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The Employment Tax Credit and issues for the future of in-work support

Edited by Fran Bennett and Donald Hirsch

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Tax credits and how to respond to income changes

Peter Whiteford, Michael Mendelson and Jane Millar

The **Joseph Rowntree Foundation** has supported this project as part of its programme of research and innovative development projects, which it hopes will be of value to policy makers, practitioners and service users. The facts presented and views expressed in this report are, however, those of the authors and not necessarily those of the Foundation.

Joseph Rowntree Foundation
The Homestead
40 Water End
York YO30 6WP
Website: www.jrf.org.uk

Peter Whiteford is a Principal Administrator (Social Policies), Directorate for Employment, Labour and Social Affairs, OECD, Paris

Michael Mendelson is a Senior Scholar with the Caledon Institute of Social Policy in Ottawa, Canada

Jane Millar is a Professor of Social Policy and Director of the Centre for the Analysis of Social Policy at the University of Bath, UK.

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First published 2003 by the Joseph Rowntree Foundation

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A CIP catalogue record for this report is available from the British Library.

ISBN 1 85935 109 3 (paperback)

ISBN 1 85935 110 7 (pdf: available at www.jrf.org.uk)

Cover design by Adkins Design

Prepared and printed by:

York Publishing Services Ltd

64 Hallfield Road

Layerthorpe

York YO31 7ZQ

Tel: 01904 430033; Fax: 01904 430868; Website: www.yps-publishing.co.uk

Further copies of this report, or any other JRF publication, can be obtained either from the JRF website (www.jrf.org.uk/bookshop/) or from our distributor, York Publishing Services Ltd, at the above address.

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Acknowledgements

We are grateful for comments received from Fran Bennett, Mike Brewer, Helen John, Tony Orhnia, Pietro Toigo, Helen Morris and other participants at the seminar held at HM Treasury in December 2002. Also from Nicholas Barr, David Rowlands, David Stanton and the Australian Department of Family and Community Services. And, in Canada, thanks for comments from Rick August of Saskatchewan Social Services, Doug Murphy, Yves Gingras and Matthew Holmes of Human Resources Development Canada and Greg Cartier, Norm Jeffrey and Kathy Turner of the Canadian Customs and Revenue Agency. Any errors are our own.

Introduction

The tax system deals with payments *by* citizens to the government. The social security benefits system deals with payments *to* citizens from the government. Each plays a different role in income redistribution. Although it has often been proposed that the two should be brought together into one single delivery system, in the UK taxes and benefits have generally retained their distinct identities, their different roles, their separate administrations, and their diverse approaches to income testing – that is, until now.

After the abolition of child tax allowances in the mid 1970s, the UK relied solely on the benefit system to provide financial support for families. This began to change in 1999 when the Labour government first introduced relatively modest tax-based payments. Now, the Labour government is planning to make the tax system, rather than the benefits system, responsible for delivering the main new programme providing financial support to families. The Inland Revenue – the tax administration department of government – took over responsibility for delivering the universal Child Benefit in April 2002. Starting in April 2003, the Inland Revenue will become responsible for two new refundable tax credits for working-age people: the Child Tax Credit, for most families with children, and the Working Tax Credit, for low-paid working adults, with and without children.

The new UK tax credits have two main aims: to tackle child poverty and to improve financial incentives to work. The Child Tax Credit will bring together into one system the various existing elements of support for children. It will be paid in addition to Child Benefit, but replace the child additions¹ paid to families receiving social security benefits (Income Support and Job Seekers' Allowance) and those paid to low to middle income working families (Working Families Tax Credit/Disabled Person's Tax Credit), as well as the small amount of tax relief now provided for taxpayers supporting children (the Children's Tax Credit). For the first time, the same financial

support from the same source will be paid on behalf of children in families across a wide income range, with the amounts received related to income but not to parental employment status.

Having this integrated system² delivered by the tax, rather than the social security system, is seen by the government to offer important advantages:

... the income tax system provides a light touch and non-stigmatising way of measuring income. ... The advent of the new tax credits offers the opportunity to introduce a new system based on the principle of progressive universalism. This means supporting all families with children, but offering greatest help to those who need it most through a light touch income test. (HM Treasury, 2002, p. 4)

But even a 'light touch' income test involves making a number of decisions – what is taken into account as income, whose income in a family unit is counted, over what time period income is measured, how long awards should last, and how responsive the system should be to changes in income and circumstances during the period of the award. These are the main design issues that the tax system must address in delivering benefits. Achieving a light touch means designing a system which, on the one hand, provides families with the help they need at the time when they need it, while, on the other hand, minimising the need for intrusive, complex, costly and administratively burdensome procedures. In short, the system must balance responsiveness and simplicity.

While using the tax system to administer benefits is a new innovation in the UK, the tax system has been used for this purpose in other Anglo-American countries for many years. Benefits for children and/or low-paid workers are administered through the tax system in Canada (the Canada Child Tax Benefit) and the USA (the Earned Income Tax Credit), and partly in Australia (the Family Tax Benefits).³ In designing the UK system, the Treasury paper notes, 'the Government has drawn upon both the Canadian and Australian

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experiences to design a system which steers a course between the two' (HM Treasury, 2002, p. 22). In chapters 1 and 2 of this report, we examine how Australia and Canada⁴ have addressed responsiveness to changes in income and circumstances in their systems, and how this has actually worked in practice. In chapter 3, we describe the treatment of responsiveness in the soon-to-be-implemented UK system. In chapter 4,

we compare the way each country deals with responsiveness – timeliness of change in benefits in response to income change – and assess these different trade-offs between simplicity and responsiveness in relation to: administrative burden; transparency, intrusiveness and compliance costs for recipients; equity; and work incentives.

1 Australia: responsiveness and reconciliation in practice

The evolution of the Australian system

Australia has a relatively long experience of dealing with the issues involved in providing an integrated form of assistance for working and non-working families with children, primarily using the benefit system. More recently, it has started to deal with issues relating to the integration of the tax and benefit systems to deliver family assistance. A modest programme (Family Income Supplement or FIS) was introduced in 1983, providing income-tested assistance for low income working families, at the same rates of payment per child as for income support recipients. Over the next 15 years coverage was expanded from only 1 per cent to nearly 14 per cent of children. The programme was expanded in stages (Stanton and Fuery, 1995). In 1987, Family Allowance Supplement (FAS) was introduced at higher rates and with a more generous income test, as part of the then government's pledge to 'abolish child poverty' by 1990. In 1993, the benefit was fully integrated with payments for families receiving income support payments. In 1995, reforms to income support payments, including the introduction of a new income test and payments of income support direct to mothers, further increased the number of families eligible for payments. At the same time, one of the remaining forms of tax assistance for 'dependent' spouses with children was largely replaced by a cash payment direct to mothers. After some further changes, by 1996 there was an integrated cash payment for all low to middle income families with children, with the money usually paid directly to mothers.

Since 1996, the means of delivering assistance have started to shift back towards using the tax system. The first step was the introduction of the Family Tax Initiative, which provided additional, small benefits payable in cash to lower income families or through the tax system to middle to higher income families. The most recent reforms

came in July 2000, when the government introduced major changes to the tax system including the introduction of a Value Added Tax, accompanied by an extensive compensation package for social security recipients, and further major changes to assistance for families. These changes simplified family payments, and provided higher levels of assistance, with reductions in the income-test withdrawal rates. The new structure combines twelve of the pre-existing types of assistance into three new programmes. Family Tax Benefit Part A assists with the general costs of raising children; Family Tax Benefit Part B is directed to single-income and sole-parent families; and Child Care Benefit assists with the costs of child care.⁵

Family Tax Benefit Part A is a two-tier payment directed to most families with children. From July 2002, maximum payments per child under 13 years are A\$126.70 per fortnight or A\$3,303.25 per year, with A\$160.72 per fortnight (A\$ 4,190.20 per year) per child aged 13 to 15 years. The maximum rate is payable to those receiving income support, plus those with a gross family income of less than A\$30,807 per year.⁶ For those with incomes above this level, payments are reduced by 30 cents for every extra dollar of pre-tax income, until the minimum rate (A\$1,062.15 per year) is reached. The minimum rate is payable up to a family income of A\$79,643 (plus an additional A\$3,212 for each dependent child after the first). Payments are then reduced by 30 cents in every dollar over that amount until the payment reaches nil.⁷

Family Tax Benefit Part B provides further assistance to single-income families, including sole parents, with higher rates for families with children under five years of age. This is a flat rate payment of A\$108.78 per fortnight (A\$2,836.05 per year) for a family with a child under five years of age, and A\$75.88 per fortnight (A\$1,978.30 per year) for a family with a child over five years of age. There is

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no income test on the first earner's income, so in the case of sole parents the payment is universal. In a couple, earnings of a second earner are ignored if these are below A\$1,752 a year. Above that level, payments are reduced by 30 cents for every extra dollar of the second earner's income.⁸

The new system provides a wider range of choices of how family assistance can be paid. Families can choose to receive direct payments into bank or credit union accounts each fortnight, or they can choose to receive payments through the tax system, either as a lump sum or periodically by employers reducing their tax instalment deductions. Families are also able to change their method of payment at any time during the year. For example, they could get fortnightly payments for the first six months but decide to claim the remaining six months as a lump sum through the tax system. There are exceptions. For people receiving income support benefits, or Rent Assistance, family payments must be paid fortnightly into their bank or credit union account.

Of the 2.6 million families with children in Australia, around 2 million families receive one or both of these income-tested payments with 1.8 million receiving Family Tax Benefit Part A and 1.2 million receiving Family Tax Benefit Part B (Commonwealth of Australia, 2001, CA 394). Table 1

provides further details of the distribution of Australian families by type and level of payment.

Responding to income changes

There have been a number of revisions over the years to the way in which the income test responds to income changes. When introduced in 1983, entitlement to Family Income Supplement was based on average joint parental taxable income in the four weeks preceding application. Entitlements were reviewed every six months. Recipients whose income fell could apply for reassessment at any time. Those whose income increased to more than 125 per cent of previously assessed income (or more than 125 per cent of the threshold for those receiving the maximum rate) were obliged to inform the Department of Social Security so that entitlement could be reassessed.

