October 2001

New Tax Credits Consultation Response

Introduction

The Joseph Rowntree Foundation (JRF) has in recent years been closely monitoring the unfolding of welfare reform. It has made two kinds of contribution to the debate. One is to analyse direct implications of its own research. The other is to bring together a range of expertise to discuss current and future developments, and thus to act as a forum for independent comment and analysis among those with relevant knowledge. In doing so it has facilitated direct discussions between those inside and outside government, as well as publishing reports designed to be of interest to people implementing and commenting on policy.

In 2000 and 2001 the Foundation has undertaken two major exercises related to the new tax credits. First, it looked at plans for the Integrated Child Credit (ICC) through an international prism, asking what the UK can learn from other countries that are going down a similar course, as well as considering more generally which would be the key issues in the implementation of the ICC plans. This produced two publications in late 2000 and early 2001 (see note 1). Second, it considered the plans for an Employment Tax Credit in the wider context of the role of in-work support and its potential implications for labour markets and for social protection. This work, which brought together leading experts in the field at a seminar in May 2001, will be published in November (see note 2).

Many experts and organisations with specialised knowledge and specific interests will be better able than the Foundation to respond to the details of the consultation document. This response sets out to do three things. First, to give an overview of some key issues and arguments identified by the Foundation that relate to the tax credit proposals. More detail can be found in the two publications mentioned above. Second, looking at the specific questions raised by the consultation document, to offer perspectives that have come out of JRF's research, discussions and analysis. Third, to look more particularly at the proposed arrangements for the timing of assessment of tax credit entitlements and the basis of awards, and to point out that the proposals potentially close off some options for reforming Housing Benefit, and could create new problems in terms of how Housing Benefit interacts with other forms of income-tested support.

The first two sections have been drafted by Donald Hirsch, JRF Special Adviser, and the third by Steve Wilcox, who advises the Foundation on housing benefit questions.

1. Overview of key issues and arguments

The broad objectives of the new tax credits, as reflected in the title of the consultation document, are to support families, make work pay and tackle poverty. These are not only worthy goals, but important priorities at a time when poverty and deprivation remain at historically high levels. The Foundation's work on income distribution (see note 3), on indicators of poverty and exclusion (see note 4), on trends in the number of people who lack basic necessities (see note 5) and on what life is like on a low income (see note 6) all point to the fact that the healthy growth in Britain in the past two decades has failed to benefit many of the poorest families. Moreover, there is a particular problem of child poverty (see note 7), whose effects can be passed down through the generations as children growing up in poor families have greatly increased chances of poverty and disadvantage in adulthood (see note 8).

During 2001, the Foundation has been considering which strategies are most likely to improve this situation over the long term, through an investigation of prospects for tackling disadvantage between now and 2021. This investigation will produce its first report - a consultative document - in the early part of 2002. Its ongoing analysis is pointing to an important over-arching distinction. On the one hand, disadvantaged groups need to be given *opportunities* to improve their income and quality of life, in particular by getting access to good quality jobs. On the other, in cases where income from earnings is insufficient to meet basic needs, there is a need for *support* that helps take people directly out of poverty.

A difficult but essential task is to find the right balance between these strategies. For many years there has been a tension between the need to prevent severe hardship among out-of-work families and the need to maintain a reasonable incentive for them to work. Today that tension remains, but the extension of in-work, means-tested support has created a corresponding tension for policies to help families with low earnings to escape poverty. Direct relief through income transfers helps them in the short term but potentially discourages them from seeking longer term solutions through increases in family earnings – since means-tested support inevitably involves high effective marginal tax rates as it is withdrawn.

The Foundation therefore believes it important to consider the proposals for tax credits in the wider context of measures helping families to escape poverty and improve their lives. Other policies that help them do this include: the New Deal, assisting people to get jobs; the National Minimum Wage, which helps make work pay; and education and training policies, which can help improve productivity, pay, career prospects and job quality. It is also important to consider tax credits alongside other forms of social protection, such as insurance benefits to which individuals might be entitled, and also other means-tested family-assessed benefits such as Housing Benefit.

