During this period, the average credit received per family increased from $201 in 1975 to an estimated $1,341 in 1996.[73] The EITC provided the model for a similar tax credit - the Working Income Supplement - introduced in Canada in 1993.[74] Experience in both countries has been a factor in the design of the WFTC. As the Financial Secretary to the Treasury, Dawn Primarolo, stated in a written answer prior to the spring 1998 Budget, "the Government are considering the introduction of a "WFTC" to help make work pay for families on low incomes. And systems used in other countries, including Canada, have been looked at as part of that process."[75]

The value of the credit is calculated on the basis of a family's annual earnings, and whether the family has one child, or two or more children.[76] The value of the credit rises with earnings, reaches a plateau when annual earnings are around $12,000, and then is withdrawn. In the two-child case, the credit supplements earnings at the rate of 40 cents per dollar, up to a total annual earnings of $8,890 (i.e. a maximum credit of $3,556 is paid). Beyond earnings of $11,610 it is withdrawn at a rate of 21% until earnings reach $28,495. The credit is refundable so that any credit due in excess of tax liability is given direct to the taxpayer.[77]

Those who support the EITC do so for a number of reasons:

> First, the EITC is said to reward work by using the tax system to supplement the earnings of low-wage workers. Recent research has found that the EITC creates work incentives for workers with

[73] "Can the tax system make work pay?", *Working Brief*, December 1997/January 1998 p.20

[74] For details of this scheme see Michael Mendelson, *The WIS that was: replacing the Canadian Working Income Supplement*, Joseph Rowntree Foundation 1998

[75] HC Deb 10 February 1998 c.138W

[76] Details on the rules on eligibility for the EITC are given in *Working Brief*, December 1997/January 1998

[77] Practical information on the EITC - *Publication 596* - is provided by the Internal Revenue Service at their Internet site : *http//www.irs.ustreas.gov/* … This leaflet is at : */prod/forms_pubs/pubs/p596toc.htm*

> the weakest connection to the job market.[78] The EITC may encourage workers to enter the job market or to increase hours worked by offering an offset to childcare, transportation, health care, and other work-related expenses. These offsets can be especially important to persons making the transition from welfare to work and to workers holding part-time jobs…
>
> Second, the EITC is justified on the basis of tax fairness. The credit makes the income tax system less regressive by reducing the taxes paid by the lowest income taxpayers. The EITC also has the effect of reducing the rate of increase in the income tax system for low- and moderate-income taxpayers. Third, the EITC is well-targeted toward its intended beneficiaries. The EITC operates on a sliding scale that is effective in directing benefits to low income working households. The EITC is one of the few anti-poverty policies for which working poor families can qualify. In addition to being well targeted, the EITC also has a high take-up rate, estimated to be between 80 and 86% nationally. The percentage of claimants in 1997 is expected to be even higher, perhaps as high as 90%.[79] High take-up rates are an indication that recipients find the policy accessible and useful.
>
> Fourth, the EITC provides assistance to workers who have recently lost a job or suffered a reduction in working hours. Although this was not the primary purpose of the credit, workers who find themselves without employment for part of the year may be eligible for the EITC because of low annual earnings. The credit, along with unemployment insurance benefits, can provide workers with cash assistance until another job is found. Fifth, the EITC provides a stimulus to local economies because low income families tend to spend their incomes on household necessities and because most of this spending occurs locally. Jobs and tax revenue are generated both from this direct spending and from its "multiplier effects" as this spending ripples through the local economy.[80]

Nevertheless, as the authors of a recent article on the EITC in *Fiscal Studies* note, some aspects of the credit system have come in for serious criticism - its cost, its potential for fraud - and there is some evidence that its impact on work incentives may be less than imagined:

> *The programme is too expensive.* Between 1986 and 1996, federal expenditure on the Earned Income Tax Credit increased from $1.7 billion to $18 billion … this rivals total federal outlays on Aid to Families with Dependent Children. In the words of tax expert George Yin of the University, of Virginia, 'a transfer programme of this magnitude … shouldn't be hidden in our tax code.'[81]
>
> *The programme is subject to excessive fraud.* An Internal Revenue Service (IRS) study of tax compliance released early in 1997 reported that taxpayers claimed $4.4 billion more in EITC refunds for 1994 than they were eligible to receive.[82] In response, the IRS recommended various actions and changes in EITC law intended to combat erroneous and fraudulent claims. The two

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78 J. Holtzblatt, J. McCubbin, R. Gillette, "Promoting work through the EITC", *National Tax Journal* 47, September 1994 pp 591-607; S. D. Hoffman, L. S. Seidman, *The earned income tax credit: anti-poverty effectiveness and labor market effects*, Kalamazoo MI: WE Upjohn Institute for Employment Research, 1990