In 1988–89, following the introduction of the more generous Family Allowance Supplement, these arrangements were changed so that entitlement was set for the 12 months of the calendar year on the basis of joint parental taxable income in the financial year ending in the previous year (that is, benefits were initially set from 1 January to 31 December each year on the basis of taxable income in the 12 months ending on the previous 30 June).

Table 1 Number of clients assisted, Australia, 30 June 2001

	Families	Children
Family Tax Benefit, Part A		
Maximum rate (with income support payment)	509,785	962,202
Maximum rate (without income support payment)	127,231	243,831
Other rates (between base and maximum)	406,105	874,747
Base rate	725,392	1,333,047
Below base rate	31,193	68,463
Family Tax Benefit, Part B		
Maximum rate (for sole parents)	559,359	951,225
Maximum rate (for couples)	289,965	622,654
Other rates (for couples)	331,716	702,254

Source: Department of Family and Community Services, <http://www.facs.gov.au/>

Entitlements could be reviewed during the year if the family experienced an increase or decrease of 25 per cent or more in current, fortnightly taxable income compared to the average fortnightly income implied by their income in the previous year.⁹ From 1990, payments were only changed if income increased by more than 25 per cent. If income fell by less than 25 per cent, families could have their payments reassessed but benefits would be adjusted only for families who thereby became entitled to the maximum rate of assistance.

The system was again changed in 1996. From January 1996 families could apply for reassessment on the basis of current fortnightly income, no matter how small the reduction in income compared to the average for the previous year. Families whose current income rose were obliged to have payments reassessed if income was 10 per cent or more above their base year income or 10 per cent above the income threshold. If incomes rose by more than this amount and payments were not reassessed, families would incur a debt. This change was mainly intended to reduce expenditure on the programme.

Under the system from July 2000, two significant changes were made. First, instead of being assessed on the basis of income in the previous tax year, customers who choose to receive Family Tax Benefit as a regular payment or regular reduced tax deduction are asked in April or May to estimate their taxable income for the next financial year to determine their fortnightly entitlement for the forthcoming year. Second, there is an end-of-financial-year reconciliation for all families when payments received are assessed against actual income. If actual income is less than had been estimated, there is an extra payment, and vice versa. For example, when completing their tax forms by 31 October 2001 the amount of the family's *actual* income in the tax year 1 July 2000 to 30 June 2001 was reconciled against the income they had previously estimated. The amount of the family payment they would have received based on

their actual income was then calculated and the difference between what they had been paid and what they should have been paid based on actual income was then either paid as a top-up or became an overpayment to be recovered.

This end-of-year reconciliation is a new feature of the system and reflects a number of objectives. Two of the primary objectives were that families receive assistance when they need it and that families could choose the means of delivery of assistance, including through the tax system. Given that the income tax system involves submitting annual returns, which then are used to reconcile under- or overpayments of tax, this was perceived as implying an extension of the principle of reconciliation to the new system of family assistance. The prospective reporting of income by customers who choose to receive Family Tax Benefit as a regular fortnightly payment or as a regular tax deduction further strengthens the requirement for reconciliation. If there were no reconciliation period, there is a risk that many people would seek to underestimate their income to maximise their payments. In addition, anyone choosing an end-of-year lump sum payment would be penalised relative to those who prospectively underestimated their income. Reconciliation was therefore seen as a way of ensuring that families with the same *annual* incomes would receive the same Family Tax Benefit entitlement, irrespective of the choice of delivery mechanism.

As noted, the reconciliation allows for either a top-up payment if income was initially over-estimated, or an overpayment to be recovered if income had been under-estimated. The reconciliation also allows for an overpayment to be offset against a tax refund, and for an income tax debt to be offset against a family payment entitlement. However, the Part A income test does not apply during any period that the person or partner is receiving income support.¹⁰ Therefore the period on income support is quarantined from the reconciliation for this payment.

Implementation: issues and problems

Controversy about the new system started towards the end of the 2000–2001 financial year when the time first approached for reconciling customers' entitlements. The issue was raised by the Opposition in the Senate Estimates Committee in May 2001 (Commonwealth of Australia, 2001), and following Press Releases by the Opposition spokesman on Family and Community Services, for example, entitled 'Zero tolerance for families', there was considerable media attention. Headlines included 'Families to be hit with order to pay' (*Sydney Morning Herald*, 28 June 2001), and 'Families to be hit with debt notices' (*Canberra Times*, 28 June 2001). In July 2001, just before what was then regarded as an important by-election, the government announced that the first A\$1,000 of all overpayments would be waived. The cost to revenue of this decision was around A\$357 million. The government narrowly won the by-election, which they had been expected to lose, although of course it is not possible to determine what role was played by this decision.

Even forgiving A\$1,000 did not, however, resolve all problems. The issue continued to be voiced in the Australian parliament, both in questions to the minister responsible and in Grievance Debates. Overpayments were raised in the election campaign towards the end of 2001, and it was asserted by the Opposition that the government was delaying the mail-out of letters requesting repayments to be made until after the election. In November 2001 the government was re-elected. Media reports continued into 2002, with headlines like 'Thousands caught in welfare trap' (*The Australian*, 22 February 2002, p. 8), 'Family assistance letters sent with the words 10,000 SA families don't want to hear – give back the cash' (*Adelaide Advertiser*, 23 January 2002). The issue was again raised in the Senate Estimates Committee in February 2002, where the questioning takes up nearly 70 pages of transcript (Commonwealth of

Australia, 2002). Again, in April 2002 there have been headlines 'Family payments in crisis' (*The Australian*, 4 April 2002).

How significant is the issue? Media reports obviously are not necessarily reliable sources for estimating the scope of the problem, but the evidence given to the Senate Estimates Committee in February 2002 provides a more balanced picture. Under the system operating before July 2000, there were limited data on the number of people who advised of a notifiable event or an increase in income of more than 10 per cent on the base year. Typically, 140,000 to 150,000 working families receiving more than the minimum rate were being paid on a current year estimate (i.e. their incomes and/or circumstances had changed during the year). In the following year, after the new system came into operation, more than 800,000 families had notified a change in their estimate of income by May 2001 (Commonwealth of Australia, 2002). The latter includes all families reporting a change (not just those receiving more than the minimum rate) so is not directly comparable with the previous year. But it is nevertheless a very substantial increase and means that more than one-third of the 2 million families receiving Family Tax Benefits reported an income change during the year.

Probably the more relevant number is how many had a debt at the end of the year. Again there was a significant increase, as would be expected given the 'buffer' arrangements under the previous system. In 1999–2000, there were about 51,800 families with debts at the end of the year. In contrast, after the introduction of new reconciliation arrangements, it is estimated 670,000 families were overpaid – more than 12 times as many as the previous year. The waiver reduced this to 198,000 families with overpayments to repay.¹¹ The total gross value of overpayments was estimated at A\$584 million; subtracting the cost of the waiver of A\$357 million, leaves a remaining level of overpayments to be recovered of around

A\$227 million. The recovery of these overpayments continued to attract media attention.

This also implies that the 'gross overpayment rate' was around one-third of all families receiving payments. Moreover, there are many families who are very unlikely to have been affected by income changes (those receiving income support benefits, those whose income stayed under the lower income threshold, and those who receive the minimum rate of Family Tax Benefit). If these families are excluded, then it appears to imply that more than half of the remaining families – that is, families in the lower to middle income ranges – underestimated their income and so received more than they should have. On the other hand, around 271,000 families received additional assistance of A\$279 million – an average of A\$1,028 per family – because they had initially overestimated their incomes. This top-up would not have occurred under the previous system. But if we add these families to those who incurred an overpayment then end-year reconciliation affected the family payments of around 940,000 families.

There were four groups affected by overpayments. The families most affected were those whose incomes were in the first income withdrawal range (e.g. A\$30,000 to A\$45,000 for a couple with two children), whose entitlements to Family Tax Benefit A were changed. These are mainly families at moderate to average levels of earnings, but where these earnings fluctuate or the second earner increases hours of work. The second most significant group were those receiving Family Tax Benefit B, where the second earner's income moved above A\$1,679, as a consequence of (re-)entering the labour force. The third most significant group were those whose entitlements were affected by maintenance income, where this was received as a lump sum (Commonwealth of Australia, 2002). Another factor is that families are entitled to receive Family Tax Benefit Part A for a child aged 16 or more only if the child's income is less than \$8,346. Therefore, the fourth group were

those who found that they were liable for overpayments when their child entered the workforce part-way through the year (the academic year finishes about half-way through the financial year for tax purposes).

Why did the level of overpayments increase so significantly? Part of the answer is that the previous system simply ignored a substantial part of what the new system treats as overpayments. But it also seems that families were more likely to underestimate their income than they were to overestimate, or indeed to get their estimates right. Given that families did not know in advance that the government would waive the first \$1,000 of overpayments, this was presumably not the result of calculation (or even more families may have underestimated their income). One possibility is that families may be over-cautious in estimating their future incomes, preferring to under-estimate rather than over-estimate. Families may be basing their estimate on last year's actual income, without factoring in rises over time. Alternatively, perhaps families need the money now or simply prefer to get the money now on the theory of a 'bird in the hand?' Another possibility is that family incomes may be more variable than is often considered, and in this context it can be noted that Australia is only now conducting its first longitudinal survey that will measure income dynamics.

The second year of the system suggested that there might be some improvement, but significant problems remained. Preliminary estimates given to a Senate Committee in November 2002 were that by that stage around 1 million of the 1.8 million families receiving payments had lodged their tax returns. Of these 336,000 families had incurred overpayments and 265,000 families were entitled to top-ups. This was around 33.4 per cent of families with debts, compared to just under 39 per cent in the previous year. Extrapolating to all families this implies that around 576,000 would be facing debts. Correspondingly, the number of families entitled to top-up payments would appear to have risen from

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around 16 per cent to 26 per cent of all families. Overall, this suggests that the problem may have reduced somewhat.