In this context, the tax credit proposals can be considered in terms of their role, alongside other measures, in doing four things:

> ***Providing adequate and stable support for low-income families with children***
>
> ***Tackling poverty more generally***
>
> ***Improving incentives and assistance for individuals to work***
>
> ***Improving incentives and capacity for individuals to improve their earnings***

These are now considered in turn.

a) Providing adequate and stable support for low-income families with children

The Foundation recognises that, through successive budgets in recent years, the government has improved the level of support for certain lower income groups, and particularly those with children. Specifically in the case of families with at least one person in work, it has introduced a more generous regime through Working Families Tax Credit (WFTC) than existed for Family Credit. The terms of this support were improved at the time this reform was made, and have improved further since then. Support paid through WFTC now compares well to the basic needs of children as identified through JRF research (see note 9), although families claiming housing benefit do have a substantial proportion of the gains clawed back through the income taper.

The WFTC continues (from its benefit predecessors) to resemble a benefit rather than a tax break in two important respects: it is assessed on family rather than individual need, and it is withdrawn relatively sharply as income rises. Delivering it largely through the pay packet is therefore a questionable arrangement, particularly insofar as the credit is intended to provide directly for the needs of children, and evidence shows that money paid to their main carer is most likely to meet children's needs. (see note 10)

The proposals for the Integrated Child Credit have some welcome features in this respect:

First and most importantly, the ICC potentially provides a stable source of support for children whose parents have low incomes, whether or not they are working. The Foundation's analysis of international parallels found that such stability is one of the most valued features of children's benefits systems, particularly where it makes such support seem less like a residual, "welfare" benefit, even though it continues to be tested against family income. Two aspects of the stability of the ICC are particularly welcome:

- Paying the same benefit to people in and out of work
- Paying a flat maximum rate up to a fairly substantial level of income (by not tapering the ICC until ETC entitlements are exhausted)

A third important aspect of stability concerns the way it is assessed and the period of entitlement. The issues related to the proposed assessment of entitlement on an annual basis (subject to review for material changes of circumstances), rather than the fixed six month periods under WFTC, are considered further in Section 3 below.

The Foundation raised, in reviewing the international lessons, eleven questions that arise for the ICC (see note 11). Unfortunately, few of these are answered by the consultation paper, since much depends on the rates that are set in practice. As argued in that review, the introduction of the ICC represents a significant opportunity to consider the particular terms of the support given to children, as well as its overall structure. We therefore recommend that the eleven questions posed are borne in mind when working out the rates and tapers for the ICC to apply in 2003. An early indication about planned rates would allow a proper debate about the right level of support for children.

(b) Tackling poverty more generally

There are several reasons for looking at families with children as a special case when aiming to ameliorate poverty. One is that children represent the future, and the evidence shows that children who grow up poor are more likely to be poor as adults and to pass down economic and social disadvantages to their own children. Another is that families with children have needs that are more difficult to meet through earnings, since the ratio of potential wage earners to family members is lower than in childless families. A third, related point is that care of children represents an extra cost, either through reduced hours that parents are available for work or through the direct financial cost of childcare. Between them these factors create a strong case for direct relief of child poverty even among families with earnings from work, but whose incomes remain low relative to their needs.

But to what extent is society willing to relieve poverty more generally? The Income Support system provides a level below which nobody is allowed to fall when they are out of work. However, the current rates of income support do leave large numbers unable to afford basic necessities (see note 12), and income support rates have fallen considerably over the past 20 years relative to general living standards. The Employment Tax Credit Tax appears to set some kind of income floor for groups in work, although the proposals exclude two of the groups most likely to have low incomes in work, part-timers and people under 25. Ironically, this form of protection is being offered at the first time in British history that a full-time worker is in any case guaranteed a minimum income, through the minimum wage (so it would be impossible for a single person or couple, without a disability, to have earnings below £123 a week and be eligible for the ETC, if their employer keeps within the law). Why, then, is an ETC needed for people without children who are not disabled? Two possible reasons such people might still be needy are:

> **i)** because the minimum wage is not enough to raise a single person out of poverty. If the basic thresholds were set at the same rate as the adult portion of Working Families Tax Credit, for example, a maximum of £59 would be payable for incomes up to £92.90 a week net. (NB: while we understand that rates have yet to be decided on, the following illustrative discussion is based on the assumption that the adult rate of WFTC will not be *lowered* in determining a new basic rate for the ETC – so the figures quoted represent a minimum, except for single non-parents, as acknowledged below). A sole earner without children, working 30 hours a week on the minimum wage and therefore earning £123 gross, and about £116 after tax and national insurance, would receive about £46, raising their net income by over a third (although potentially much less if this gain is clawed back in reduction of housing benefit). However, if as suggested the rate for a single person without children is set at a lower rate than for couples, which seems logical, the gain would of course be considerably lower. If for example the rate were £30 with the same income disregard and taper, no single person earning above £147 net, equivalent to just over £160 gross, would be eligible. Given that someone working 36 hours on the minimum wage would presently earn £148, and relatively few people work between 30 and 35 hours (see note 13), it would then require only a small increase in the minimum wage to make the ETC for single non-parents virtually irrelevant. This serves to illustrate how the minimum wage might be seen as a more logical way of avoiding the most severe poverty among this group.
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> **ii)** because only one person is working in a couple. If a single-earner couple had one person working on the minimum wage, again their net income would be around £116, and their income would be topped up by over a third if the present terms for the WFTC were applied, as described in (i) above. Thus there is a prospect that the ETC effectively provides an extra income for a non-working partner that, at maximum, is close to the amount allocated to an adult for basic living expenses on Income Support. It is true that not many people would get this maximum. However, this raises an important point of principle. If the cause of poverty in such a couple is that one of the adults is not working, the most obvious route out of poverty is for that person to find work. Yet the tax credit will effectively provide a replacement income (albeit a small one) without either requiring that person to look for work or assisting them to do so. Given

that a second person earning has been shown to be the commonest route out of poverty for such families (see note 14), this might not be the best approach (and see (c) below) – at least for those partners able to work. In the case of those with a disability, or with health difficulties, a wider range of options and support need to be considered.

(c) Improving incentives and assistance for individuals to work

In-work benefits can play an important part in avoiding the "unemployment trap" for families who otherwise might be little better off in work than in benefits. The Working Families Tax Credit and its predecessors, Family Credit and Family Income Supplement, have played an important contribution in making work pay for families with children. For those without children, the need for an incentive is less obvious, since benefits will be lower relative to potential earnings. Moreover, for some individuals, partners of people claiming the credit, it can produce a disincentive to work, because the credit is reduced as family income rises.

The treatment of partners in ETC seems out of step with the more "active" orientation of the benefits service in JobCentre Plus. Unlike non-working partners of unemployed people, non-working partners of people on low incomes will have neither the support nor the requirement for job search from the agency – in this case the Inland Revenue – giving the income replacement. Indeed, they will have no relationship with it at all, since the money will be received by their partners through the pay packet. This does not seem like the most productive way to approach family poverty, and we would suggest that as the policy develops, the government should look carefully at the situation of non-working partners and at how to improve their opportunities.

(d) Improving incentives and capacity for individuals to improve their earnings

Means-tested in-work support attempts to "target" fiscal help to people on the lowest incomes, but in so doing produces potential disincentives to increase earnings – whether by working longer hours or through career progression. Yet the government rightly wants individuals to invest in human capital, to increase their productivity, and employers to increase job quality and invest in their workers. Too much of an emphasis on in-work top-ups could send unhelpful messages to both employees and employers about the pay-off on these investments. The most unhelpful message would be that greater use of low-skill, low-cost labour is the most fruitful way to develop new employment opportunities.

There is thus a need for several balances to be struck in government policy, all of which require the Employment Tax Credit to be used in moderation rather than as the main instrument for tackling in-work poverty:

i) a balance between means-tested top-ups and a more adequate minimum wage. The latter could give greater incentives for individuals within families to work extra hours (and for second earners to work at all), whereas a low minimum wage with greater use of means-tested tax credits result in a much smaller net return to working more. It is not helpful therefore for government statements to imply that tax credits effectively increase the minimum wage, as the Chancellor did in his last Budget speech.