79 State Communities Aid Association, *Making the case for a state earned income tax credit: a county by county profile of New York state claimants*, Albany NY February 1994

80 "Can the tax system make work pay?", *Working Brief*, December 1997/January 1998 p.21

81 G. Yin, "Should today's fastest growing federal assistance program be roped in?", *The American Enterprise*, July/August 1996 p.78

82 "Treasury wants more IRS resources spent on EITC administration", *Tax Notes*, 28 April 1997 p.484

> principal compliance issues involve assuring that the work that is reported to justify receipt of the subsidy has actually occurred and verifying that children reported as a basis for claiming the credit are indeed in the household.[83]
>
> *The effects on labour supply may be perverse.* Since the EITC raises marginal tax rates for more workers than get marginal tax reductions, on balance the EITC may lower work effort.[84] The actual consequence of the policy for labour supply is complicated by timing of the reward. Again to quote Yin, 'EITC benefits may be perceived as an income tax refund, a product of the tax preparer's ingenuity, or simply a windfall, and not a reward for work effort. This mutes any significant influence the programme might have on work levels.'[85]
>
> *The good news arrives so late that the message is lost.* As is clear from the figures presented above, the disjuncture between earning and receiving the EITC means that the tax reduction fails both as a reward for work and as a contribution to family liquidity during the difficult welfare-to-work transition. A number of experiments have been proposed in the US to use third parties – welfare agencies, state revenue offices or community organisations – to deliver the benefit as the claim is accrued and to integrate the EITC with other components of the transfer system.[86] Some encourage third-party participation as a method of reducing fraud and improving EITC Administration;[87] others see it as an essential element in an integrated tax and benefit system. One reluctant endorsement comes this way: "Sad to say, what is needed to effectively administer a programme like the EITC is a caseworker; a person who can explain rules and choices to potential beneficiaries, use discretion in difficult cases, and monitor the flow of public funds ... If EITC funds were folded into the welfare funding pot, efforts to reform welfare into a system for firmly leading recipients to work would be easier."[88] To date, the IRS has resisted attempts to experiment with such integration."[89]

Clearly the EITC encourages labour-force participation by the low-paid, as it provides a bonus on top of a family's earnings, which increases in value as those earnings rise. Nonetheless a contrary incentive will operate for those whose incomes are such that they find the value of the credit is constant or falling as their earnings increase (the poverty trap effect). Indeed it is well known that the withdrawal of income-related benefits may result in lower-paid workers, especially those with children, finding that increasing their earnings leaves them little, or no, better off.

In their summer 1997 *Green Budget* the Institute for Fiscal Studies noted that although the EITC encourages labour-force participation, it creates work disincentives for the 70% of EITC recipients whose incomes lie in the region where the credit is constant or being phased out.

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83 G. Steuerle, "Cheating and the Earned Income Tax Credit", *Tax Notes*, 9 June 1997 pp 1413-1414

84 The authors of the piece on the EITC in *Working Brief*, December 1997/January 1998 cite some evidence that a relatively small number of claimants actually understand how the EITC is structured. One would imagine this lack of understanding reduces the impact that the credit has on employment decisions.

85 G. Yin, *The American Enterprise*, July/August 1996 p.78

86 M. Wiseman, *Welfare work incentives in real time*, (manuscript) 1995

87 G. Steuerle, *Tax Notes*, 9 June 1997 pp 1413-1414

88 G. Yin, *The American Enterprise*, July/August 1996 p.78

89 Robert Walker, Michael Wiseman "The possibility of a British EITC" *Fiscal Studies* 4, 1997 pp 418-419

Several studies have identified these conflicting effects.[90] Eissa and Liebman (1996)[91] found that the 1986 expansion of the scheme had positive participation effects for single women with children, but no change in the hours worked by those already in the labour force. Work by Scholz (1996)[92] estimates that the 1993 expansion of the scheme led to both an increase in labour-force participation and a reduction in hours of work by those already in the labour market, but suggests that the magnitude of the participation effect is large enough to offset the decrease in the hours worked by workers.

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[90] IFS, *The IFS Green Budget: Summer 1997*, May 1997 p.77

[91] Nada Eissa & Jeffrey B. Liebman "Labor supply response to the earned income tax credit", *Quarterly Journal of Economics*, May 1996 pp 605-637

[92] John Karl Scholz "In-work benefits in the United States: the earned income tax credit", *Economic Journal*, January 1996 pp 156-169