In September 2002, the Australian government announced that it would further 'fine-tune' the family assistance system. Under the new measures that took effect from November 2002, families have a number of additional options in the way they receive payments. One option is that families with a change of income during the year can ask to be paid at a lower rate than their actual entitlement for the remainder of the year. Families will also be given the choice to receive some of their payments during the year and the balance at the end. This means that they can, in effect, set themselves a regular rate of payment in order to ensure that they receive some ongoing assistance, and also ensure that they are less likely to accumulate an overpayment. In addition, families can also defer payments for their older teenagers, so that they will not incur an overpayment for them, while continuing to receive regular payments for their younger children. Finally, families have also been given the choice of only receiving the base rate of Family Tax Benefit Part A on a fortnightly basis, and the rest as a lump sum at the end of the year. This will mean that so long as income remains below A\$80,000 they will not accrue an overpayment. The government sees these initiatives adding flexibility and choice to the system, while reducing the likelihood that families will be overpaid.

However, in February 2003 the Commonwealth Ombudsman released a report detailing the results of an investigation of the family assistance scheme (Australia, Commonwealth Ombudsman, 2003). This report was motivated by the roughly 1,800 complaints about the operation of the scheme

received by the Ombudsman's Office between July 2000 and September 2002. The main areas of concern highlighted by the Ombudsman's report included:

- that the system seems to inherently result in a large number of debts and that many debts are significantly high
- that debts arising from the scheme are affecting many lower-income families
- that debts may be unavoidable, even when families fully comply with all requirements
- that debts seem to have an unfair retrospective effect in some circumstances (for example, changes in family circumstances during the financial year, which families cannot anticipate and may be beyond their control, can result in significant debts and/or other losses)
- concern about the manner in which debts are recovered, and
- concern about the effect of debts on other entitlements.

The report noted that the measures already announced by the government in September 2002 would address some of these issues and also made some specific recommendations. Nevertheless the Ombudsman concluded '... the analysis suggests that, even if my recommendations are adopted in full, the scheme is likely to continue to result in significant numbers of unavoidable debts for families' (Australia, Commonwealth Ombudsman, 2003, p. 10). As a result, it was suggested that the government should consider further options for policy change.

2 The Canadian approach: simple but non-responsive

The structure and evolution of the Canada Child Tax Benefit

The Canada Child Tax Benefit has a complex two-part structure whose parameters change somewhat each year with indexing to the Consumer Price Index, even if there is no *ad hoc* increase otherwise implemented. For the 12-month payment period July 2002–June 2003, the first element of the Canada Child Tax Benefit, the basic Child Tax Benefit, paid a maximum C\$1,151 per year per child under age 18 from July 2002 to June 2003 inclusive.¹

Maximum payments went to families with net incomes under C\$32,960. Maximum benefits were reduced above this level at the rate of 2.5 per cent for families with one child and 5 per cent for those with two or more children, which will be lowered by 2004 to 2 per cent for one child and to 4 per cent for two or more children. Eligibility for benefits ended at relatively high incomes – C\$79,000 income for families with one or two children. The Canada Child Tax Benefit paid some benefit to more than 80 per cent (about 2.9 million) of Canadian families with children. Canadian average gross family income in 1999 was about C\$73,000 for two-parent families with children and about C\$30,500 for lone-parent families with children (Statistics Canada, 2001). Median net income reported on tax forms is lower, thus accounting for the high percentage of families receiving some child benefits.

On top of the basic Child Tax Benefit is a second element called the National Child Benefit Supplement that goes to low income families only. For the 12-month period July 2002–June 2003, the National Child Benefit Supplement paid a maximum C\$1,293 for the first child, C\$1,087 for the second child and C\$1,009 for each additional child. The National Child Benefit Supplement phases out above net family income of C\$22,397 at the rate of 12.2 per cent for one child, 22.5 per cent

for two children and 32.1 per cent for larger families. The National Child Benefit Supplement falls to nil once net family income reaches C\$32,960 for families with one, two or three children (the level at which the basic Child Tax Benefit begins to reduce its payments). Together, the basic Child Tax Benefit and the National Child Benefit Supplement paid a maximum annual Canada Child Tax Benefit of C\$2,444 for one child, C\$2,238 for the second child and C\$2,239 for each additional child from July 2002 to June 2003 inclusive.

As in Australia, almost all Canadian adults fill out and submit a detailed annual tax form. Most working Canadians make regular fortnightly, monthly or quarterly tax instalments, either in the form of deductions from pay, or in payments directly to tax authorities for the self-employed, but these payments are only loosely calibrated to the actual tax owed. Therefore, the annual tax filing acts for most Canadians as a reconciliation process, wherein the precise level of tax owed can be reconciled against the total already paid, and a refund or an amount owing can be determined.

The annual reconciliation process is a feature of the tax system in all countries that do not maintain a strict pay-as-you-earn system like the UK's. The existence of this annual process provides a ready vehicle for all sorts of adjustments and credits. For example, if a provincial government deems it wise to reduce property taxes (equivalent of council tax in the UK) for the elderly, it need not do so through complex indirect arrangements paying funds to municipal governments, instead the provincial government can do so directly by building in a special tax credit just for its elderly constituents. There are obvious advantages for any government in making its tax reductions directly to its taxpayers, rather than indirectly. This tax vehicle has become even more attractive as information technology has made processing complex transactions less expensive.

Although there are many types of tax credits now built into the tax system in Canada, credits have been most importantly used for the payment of benefits to families on behalf of their children, beginning over two decades ago. In 1978, Canada introduced the Refundable Child Tax Credit. This credit was called 'refundable' because, unlike past credits, it was not simply subtracted from income tax payable but paid the full benefit as a 'negative tax' even if there was no or little tax owing. This was Canada's first use of the income tax system to deliver benefits to families too poor to owe income tax. However, parallel to the new Refundable Child Tax Credit the federal government continued to maintain a system of universal child benefits, as well as an exemption in the tax system for each dependent child. In addition, Canadian provinces also provided child-related benefits in their social assistance systems, and were discouraged from integrating their social assistance rate structures with the new Refundable Child Tax Credit.²

Over the next decade and a half, experience accumulated in administering a positive benefit through the income tax system until, in 1993, a new Child Tax Benefit payment replaced all previous major federal child benefit programmes. At the same time, a Working Income Supplement was introduced, payable only to low-income families with children and with earned income, modelled on the US Earned Income Tax Credit. As well, provincial social assistance continued to pay an independent non-integrated child-related benefit.

In 1998, the federal government restructured its Child Tax Benefit and Working Income Supplement into what is now called the Canada Child Tax Benefit, increasing the amount of the benefit and paying it regardless of employment status. Further, an accord was reached with provinces to integrate the Canada Child Tax Benefit into social assistance rates; thus for the first time Canada was attempting to begin developing a fully integrated child benefit system. The expectation is that as the Canada Child Tax Benefit is increased over time, it will eventually

replace child benefits in the provincial social assistance system.³

Responsiveness in the Canadian system

The Canada Child Tax Benefit is paid on a monthly basis, either in the form of a cheque or a direct electronic fund transfer. More than 70 per cent of recipients now have direct deposits and this is rising. The payment is made to the primary caregiver, which is presumed to be the mother unless indicated otherwise. The amount to be paid is determined according to the *family* net income (income of both parents, net of certain standard deductions such as pension contributions and union dues) for the previous calendar year reported in April tax filing time,⁴ with the amount of the benefit set for July to June inclusive. The monthly payment is simply the annual entitlement divided by twelve. Thus, for example, tax returns must be filed by 30 April 2002, reporting annual income for January to December 2001 inclusive, and the Canada Child Tax Benefit payable is then adjusted accordingly beginning in July 2002 and continuing until June 2003. In July 2003, Canada Child Tax Benefit payable will be adjusted anew according to the income that has been reported by the end of April 2003 for the January to December 2002 tax year.

There are no mid-year adjustments due to changes in income *per se*; however, mid-year corrections are made for changes in family composition, such as marriage or common-law arrangements, or divorce or separation, which of course affects family income. Examples of other changes that attract immediate response include the birth, adoption or death of a child.⁵ Out of approximately 2.9 million families receiving the Canada Child Tax Benefit, there are about 80,000 mid-year corrections due to change in marital status and about 600,000 mid-year changes to add or reduce the number of children.⁶ Families are required to fill out a separate application form only

once, when the family has an eligible child (usually at birth), or upon change in family composition, but then must file tax returns each year to continue receiving the Canada Child Tax Benefit.

In the event that a family has a dramatic drop in income during the year, the family may be entitled to claim provincial social assistance. Provincial social assistance will top up the amount the family gets to the equivalent of provincial social assistance rates for children. Families who were not receiving the full Canada Child Tax Benefit, whose composition remains the same and whose income drops, but does not drop sufficiently to entitle the family to social assistance, are *not* eligible for a mid-year adjustment of their Canada Child Tax Benefit. They must wait until the next July. Similarly, families whose income increases do not report the increase until they file taxes and their benefit is not adjusted downwards until the next July. In sum, the only response to current income change *per se* is through an emergency back-up system – social assistance – that applies solely to those in very dire straits.

There is no repayment of the Canada Child Tax Benefit required (except in cases of fraud, unreported death or changes in family composition, or retrospective reassessments of net family income, for example following a tax audit), because benefits are paid strictly according to income reported in the previous year.⁷ This means that the income used to determine the value of the Child Tax Benefit may be up to about two years out of date, in some cases – for example, if a family loses all its income in June 2000, it will report half its previous annual income for the 2000 tax year in the next tax filing in April 2001 and only show no income for the 2001 tax year in the tax filed in April 2002. The full adjustment of the Child Tax Benefit will therefore not occur until July 2002 for a decline in income that happened two years earlier, in June 2000.