ii) a balance between providing support for people with low incomes and encouraging or helping them to move towards better jobs. And finally

iii) a balance overall in government policy between reducing the number of jobless families and improving opportunities within work. The New Deal has hitherto emphasised job search and entry, while the new Department for Work and Pensions is particularly focused on encouraging a wider range of people (eg lone parents and disabled people) to consider moving into work. But job quality and career progression need to become equally important if those with the most tenuous foothold in the labour market are to avoid a "merry-go-round" of low-paid, unstable work and unemployment. (see note 15)

2. Response to (selected) questions posed by the consultation document

(references are to points on pages 66-67)

Heading 3, first bullet: couples who jointly work 30 hours

The hours rules for tax credits raise some fundamental questions about how the government regards full- and part-time work. In Australia, a relaxation of the rules for claiming unemployment benefit while working *part-time* effectively gives an earnings top-up to people working part-time, rather than full-time as in the UK. More of a "continuum" of support of this kind seems in principle desirable. The proposed combining of hours rules would open up more opportunities for part-time work, and would also be more compatible with joint income assessment than an individual hours rule. This applies to couples without children getting any support as well as couples with children getting the 30-hour top-up. Overall, the status of part-time work in the tax credit and benefit system needs to be reviewed, since a dichotomy between being in or out of full-time work is not appropriate to the working patterns of today.

Heading 3, second bullet: how working hours should be defined

The clearest principle for claimants would be to apply hours rules to the same period of work as that over which income is assessed. Ideally, hours should therefore be looked at on an average basis over the assessment period, which is now effectively one year. This might not however always be practical, since it is not easy for an individual to make the calculation exactly or for it to be verified. It might help to step back and think about why exactly there is a minimum hours rule. This is there presumably primarily in order to avoid creating a perverse incentive not to work full-time. In this context, a fairly rough and ready application of the threshold seems appropriate, rather than investigating in the minutest detail whether people meet the criterion. One way to do this might be to require applicants to report what were their "normal" working hours during the reference year, or, if hours very irregular, what is their best estimate of average hours (and if working circumstances have changed during the year, to make separate estimates for each period). A cross-check could be to require applicants to report their wage rates, and investigate further where reported income divided by wage appears to indicate that the threshold may not have been reached in reality.

Heading 3, fourth bullet: incorporating Employment Credit

The Employment Credit appears to have been popular among recipients and its continuation would be welcome. However, it could be somewhat confusing to have the two systems used together, and the more the extra payment can seem like part of the main ETC the better. One more straightforward option would be a supplement, with eligibility conditions similar to those in the Employment Credit, that continued indefinitely as part of the ETC rather than stopping after a year. This would need to be somewhat smaller than the Employment Credit if it were not to cost more, but would avoid the serious risk of difficulties when a time-limited work incentive is discontinued. A further option, more straightforward still, would be simply to have an over-50s supplement to the ETC. This would be broader in its coverage, and thus would need to be more expensive or less generous, but could serve to assist older workers to *retain* employment, rather than having to re-enter it after a gap – a much harder thing to do.

Heading 4, first bullet – payment of childcare costs to main carer

It is logical to pay the childcare costs to the main carer. But to label them as the "Employment Tax Credit" when doing so risks undoing part of what has been achieved through "simplifying" the system. Will it seem "simple" for a carer to receive three payments – child benefit, ICC and part of ETC in the form of a childcare credit – while at the same time a different part of the ETC comes in a credit through the pay of the carer or her partner? To the recipient, therefore, it is important that the childcare element seems like an integrated part of the support for the child, while making clear that (a) it is conditional on the parent(s) working and (b) it is tapered before the main ICC as income rises. But in delivery terms, the more it can seem like part of the ICC the better.

3. Tax credits, the basis of awards and help with housing costs

Periods of award

The proposal to fix the awards of the new tax credits for a 12 month period, but subject to review in the event of substantial changes of circumstances, is a radical departure from the current arrangements for WFTC, where awards are fixed for six month periods without being subject to review.

This proposal has both advantages and disadvantages. For households whose circumstances do not change materially during the course of a twelve month period the proposal will reduce the frequency with which they have to apply. However for those households whose circumstances change during the course of a year the proposed system does not offer the certainty provided by the current arrangements.