Despite these long time lags in adjustment, the Canada Child Tax Benefit's lack of responsiveness

has never arisen as a public or political issue and has not been noted by advocacy groups as a problem. However, officials designing the Canada Child Tax Benefit and its federal and provincial predecessors have extensively discussed the issue of responsiveness in the planning stages. At least at the provincial level, responsiveness became a particular focus of design discussions when it was decided to develop an integrated child benefit where such benefit would also be the only child-related payment for people on social assistance (see, for example, Naylor *et al.*, 1994). While it was felt that lower middle income families could make do for a year or so while awaiting an adjustment in income, this was not possible for families on social assistance who needed every penny of their entitlement immediately. Allowing all families whose incomes fell to collect added benefits, but not reducing the benefits of those families whose income increased, would have added roughly 10 per cent to the total cost of the programme, according to calculations done in Ontario. Therefore, unless they were willing to pay a hefty premium, government could not just take the 'easy way out' by ignoring increases while responding to decreases in income, and had to apply any process changing benefits symmetrically to benefits going down as well as up.

In the end this problem was resolved, if not solved, pragmatically by allowing last-resort social assistance programmes to play the role of fallback programme on an interim basis. Data indicate that this affects a very small number of social assistance recipients, about 6 per cent of the caseload.⁸ This solution has meant that families with a drop in income during the year who are not entitled to social assistance must wait, but this has never been seen as a problem in Canada, as noted.⁹ It has also added a little to total costs, since there is no symmetrical requirement at the upper end, but very few families who are not poor enough to collect full Canada Child Tax Benefits find themselves entitled to social assistance in just one

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year. In other words, if you were earning more than the income level at which full benefits are no longer paid, and there is no change in family composition, you are not likely going to be eligible for social assistance the next year, or even two year's hence.

3 The UK proposals

The new UK tax credits

There are to be two new tax credits in the UK: the Child Tax Credit and the Working Tax Credit.¹ The Child Tax Credit will be paid in addition to Child Benefit and replaces the child payments in social security benefits, the tax allowance for children, and the child component of the Working Families and Disabled Person's Tax Credits. It is intended to meet two of the government's key policy objectives: to provide additional financial support to families and to help combat child poverty. It will therefore be paid to the majority of families (about 90 per cent will be eligible overall), but with higher amounts for the poorest families. The amount payable will be based on the combined annual income of a couple (see below), and be 'jointly owned' by them, although it will be paid to the 'main carer,' on either a weekly or a monthly basis.²

The Working Tax Credit replaces the adult component of the Working Families and Disabled Person's Tax Credits, providing a wage supplement for low-income workers, and is intended to improve financial incentives to work. It will include childless couples and single people aged 25 and above but with a higher hours requirement (30 hours per week, as opposed to the 16 hours per week for those with children and disabled people). The Working Tax Credit will include an element intended to meet part of the costs of registered childcare for employed parents, but for couples this only applies if both parents are in work for 16 or more hours per week. As with the Child Tax Credit, the assessment will be based on joint annual income. Employers will pay the Working Tax Credit via the pay packet, alongside wages.³ But the childcare component will be paid alongside the Child Tax Credit, to the main carer. Thus, as Duncan (2002, p. 25) puts it:

The aim is to streamline and simplify the existing system. For example, the integrated child credit [now Child Tax Credit] will combine three sources of support for families with children into a single instrument paid directly to the caring parent. And the employment tax credit [now Working Tax Credit] will be available to all low-income working households, not just those in families with children. This makes the logic of the system easier to understand: child support will be paid directly to the caring parent while the employment credit will be paid with wages by employers. It should therefore be easier to target each of the three stated policy objectives of the UK government (supporting families, alleviating poverty and promoting employment) through the separate policy instruments.

However, although these tax credits may be described as separate instruments in formal design terms, they will all be assessed in the same way by the same system, and will be subject to the same withdrawal rates. The level of tax credit entitlement is calculated by adding up the various elements to establish a maximum amount (see the Appendix). This is then compared with gross income to calculate the amount of the tax credit award. Income is either the previous tax year's annual family income or expected annual family income in the current tax year.⁴ Joint income will be calculated for couples by adding their individual incomes together. Those with an annual joint income below the first threshold of £5,060 per year will receive the maximum amount. For those with annual joint incomes above £5,060 the maximum amount will be reduced by 37 pence per pound of income. This reduction will be applied first to the Working Tax Credit, next to the childcare element, and finally to the Child Tax Credit.⁵ Thus £13,230 is the lowest income level from which the Child Tax Credit starts to be withdrawn (although Working Tax Credit will be withdrawn from £5,060) and the family component (and baby element) of Child Tax

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Credit will be retained in full until income reaches the next threshold of £50,000. After this income level, the Child Tax Credit will be reduced at a rate of 6.67 per cent (£1 for every £15) above the threshold, finally disappearing at £58,000 or, for those receiving the baby addition (paid in the first year of life) at £66,000.

Responsiveness in the new UK system

The UK system is intended to combine 'continuity of support for those who are not experiencing significant changes in circumstances or income, with the ability to adjust quickly for those who are facing major changes' (HM Treasury, 2002, p. 19). The key features of this 'responsive system' apply in the same way to all tax credits, and are as follows:

- The amount of tax credit to be paid will initially be calculated with respect to previous tax year's annual gross income and the award will run for up to the next 12 months.
- There will be annual renewal forms sent out at the end of the tax year. The forms will include information on income and circumstances already held by the Inland Revenue, which applicants will be asked to confirm or to modify. This will provide the basis for any reconciliation of credits that should have been paid during the year against what was actually paid, given any income changes which were not notified during the year, as well as providing the basis for the next years' tax credit award.
- If the number of adults in the family changes, then the tax credit award will be deemed to have ended. This is also the case if one adult leaves or another joins the family. Claimants are required to notify this change within three months. Their claim will be re-

assessed in the usual way (i.e. on the previous year's income), which means newly-formed couples would be initially assessed on the basis of 'joint' income made up from the sum of their individual incomes before they started living together.

- Families receiving support for childcare costs will be required to notify the Inland Revenue if they cease to use qualifying childcare, or have a significant reduction in the cost of this.
- Families can choose to report other changes in circumstances that would affect the amount of credit they would receive (e.g. children leaving home) but they are not required to notify these until the end of the tax year. However backdated payments can only be made for a maximum of three months. So any change that would increase the amount of tax credit must be reported within three months for the family to receive the full amount.
- Families whose income changes during the course of the year can either notify the Inland Revenue at the time or they can wait until their annual re-assessment. Each family will receive guidance (with their annual assessment) as to what level of change in their annual income would change their award, in order to help them decide whether to notify the change. Whether the change is reported at the time it happens, or at the end of the year, will make no difference to the tax credit entitlement for that year.
- Any income rise from the previous to the current year that is less than £2,500 will be disregarded for the current year. This means that if income rises by less than £2,500 there will be no change in the assessment. If income rises by more than £2,500, the assessment will be based on current year

annual income minus £2,500. The disregard applies only to the tax year in which income rises.

- Any income fall from the previous to the current year can be fully taken into account in the current year. If income in the current year is less than income in the previous year the assessment is based on current year annual income.
- Families who start to receive Income Support or Jobseeker's Allowance will automatically receive the maximum amount of Child Tax Credit for the duration of the claim.
- At the time of the annual renewal there will be reconciliation when entitlement for the year ended will be finalised with reference to actual income and other circumstances during that year. If there has been an underpayment this will be covered by a single lump-sum payment. If there has been an overpayment, this will be recovered either by adjusting subsequent tax credit awards or (if tax credits are no longer due) by adjustments to PAYE tax codes. Or, if these are not possible, by direct repayment.

The Treasury paper gives two examples to illustrate what would happen if income falls or rises during the period of an award (HM Treasury, 2002, pp. 24, 26). In the first, a married couple with two children and a joint gross income of £18,000 in the previous tax year receive a tax credit award of £2,270. In the current year their gross income falls to £14,000 and their award is re-assessed on the basis of their new annual total, giving an award of £3,750.⁶ In the second, a lone father with one child has an income of £8,000 in the previous tax year and so is awarded a tax credit of £4,527. In the current tax year his income rises to £11,500. The first £2,500 of this is disregarded and so his tax credit award is based on an income of £9,000 (£11,500 minus £2,500), giving him a new award of

£4,157. In the following year, however, his previous year's income would be calculated as the full £11,500 (the disregard only applies in the year in which income rises) and so his award would fall again to about £3,224.

Thus the system starts initially with previous years' income but this is then, in certain circumstances, recalculated to adjust benefits according to the payment in the year just completed. The final amount paid in respect of any given year will therefore be based on that given year's income. As the current year's income is not finally known until after the conclusion of the current year, a reconciliation period is required. Thus, to illustrate, the payments to be made in year 2 are calculated initially according to income in year 1, but at the end of year 2 the amount that was paid is recalculated according to income in year 2, and the amount paid out in year 2 is then reconciled against the amount that *should* have been paid out, with a disregard of £2,500 for increased income.

Those whose income changes during year 2 can apply for a mid-year variation in their tax credits. Annual income in year 2 will then be re-estimated and a new payment put into effect for the remainder of the year. This new payment level will reflect a retrospective reassessment of the credit award for the *whole* year; i.e. the award for all the past months will be readjusted in light of the new annualised income level. The remaining payments for the year will reflect this, which ensures that the credit being paid will usually equal the amount that would be paid for the current flow of income, rather than just for the new annualised average income. Moreover, whether or not a variation in the amount is requested in mid-year 2, it all evens out in the end in the reconciliation at the conclusion of year 2. Any underpayment accumulated during year 2 will be paid as a lump sum, and any overpayment recovered during year 3 either as a reduction in tax credits or an increase in taxes. Thus the tax credit system is meant to respond to some

changes in circumstances that occur during the course of an award but also, to some extent, to allow people to choose between immediate responsiveness to income changes and annual reconciliation.

Overall the reporting requirements do seem to have a 'light touch', with very few requirements to report changes in circumstances and no requirements to notify any changes in income. However, although the design is elegant, what is important is how this will work in practice. In order to assess this we need to consider first, how many families might experience changes during the course of a year; second, how many might report these changes at the time they happen and how many at the end of the year; and finally, we need to assess what might happen to take-up rates.

How many income changes might be expected?

As noted above, there are two main types of changes that families are required to report. The first are changes in the number of adults in a family – from lone-parent to two-parent family or vice versa. The Treasury paper gives no estimate of how many families might be expected to experience such changes during the course of a year. Data from the *Families and Children Survey* found that around 8 per cent of lone parents became couples over the course of the year 1999–2000, and about 6 per cent of low to moderate income couples became lone parents (Marsh and Rowlingson, 2002).⁷ This implies that around 7 per cent of all Child Tax Credit recipients might experience changes in family status in a 12-month period such that they are required to make a new claim. The other type of change that must be reported is when childcare costs cease or reduce 'significantly', defined as a fall of more than £10 per week for at least a four-week period. Again there is no estimate in the Treasury paper of how many families might be affected by this.

The Treasury paper does give some estimates of how many families might experience income changes during the course of one year. It concludes that:

... in steady state, around 750,000 individuals and couples a year will move onto a current year basis of entitlement and see their awards change as a result of a rise in income. These are the people who would be advised to ask for an adjusted award during the year to reduce the risk of overpayments. This compares with around 1 million cases with falling income leading to a changed award, who would also have the option of asking for an adjusted award during the year. (HM Treasury, 2002, p. 28)

About 5.75 million families will fall within the range of the Child Tax Credit. The estimate of 1.75 million households with income changes is for all households, not just those with children. Nevertheless it does suggest that families with income changes may be a fairly substantial proportion of the total.

The Treasury paper provides no estimates for the other changes that families might experience. Changes in the hours of work, for example, could affect entitlements and not just level of awards. The requirement to be in work is continuous, with minor exceptions such as sick pay and maternity pay, which means that the hours/work requirements must be fulfilled all the time that the Working Tax Credit and childcare element are in receipt. Those in receipt of the 30 hours bonus must also fulfil the 30 hours requirement all the time. Similarly, the childcare element for couples requires both parents to be usually working 16 or more hours per week, so if one parent leaves work or has a reduction in usual hours of work the family would lose their entitlement to help with childcare costs. In fact these hours requirements, which are not discussed at any length in the Treasury paper, may prove to be quite a complex aspect of administration, since the rules involve *weekly* hours but *annual* income.

There is little information about the type of families who are most likely to experience changes in income or circumstances. For middle-income families, who are eligible only for the Child Tax Credit, the system is relatively simple. But for low-income families, who are also eligible for the Working Tax Credit and the childcare element, as well as other benefits such as Housing Benefit, this is not the case. The Treasury estimates that, of the 750,000 households who have a rise in income that would affect their awards, about 100,000 are estimated to be eligible for the maximum rate and 500,000 are estimated to have income below the first income taper. The exact income level of the first income taper depends on factors such as family size and eligible childcare costs. But many of those below the first taper are low-paid and it is low-income households in particular who will have to make decisions about whether or not to report income changes during the year.

In the first year of the new tax credits (starting from April 2003), all assessments will be made on the basis of income during the tax year ending April 2002. In the first year, therefore, the time gap between current income and the income on which the tax credit is assessed is longer than it will be once the system is fully up and running. The first year is therefore likely to have a particularly large number of people potentially seeking re-assessment.

When will people report changes?

Overall, therefore, it is difficult to estimate the number of changes that families might experience during the course of a year. It is also difficult to estimate whether or not these will be reported as (or soon after) they happen, or not be picked up until the end of the year. Some changes are likely to be identified more readily than others. This applies both to the changes that families are required to report and to those where reporting is not required at the time of the change. For example, women who become lone parents often start to claim Income

Support, so many of these families may be picked up in this way. But lone parents who form new partnerships may be less likely to report this as a change, for a variety of reasons, not necessarily fraudulent. Income Support estimates, for example, show that failure to declare that they had a partner accounts for about 42 per cent of money lost to fraud/error in payments for lone parents (DWP, 2000). The changes in circumstances that affect entitlement (such as the birth of a child, a child reaching the age of 16, a change in the adults in the household, a change in hours of work) are, it could be argued, rather visible changes that families are not likely to miss. But much will depend on families knowing and understanding the rules. And this in turn will depend to a great extent on the effectiveness of the Inland Revenue's advertising and awareness campaign.

On the income changes, the Treasury paper states, 'where a change would result in an increased amount being paid out, it is very likely that this will provide sufficient incentive to tell the Revenue and get extra support' (HM Treasury, 2002, p. 20). This would suggest that the expectation is that income falls (leading to underpayments) will be reported, while income rises (leading to overpayments) might not be. On the other hand, however, many decades of evidence on take-up of benefits shows that people often do not, in fact, collect benefits to which they are entitled. In practice, as such research has consistently shown, people are often eligible for some time before they make a claim – they do not respond immediately. The parallel is not quite exact, since tax credit recipients are already in the system and eligible non-claimants of benefits are not. Nevertheless, if people behave as they do for means-tested benefits, then it is likely that many changes will go unreported and so the end-year reconciliation is likely to be the main point when the Inland Revenue will be taking these changes into account. This was true in Australia and, as happened there, the end of year reconciliation

could involve a substantial number of families.

Thus, as Thurley (2002, p. 7) notes, 'to avoid overpayments it will be particularly important to keep track of how earnings, hours and childcare costs change over time and report significant changes'. Families will not necessarily have to keep detailed records themselves but they will need to keep on top of what does, and does not, have to be reported. The Treasury paper is quite sanguine about this, suggesting that these families are used to dealing with the Inland Revenue and that this is less of a reporting requirement than under Working Families Tax Credit,⁸ but making a new claim every six months is not the same as reporting some, but not other, changes in circumstances and income when they happen. This is quite a challenging task and, if families fail to do this and inadvertently receive too much, they may find themselves with reduced tax credit payments in the future. Or they may lose money because some payments (following changes in circumstances) cannot be backdated for more than three months. Given that these credits are intended as the main support for children in poor families either of these could have significant consequences for their income and living standards. And, if families fail to notify those changes that they are required to notify, they will be at risk of committing fraud. The Department for Work and Pensions has increasingly come to realise that one of the best ways to tackle fraud and error is to 'secure the gateway', to have systems that reduce the risks of overpayments following from failure to understand the rules, rather than from people deliberately seeking to cheat the system (DSS, 1999). Looked at from this perspective the tax credits system could be vulnerable to 'inadvertent fraud', if people fail to understand these rules.

What will happen to take-up rates?

Achieving high take-up rates for income-related benefits has always been difficult. Take-up is measured in two main ways: caseload (the proportion of eligible people who are in receipt)

and expenditure (the proportion of money that is claimed). The latter is usually higher than the former because people with higher entitlement are more likely to take these up. In the first year of the Working Families Tax Credit (2000–2001) the take-up rates were 62 to 65 per cent by caseload and 73 to 78 per cent by expenditure (IR, 2002).⁹

But it is difficult to use these figures to extrapolate to take-up of the new tax credits, since the systems are very different. For example, new ways of measuring take-up will be needed, since eligibility is not fixed over any single time period, but changes as income and circumstances change. As long as eligible families are receiving some payment, they can be considered to be taking up the tax credit, even if they are not receiving the 'correct' amount in relation to their current circumstances. It will therefore be important to get as many families as possible into the system. There are, however, some complicated messages for the Inland Revenue to get across here. Potential claimants have to be able to recognise that they may be eligible and it is therefore important that people understand that the award is initially made on the basis of family income during the previous tax year. But they also have to be aware that, if their income and circumstances have changed since then they can be assessed on the basis of current income. They also have to understand that there are some changes that they are required to report and others that they are not.

Claiming must also be seen as worthwhile. There is some reason to think that getting the middle/higher income families into the system might present a particular challenge in this respect. Those with entitlement only to the 'family element' may feel that the amount they would receive is not worth the effort of applying (as noted above, take-up is lower for lower amounts). It is estimated that the Children's Tax Credit (which was, broadly speaking, the equivalent of the family element) was received by about 72 per cent of those eligible in 2000–2001 (IFS, 2002, p. 82).

For lower-income families, take-up of the Child Tax Credit may be higher as the amounts involved are higher. For families who start to receive Income Support or Jobseeker's Allowance the maximum amount of Child Tax Credit will automatically be paid. This should be relatively straightforward, provided that the two administrative bodies involved – Jobcentre Plus and the Inland Revenue – have the necessary (computer) systems of communication.

But the situation for families entering low-paid work is complicated by the other credits and benefits to which they might be entitled. On moving into work, the Treasury argues that there will be:

greater security on the move into work – families will continue to receive the Child Tax Credit when they return to work without the need to re-apply. The Child Tax Credit will be paid at the maximum rate for all families until income reaches £13,000 a year, delivering a secure stream of income for families moving off welfare and into work.

(HM Treasury, 2002, p. 9)

However, the maximum rate only applies to the Child Tax Credit and not to the Working Tax Credit or to the childcare element – both of which will presumably have to be claimed at that point. Nor is it obvious how they will be able to receive the Child Tax Credit 'without the need to re-apply' since it will be necessary to re-assess their entitlement at that point. However, they will still be within the system, and still be receiving the Child Tax Credit, while this is happening (unlike the current system). The Child Tax Credit may be seamless in this sense, but the total system is not, and it is the latter that poor families experience. In general, the relationships between the different tax credits and between tax credits and other forms of in-work support (notably Housing Benefit) are not fully addressed in the Treasury paper. But it is the interrelationship with the various benefits that is likely to make the tax credits opaque rather than

transparent to recipients, particularly low income families, and which may affect take-up.

Learning lessons?

The Treasury paper notes that lessons have been learned from Australia and Canada, and in particular that the UK design will avoid the main problems that developed in Australia. How far is this the case? As we noted above, apart from the general tendency to underestimate forthcoming income, there were four main factors that generated the overpayments in the Australian system: income changes among workers on moderate to average earnings; increased incomes for second earners (particularly for women (re-)entering the labour force) receipt of lump-sum child support payments; and children leaving school and starting work part-way through the year. In the UK, children moving out of eligibility because they leave full-time education should be picked up by the same administrative procedures that operate in respect of Child Benefit.¹⁰ The child support issue does not apply in the UK, because child support payments are fully disregarded. There is no separate threshold for the wages of second earners in the UK, as there is in Australia, so this factor may also be less important. But changes in total earnings, whether of first or second earners, are likely to be an important factor in the UK, as they have been in Australia.

However, the UK proposals for dealing with mid-year adjustments and end-of-year reconciliation have been designed to minimise the risk of problems as experienced in Australia. If mid-year changes are reported, then awards will be cumulatively adjusted for changes reported during the year, in a similar way as PAYE adjustments are made for income tax. This did not happen in Australia, which meant that even families who reported changes could find that they still owed a debt at the end of the year. In the UK end-year reconciliation, in families where there has been an

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underpayment, there will be a lump-sum payment – something that the UK benefits system has not really delivered before and something which families may find of particular value in their budgeting. If the opposite occurs, the £2,500 disregard will ‘minimise the scope for substantial overpayments’ (HM Treasury, 2002, p. 29) and so will provide a significant reduction in the number of families who would otherwise face a ‘debt’ in the reconciliation process, resulting in a reduction in next year’s credits. As well, because this is a disregard, it affects everyone equally who experiences an increase in income during the year,

even those whose increase exceeds £2,500. This should also greatly reduce the average value of any overpayments that are made.¹¹ The proposed method of recovery of overpayments (by adjustments to subsequent awards) will spread the repayment of any debts that are incurred and avoid the single large bill that has been so unpopular in Australia. On the downside, however, this could mean that, when families have deductions for previous overpayments they will receive payments that bear very little relation to their current incomes, at least until the overpayments have been recovered.

4 Discussion

Each of the three systems discussed in this report has the same basic design – they deliver income-related financial support through the tax system – but each involves different trade-offs between competing objectives. How should we assess these systems? In this chapter, we first compare the way each country has dealt with the issue of responsiveness (timeliness of change in benefits in response to income change) and then discuss the three systems in relation to issues of administrative burden; transparency, intrusiveness and compliance costs for recipients; equity; and work incentives.

Comparative analysis of responsiveness in each system

Unlike Canada, both the Australian and the UK systems are designed so that the tax credits awards can be adjusted to reflect current income. In Canada, payments are based on last tax year's income and may be seriously out of date. The Canadian system does not attempt to reflect current income, so child benefits will often not be increased when a family is experiencing a decline in income (and conversely Canadian benefits will be paid when a family's income has increased). If the core objective of an income security system is to provide families with income when they need it, then the Canadian system fails for many families in this central objective.

If the purpose of an income-tested child benefit system is to supplement the incomes of families with children inversely to income, then such long time lags in response to change in income must be of concern. If child benefits were paid four or five years later, could this be acceptable? Obviously, at some point the lack of timeliness in an income-tested system defeats the whole reason for having the system in the first place. However, up to this time, unlike both the Australian and the planned UK system, Canadians have accepted the one large trade-off of a lengthy time lag to achieve an extraordinarily simple system.

The Canadian system has relatively lower benefit levels than that in Australia and those planned in the UK (Battle and Mendelson, 2001). Could it be that the trade-off of responsiveness and simplicity tips in favour of responsiveness as benefits increase? Perhaps the need to reflect more current income increases in proportion to the relative size of the benefit. In this case, the more or less unproblematic operation of the Canada Child Tax Benefit with out-of-date income might not be quite so acceptable were the amounts paid at the Australian or planned UK levels.¹ Against this point of view is the actual Canadian experience, which has been just the opposite – the development of a simple, straightforward tax credit has coincided with a steady increase in benefits in the last several years. There is no evidence of dissatisfaction with the non-responsiveness of the Canadian system in that period. Indeed many Canadians would argue that the simplicity of the system has made benefit increases possible.

However, there may be intrinsic limits on responsiveness in any system. Unless the accounting period (i.e. the period over which entitlement is assessed) coincides exactly with the pay period (i.e. the period over which payments are made), every system will respond to average income over a multi-pay period of time and to that extent cannot be fully responsive. As the Australian and UK systems have annualised accounting systems with much shorter pay periods (weekly / monthly in the UK, fortnightly in Australia), this limitation on responsiveness necessarily applies in these countries.

In addition, in both the Australian and UK systems, the annual reconciliation must compromise responsiveness, by introducing another type of accounting and accountable period. For example, unless families inform the government immediately of any income changes (and other relevant circumstances, such as changes in family structure) and unless adjustments to benefits can then be made immediately, revised

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payments will not match current income. This is because the unavoidable time gap in adjusting payments will mean that for a certain period families will have been overpaid, so to achieve annual balance they should then be underpaid. Indeed, this is reflected in Australia in the most recent changes announced in September 2002. If income or circumstances change more than once in a year, the situation will become even more complex and current payments will never precisely reflect current family incomes, but will instead reflect a sort of moving average. In the UK, payments may also be reduced in order to recover previous overpayments, which also means that current income and current payments may be out of line with each other.

Given these considerations it can be asked whether 'full responsiveness' is actually a reasonable goal since any fully responsive system would likely also be highly intrusive. A fully responsive system is one that involves fortnightly or weekly income testing alongside fortnightly or weekly pay periods. Although shortened accounting and pay periods are often the basis for social assistance benefits, few governments would want such a system to be applied to the majority of families with children. Indeed, for the UK government, moving away from such a system in respect of support for children is one of the perceived advantages of the Child Tax Credit. On the other hand, with information technology continuing to fall in price and increase in capacity, and with cash rapidly disappearing in favour of electronic funds transfer, the day may not be too far off when benefits may be adjusted automatically on a bi-weekly basis without the need for any forms to be submitted. Of course, the trade-off here would be a massive loss of privacy.

Administrative burden

Both the UK and the Australian system will result in many families receiving overpayments that must

be recovered in some form. Aside from reducing responsiveness, this also places an administrative burden on both government and recipients.

It has been argued in Australia that overpayments accumulated could be regarded as an interest-free loan from the Government, rather than a problem to be minimised. Indeed, the Labour opposition in the 2001 election proposed that families should be able to borrow up to A\$1,000 from their future family payments. However, there is a difference between consciously choosing to borrow against future entitlements, and retrospectively discovering that you have done so. Presumably in the former case, family payments would have been reduced during the year to repay gradually the funds borrowed and there would not be a problem at the end of the year. With current unplanned 'loans', except in the unlikely event of families placing their family payments in a separate account and earning income on the overpayments, reconciliation is likely to produce an unwelcome surprise for those affected. Nor would it appear to be desirable to tell families that they should treat the system as providing interest-free loans, unless that was a deliberate policy decision, and a system in place to make monthly repayments. Moreover, at the end of the day, whether warned in advance or not, families still resent paying money back to the government and say so loudly and clearly to the media and to politicians.

Clearly, there were a number of disadvantages inherent in the Australian approach as originally undertaken. From a political perspective, the fact that a new system can lead to nearly 12 months of negative media reporting and political controversy can hardly be regarded as a positive. The waiving of the first A\$1,000 of overpayments involved additional unanticipated direct expenditures of around A\$319 million. This is less than 3 per cent of total expenditure on Family Tax Benefit, but it is still a substantial amount. The cost also does not include advertising the government's response to the overpayments, or the recruitment of additional

staff to deal with the reconciliation process, although these would be far less significant than the cost of the waiver.

One of the goals of Australian policy makers in introducing the prospective income test was to give families a great deal of choice about the way they receive benefits, both in respect of frequency and method of payment.² The previous system in Australia did not allow families to receive additional assistance if they initially overestimated their income, so it could not equitably accommodate prospective attempts to estimate current income. The new Australian system provides reconciliation at the end of the year so that no matter how benefits are paid – whether through the tax system, as a lump sum or in regular instalments – it all comes out the same in the end (assuming there is no waiver and ignoring the exclusion of time on social assistance).

Like Australia, Canada and the UK both have a reconciliation period. Since all three systems have a reconciliation period, all can provide choice of payment mechanism. What is not known is whether recipients particularly value this choice over payment method and timing. So far, early indications are that few families choose to take their benefits as a lump sum in Australia. Interestingly, this is exactly the opposite to the situation in the US, where the Earned Income Tax Credit may be taken either as a lump-sum payment or as an addition to regular paycheques, but 99 per cent of recipients choose a lump-sum benefit. (Meyer, 2001)

Transparency, intrusiveness and customer compliance costs

Due to its simplicity, the Canadian system is easy to understand and it is easy for any recipient to figure out the basis upon which their child benefit is paid. Although the situation in Australia will no doubt improve over time and with some continuing fine-tuning, it will remain a difficult system to

understand. In Australia, there are two sets of calculations to comprehend: the setting of the award based on prospective income and the reconciliation based on income in the year just past. In the UK system, there will also be a reconciliation based on immediate past year's income, with initial awards based on the previous year's income. As well, in the UK the amount of the award can be adjusted to reflect an overpayment and the reconciliation may be affected by the £2,500 disregard. This will make it difficult to understand the amount of the award at any given time.

There is also a high administrative burden for the families in Australia and the UK, who must keep records of income and circumstances, and changes in these, and be aware of often quite complex rules about the reporting of changes. These compliance costs may be significant. For example, the Australian system is more intrusive for families in respect of the amount of information they need to provide to the government (and therefore also has additional administrative costs for the government). Associated with this is the possibility that the additional reporting burden and the potential for accruing overpayments may reduce the public acceptability of the programme, both for recipients and for others.

One view in Australia is that the problem of overpayments is transitory and after a couple of years, families will be able more accurately to estimate their incomes. Indeed, the Department of Family and Community Services and Centrelink have been working intensively to remind families of the need to keep their income estimates up to date and are providing assistance to help avoid an overpayment. A continuing strategy is in place to remind customers to update their estimates with every contact and through the media. Letters are being sent to customers with overpayments including information to help them estimate their income, and the Family Assistance Office is helping families adjust their income estimates to reduce the chance of overpayment. Alternatively, families that

have particular difficulty in providing a forward estimate of their income are able to claim their family assistance as a lump sum at the end of the financial year, when their actual income is known. Customers also have the option of minimising the risk by estimating their income towards the top of its likely range with the assurance that they can receive a top-up at the end of the year.

While this approach is consistent with the view that full reconciliation is desirable, to some degree it relies on optimism about the ability of families accurately to foresee their incomes. In addition, there will always be new families entering the system. It also implies a permanently higher administrative burden, both on the government and on individual families, than under the previous approach. Finally, it assumes a rather rosy view of human nature. Why not underestimate income, get higher payments and hope that this year the government will, despite its denials, once again forgive some of the overpayment?

An alternative might be to maintain the principle of prospective income reporting with reconciliation, but make sure that everyone is underpaid initially. This could be achieved by adding a 'buffer amount' to all estimates. The problem with this approach is that it contradicts the objective of being responsive to actual changes in income. It also restricts choice, and may be regarded as penalising those families whose estimates are accurate, not to mention those whose incomes drop during the year. Further, families could quickly learn to respond by providing their own 'counter-buffer' implicit in their estimates. Having said this, it could also be noted that the approach of providing intensive advice to families to adjust their income estimates might be little more than a more complicated and burdensome way of achieving the same objective.

The planned UK system will also have overpayments, but the UK has learned from the experience in Australia: through the disregard and

through gradually deducting overpayments from future benefits, the UK hopes to minimise the negative effects. Ironically, this is at a sacrifice of responsiveness, which is the reason why the system was permitted to have overpayments in the first place. Is a system with retrospective recollection of overpayments due to a previous tax year's income more or less responsive than one that pays from the start according to the previous year's income? The answer to this question is not self-evident and only time, experience and careful evaluation will provide an answer.

The Canadian system has no overpayments and very low compliance costs for recipients. The amount to be paid during the year is known and easy to understand. Monthly cheques once established are reliable and do not often change, in what may be perceived as an unpredictable fashion, from month to month. The administrative costs are low, both for the government and especially for families who do not have to fill out any special forms, except once in a child's lifetime (excluding changes in family composition). This lack of intrusiveness may reflect the preferences of recipient families. In Canada, a focus group of working Child Tax Benefit recipients was asked if they would prefer a non-intrusive monthly reporting system so that the benefit level could change if their income changes. The response was unanimously and loudly negative. The intrusiveness of a more responsive system was not seen as remotely worth the trade-off. At least to the extent that this focus group was representative, working families would rather risk doing without a full child benefit for a year, than put up with a more intrusive system (Battle and Mendelson, 1997). However, these views may also depend on the size of the award and people might respond differently if more substantial sums of money were involved.

Equity

The Australian reconciliation system was designed to deliver equal annual entitlements regardless of delivery method, and regardless of how incomes fluctuated during the year. This is intended to ensure that families in like circumstances are treated the same.³ However, in the first year of prospective income reporting Australia was forced to waive the first A\$1,000 of overpayments. This means that families underestimating their income ended up with somewhat higher benefits than other families with exactly the same income who accurately estimated their income. The Australian government has not repeated the A\$1,000 waiver in the second year of the system, but has therefore had to cope with a large number of smaller overpayments – increasing equity but at the cost of administrative burden and loss of transparency.

In the UK, the £2,500 income disregard has been built in as a permanent feature, as a means of reducing overpayments. The UK system will thus be somewhat inequitable in that those with an increase in income during the year will be better off than those whose income is more accurately forecast at the beginning of the year. For example, a family with £10,000-a-year income last year whose income rises to an annual average of £15,000 will have their benefit award adjusted to an income of only £12,500, while a family that starts and finishes the year with an average annual income of £15,000 will not experience the £2,500 disregard. For many families the disregard will be worth £925, which is not at all a trivial amount of money. For a family with £15,000 income this would amount to a difference of about 6 per cent in before-tax income.

The Canadian system does treat families the same that have the same income and are in the same circumstances, but it is last tax year's income rather than current income. The Canadian approach provides 'retrospective equity.'

Responsiveness and work incentives

There is very little information available to assess directly the effect of varying responsiveness regimes on work incentives. In Canada, negative effects on work incentives are reduced because awards do not respond immediately to increases in income (as used to be the case in the UK under Family Credit/Working Families Tax Credit). In Australia, the arguments are mixed. The system appears more responsive, so therefore work disincentives should be greater, and the familiar 'poverty trap' effect should apply (see Barr, 1998). However, the fact that recipients have to notify the authorities before payments are adjusted (that is, entitlements change, not payments), and the adjustment is not necessarily made until the end of the financial year, means that the loss of benefit is: in the future, and hence discounted; and uncertain (e.g. the increase in income may have reduced again by the end of the financial year). Indeed, the fact that the level of overpayments has been so high suggests that over the past two years actual behaviour has been largely unaffected by these potential work disincentives – clearly significant numbers of people simply went ahead and increased their income. However, the counter-factual is unobservable – what would be the amount of work undertaken if the system was less responsive? Perhaps the most important potential impact of the Australian system is in reducing public satisfaction with the system. Similarly, for the UK, the impact on work incentives is difficult to predict. It could be positive in that the disregard means that some increase in earnings is protected from a reduction in the tax credit award. On the other hand, the system is not very transparent and if people cannot understand the system they may be reluctant to risk their awards by increasing their earnings.

5 Conclusion

Table 2 gives an overall assessment of the strengths and weaknesses of the three countries' systems of child benefits, in respect of these key objectives: timely responsiveness to income change, administrative burden, transparency and compliance costs, equity and impact on work incentives.

One of the purposes of the UK design is to move away from a fully responsive system, such as in Income Support assessments, where weekly payments relate to current weekly income and circumstances, so that all changes in these must be reported as they happen. Such a system may be equitable, in the sense that awards relate to income in the same way for all claimants. It may be more or less transparent, depending on the complexity of the reporting requirements. But it is highly intrusive for recipients and it also has substantial administrative costs. It may also have a more direct negative impact on work incentives, since awards will be reduced more immediately by income earned, although this can be offset by high earnings disregards.

The new UK design also rejects the Canadian model – which is similar to the Family Credit/ Working Families Tax Credit design – in which income is measured over one set period and awards paid over another, regardless of changes in income or circumstances. Such a system is very simple to administer, is non-intrusive for recipients and does not involve them in significant compliance costs. It is equitable in the sense that it treats families with the same income and

circumstances in the same way, although it is last tax year's income rather than current income that applies. The impact on work incentives is reduced because awards do not respond immediately to increases in income.

The UK and Australian systems have much in common, except that Australia uses prospective and the UK retrospective income for the initial assessment. Each then seeks to respond to some changes as they happen and other changes in an annual reconciliation. These are therefore quite complex systems, both in administration and in compliance costs and intrusiveness for recipients. This is especially true in the UK, where there are several tax credits and in-work benefits. Equity is compromised by the existence of the disregard in the UK. For the UK, the impact on work incentives is difficult to predict. It could be positive in that the disregard means that some increase in earnings is protected from a reduction in the tax credit award. On the other hand, the system is not very transparent and this may reduce take-up.

The annual reconciliation is very new to the UK benefits system and indeed to most UK taxpayers who currently pay their income tax through PAYE and do not complete annual tax returns (unlike Canada and Australia). The Australian experience warns us of some of the problems that can arise. A key lesson for the Inland Revenue is that it will be critical to ensure that all potential recipients have the right information and advice at the right time.

The UK appears to have taken a bit of each of the Canadian and Australian system. Has it made

Table 2 Assessment of alternative approaches to dealing with changes in income and circumstances

	Australia	Canada	UK
Responsiveness	High	Very low	High
Administrative burden	High	Very low	High
Transparency	Low/Moderate	High	Low/Moderate
Customer compliance costs	High	Very low	High
Equity	High (except for waiver)	High	Moderate
Work incentives	Positive?	Positive	Positive?

the right trade-off? Income testing can never be both simple and responsive in practice. There is always a trade-off between a simple system that does not reflect exactly the current circumstances of the recipient and a more complex system that adjusts to the detailed profile of a recipient's needs. The challenge is to decide when the trade-off is worthwhile. Should the UK instead have opted for the simplicity and efficiency of the Canadian

approach at the expense of not responding to current needs? Is the UK courting a smaller version of the Australian difficulties by requiring people to pay back the government? Or has the UK found the optimal compromise between the two? The question for the UK is whether in so compromising it will have created a system that is reasonably acceptable to all, or whether instead it will fail fully to satisfy anyone.

Notes

Chapter 1

- 1 By 'child additions' we mean the additional benefits paid to families with children in any income security programme just as a consequence of having a child or children in the family.
- 2 The Child Tax Credit was initially described as the 'Integrated Child Credit' (HM Treasury, 2000), reflecting the importance placed on this bringing together of support for working and non-working parents.
- 3 Many European countries also use their tax systems to transfer resources to families with children (Bradshaw and Finch, 2002).
- 4 The US system is similar to Canada's in regard to many of the main administrative issues we are interested in here, in that it pays the Earned Income Tax credit based on last year's income tax filing. However, the US has never attempted to develop an integrated child credit, so it has not had to consider most of the issues discussed in this paper.
- 5 There is also an income-tested Rent Assistance scheme. In this article we focus upon the family payments, not on rent allowances or childcare costs. See Whiteford (2001) for further information on the operation of these.
- 6 The current exchange rate is £1 equals A\$2.71, but the purchasing power parity is £1 equals A\$ 2.06. For Canada, the exchange rate is £1 equals C\$ 2.27, but the purchasing power parity is £1 equals C\$1.87. Purchasing power parity is likely a more relevant indicator for comparing benefit levels since it reflects the relative purchasing power of national currencies in their home countries.
- 7 In 1999–2000, average gross family income for couples with children was nearly A\$61,000 and median family income for couples with children was A\$52,000. For lone parents the

average was A\$26,500 and the median was A\$22,000 (Australian Bureau of Statistics, 2001). Around two-thirds of lone-parent families and 16 per cent of couples with children would be eligible for the maximum rate of Family Tax Benefit Part A.

- 8 Further details can be found at <http://www.familyassist.gov.au/>.
- 9 Most wage and salary earners in Australia are paid on a fortnightly basis.
- 10 There is a separate income test on child support payments.
- 12 In addition, just over 100,000 families received around \$15 million worth of overpayments of Childcare Benefit.

Chapter 2

- 1 In addition, there was a C\$80 per year supplement for the third and each additional child and up to C\$228 per year extra for each child under age seven for whom the childcare expense deduction (a tax break for families with receipted child care) was not claimed.
- 2 Provinces have constitutional sovereignty over their social assistance systems and cannot legally be prevented from adjusting their social assistance benefits for children. However, provinces that reduced their child-related social assistance benefits to reflect federal increases were often perceived to have 'taken away' the federal increase from social assistance recipients and were browbeaten both by the federal government and social advocacy groups.
- 3 The major controversy in Canada's Child Tax Benefit has stemmed from replacing social assistance child-related benefits only gradually. Each increase in federal child benefits has been accompanied by an equivalent decrease in provincial child benefits for social assistance

recipients, in most provinces. Although provinces have undertaken to reinvest their savings in programmes for families with children, and recipients are no worse off, these 'reductions' in social assistance have been widely condemned by advocacy groups and have proven very hard to explain. In contrast, had there been a simple one-time increase large enough to offset fully social assistance, as is planned in the UK, the substitution of one form of payment for another would have been much easier to explain.

- 4 Tax must be filed by April 30 but Canadians are encouraged to file earlier if they have all the needed information.
- 5 Specifically, a recipient is requested to contact the Canadian Customs and Revenue Authority as soon as possible about the changes listed below, as well as the date they happened or will happen. If a recipient fails to report any of these changes their benefit will be retrospectively adjusted to the date that the benefit would have decreased, or up to 11 months in the past if the benefit would have increased (and special circumstances may be pleaded to obtain retrospective adjustment beyond 11 months). The income tax system provides penalties for failing to report accurately, but there are no penalties for non-reporting of changes outside of the income tax system. Changes:
 - i if a child for whom you were receiving the benefit is no longer in your care, stops living with you, or dies
 - ii if a child is born or adopted or otherwise comes into your care
 - iii if you move residence
 - iv if your marital status changes
 - v if a CCTB recipient (for example, the child's mother) dies
 - vi if you or your spouse or common-law partner's immigration or residency status changes

vii if any of the personal information, such as marital status or child information, shown on your Canada Child Tax Benefit Notice is incorrect.

- 6 The estimates are courtesy of the Canadian Customs and Revenue Agency, personal correspondence with author (2002).
- 7 An income supplementation programme that allowed for prospective estimation of income was introduced in one Canadian province (Saskatchewan) in the mid-1970s. As in Australia, the Saskatchewan government found itself in hot water trying to collect money from lower-income families at the end of the year. This experience may have coloured decision making in the design of federal tax credits, especially since many Saskatchewan officials moved to influential positions in the federal government in subsequent years.
- 8 Data from Saskatchewan Child Benefit Adjustment programme, private correspondence.
- 9 A family member may also be entitled to unemployment benefits, worker's compensation or public or private disability benefits. Most families on these benefits will experience a sizable drop in income, although income will not be as low as on social assistance. Unemployment benefits provide some child-related supplements, and this may partly offset some demand for immediate adjustments in the Canada Child Tax benefit, but unemployment benefits are far from universal and this will affect relatively few recipients. Data is not presently available on the overlap of these programmes.

Chapter 3

- 1 The development of these new tax credits is outlined in various Treasury papers (HM Treasury, 2000, 2002), and in Inland Revenue

- (2001), House of Commons Social Security Committee (2001), Bennett and Hirsch (2000), Hirsch (2000) and Brewer *et al.* (2001).
- 2 Couples will be asked to nominate the 'main carer.' As Bennett (2002) points out, 'joint ownership is new territory', and may cause problems, for example, if couples separate but have a joint liability for overpayments.
 - 3 If both partners in a couple are employed, they can choose who should receive the payment. But payment will be made through the pay packet – they cannot choose to be paid directly (except in certain specified circumstances).
 - 4 The UK tax year runs from April to March.
 - 5 Thus, for couples, payments via the pay packet will be reduced before payments to the main carer. The main carer will be receiving the childcare element as well as the Child Tax Credit and so would lose some of their payment when the childcare element of the Working Tax Credit is withdrawn. However, the main element of Working Tax Credit is withdrawn before the childcare element.
 - 6 Note that if this income change occurred in, for example, week 12, annual income in the current year would be estimated as 12 weeks at £18,000 pro-rata and 40 weeks at £14,000 pro-rata – an annual total of about £14,900.
 - 7 This is a longitudinal sample of families with children, which started in 1999 (Marsh *et al.*, 2001). It is representative of all lone parents but initially of low to moderate income couples only. Since 2001 it has been extended to cover all families with children, regardless of income.
 - 8 'Such recipients will generally have some experience of regular contact with the Inland Revenue, and currently have to make two claims each year.' (HM Treasury, 2002, p. 28).

- 9 By comparison, in the final year of operation (1998–99), Family Credit take-up was about 66–70 per cent by caseload and about 73–79 per cent by expenditure (IR, 2002). Survey data for 2001 suggest a slightly higher take-up rates of Working Families Tax Credit, at 67 per cent (McKay, 2003).
- 10 Child Benefit is payable to children aged under 16 or under 19 and in full-time education. All recipients are written to when their children are coming up to age 16, to check if they are still in education and therefore still eligible.
- 11 The disregard will also reduce disincentives to working extra hours or in higher-paid employment, and for second earners, since in all these cases the family would benefit from the disregard. But this reduced disincentive may still not be enough to encourage second earners. See Bennett (2002) and Brewer *et al.* (2002) for further discussion of incentives issues.

Chapter 4

- 1 Canadians may get a chance to find out: the February 2003 Canadian budget announced that maximum Canada Child Tax Benefit payment will rise from C\$2,632 in July 2003 for the first child to a projected C\$3,243 in July 2007. The maximum benefit for a second child will increase from C\$2,423 in 2003 to C\$3,016 in 2007, and for the third and each additional child from C\$2,427 to C\$3,020 over that period.
- 2 The level of assistance is also significantly higher than before July 2000, and the withdrawal rates are lower, but these are not results of the way the new system deals with changes in income.
- 3 Although it should be noted that none of these systems is strictly equitable because each has a flat plateau across which families with different levels of income nevertheless receive the same amount of money.

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Appendix

The UK Tax Credits: how the income test works

Income used to calculate tax credit entitlement is annual gross income, before any tax or national insurance deductions. For couples this will be joint income and the claim form requires that both partners supply information and sign the form. Capital is not taken into account, but income from capital (not including the first £300) is included. Taxable social security benefits are also included as income (for example, Widowed Mothers

Allowance, Invalid Care Allowance, contributory Jobseeker's Allowance, Incapacity Benefit, Widows' Pension) but with some elements partially disregarded (for example, £100 per week of Statutory Maternity Pay is not counted). Earnings from employment, or self-employment, are all included.

The tax credits are made up of a number of elements (shown in Table A1), which are added

Table A1 The UK Child and Working Tax Credits, 2003–2004*

	Amount (£)
Working Tax Credit (for employed people)**	
Basic element (per person)	1,525
Couple and lone parents element (per couple/lone parent)	1,500
30 hours element (for couples this can be 30 jointly)	620
Disabled worker element	2,040
Enhanced disabled worker element	865
Childcare Element (in couples both parents must work 16 or more hours p.w.)	
Maximum eligible cost for one child	135 p.w.***
Maximum eligible cost for two or more children	200 p.w.
Per cent of eligible costs covered	70%
Child Tax Credit (for families with dependent children)	
Family element (per family)	545
Family element, baby addition (for first year of life)	545
Child element (per child)	1,445
Disabled child element (per child)	2,155
Enhanced disabled child element (per child)	865
Income Thresholds	
First income threshold	5,060
First withdrawal rate	37%
Second income threshold	50,000
Second withdrawal rate	6.67%
First income threshold for those entitled to CTC only	13,230

* All figures are in £s per year unless otherwise stated.

** For disabled people and those with children, the hours requirement is 16 or more per week. For single people aged over 25 (under 25s are not eligible) and childless couples, the hours requirement is 30 or more hours per week.

*** The childcare element is expressed in weeks not years, as it is the four-weekly childcare payment that determines entitlement.

Source: HM Treasury, 2002, Table A.1

Timing it right?

together to make up the maximum entitlement for the family. Thus, for example, maximum entitlement for a lone parent with one child and who is working 30 hours per week would be: £1,525 (Working Tax Credit basic element) plus £1,500 (Working Tax Credit lone-parent element) plus £620 (Working Tax Credit 30 hours element) plus £545 (Child Tax Credit family element) plus £1,455 (Child Tax Credit child element) – in total £5,640. Child Benefit (of £819) would be received in addition.

The assessment follows a series of steps (National Council for One-Parent Families, 2002; Thurley, 2002), which work as follows:

- *Step 1:* Calculate the maximum amount of tax credit by taking the various elements to which the family is eligible, calculating the daily equivalent and multiplying by the number of days in the relevant period. Add up the various elements for the 'relevant period'. A relevant period ends when there is a change that affects the maximum amount of elements that a claimant is eligible for (e.g., a shift to over 30 hours' work, a new child in the family, a fall in childcare costs, a change in the number of adults).

- *Step 2:* Calculate gross income for the relevant period: income in the previous tax year, except when current income is lower (use current income), or when current income is higher by more than £2,500 (use current income minus £2,500).
- *Step 3:* Find the first income threshold (£5,060 for Working Tax Credit and £13,230 for Child Tax Credit only), and calculate the amount over the relevant period.
- *Step 4:* Compare income with threshold.
- *Step 5:* Calculate entitlement for the relevant period: if income is below the threshold the family receives the maximum amount. If income is higher than the threshold, the maximum amount is reduced by 37 per cent of the difference. The taper applies first to Working Tax Credit, then to the childcare element, and then to the child element of Child Tax Credit. The family element remains in payment until the second threshold (£50,000) is passed and then a taper of 6.67 per cent (£1 in £15) is applied.