Households receiving tax credits are inevitably living on relatively modest incomes, and their capacity to adjust to retrospective adjustments to the awards of tax credit will be inherently limited. There must be concerns about the potential hardship that might arise from backdated adjustments that may go back to changes of circumstances that took place up to eleven months prior to the review of annual entitlement. There must similarly be concerns that such retrospective changes will bring the new tax credit system into disrepute, and undermine its positive impact on work incentives.

In part the strength of these concerns will depend on the definition of the extent of changes of circumstance that will trigger a retrospective review of entitlement, and the proportion of claimants that are likely to experience such changes of circumstance during the course of a twelve month period. Unless it can be clearly demonstrated that only a very small proportion of households would be subjected to such retrospective reviews of entitlement there is a strong case for retaining the current six month fixed awards that are one of the strengths of the current WFTC.

There is also a very particular concern about the periods of tax credit awards, and their relationship to the housing and council tax benefit schemes. Any retrospective change of tax credit will have further implications for households also in receipt of housing or council tax benefits. Under those schemes changes of circumstances are currently taken into account with immediate effect (or at least as soon as they are either reported or discovered).

However, because the tax credit change will only be made at the end of each twelve month period, housing and council tax benefits will need to be changed twice for any material change of circumstances – once at the time of the change, and once when the tax credit is reviewed. The only way of avoiding such a damaging administrative anomaly would be to align the time period rules for the tax credit and housing benefit schemes.

This would be a major change for the housing benefit and tax credit schemes, that needs further evaluation in its own right. Even with such a change this would still leave open the prospects of significant backdated revisions to housing and council tax benefit awards, to compliment the retrospective changes in tax credit entitlement.

These complexities add further to the concerns about moving away from the current tax credit system of fixed awards that cannot be subjected to reconciliation.

Assessments based on gross rather than net incomes

WFTC is currently assessed on the basis of net incomes, as are housing and council tax benefits, and other social security benefits. There are some advantages in assessing tax credits on gross incomes – most notably that recipients would get the full benefit of future general tax reductions, for example through the raising of personal allowances. However, there are also drawbacks that cause some concern.

While the old rent rebate and allowance schemes were assessed on the basis of gross incomes, this was linked with a number of difficulties. Under the old system is was far more readily possible for households to face marginal tax and benefit tapers in excess of 100%. While to some extent the taper rates for individual schemes can be adjusted to reflect their application to gross rather than net incomes, the more elements of the tax and benefit system that are related to gross incomes the greater the possibility of anomalies arising that result in absolute losses of income from a marginal rise in earnings.

More generally if the tax credit system is to be assessed on the basis of gross earnings it will become more difficult to align the administration of tax credits with the housing and council tax benefit schemes for those households that remain dependant on both forms of support. It will also inevitably introduce a measure of confusion for the households in receipt of both forms of support.

Simplifying the administration of housing and council tax benefit

The housing and council tax benefit schemes are administratively complex, and the variable standards of administration of the housing benefit scheme is a particular cause for concern. More than a quarter of all cases fail to be administered within the specified 14 day period following the completed submission of an application. This is the focus of a number of government policy initiatives that are intended both to simplify the scheme and to improve its administration, particularly by those authorities that currently have the poorest administrative standards.

From this perspective there is a concern that the proposed tax credit reforms will result in a more complex interface between the tax credit and housing benefit system.

In this respect concerns also relate to the proposal for a pensioner credit scheme, which might potentially interact with the housing benefit scheme on a different basis to the employment and integrated child credit schemes, adding yet further to the complexity and administrative difficulties of the housing benefit scheme. There is a very strong case for requiring the Inland Revenue and Department of Work and Pensions to consult closely so that the detailed proposals for the employment credit, integrated child credit and the pensioner credit are developed with consistent rules in respect of their relationship with the housing and council tax benefit schemes.

Savings

It is proposed to abolish the £3,000 capital disregard and the penal rate of tariff income assumed for savings over that limit (£1 per week for each £250 savings). Instead it is proposed to take into account actual income from savings.

While there are objections to the current penal rate of tariff income, the tariff system does have administrative advantages. It avoids the need to seek detailed information on actual income from savings, and the £3,000 disregard avoids the need to seek and assess information in respect of relatively minor levels of savings (in a context where the distinction between limited savings and working balances in current accounts is becoming increasingly blurred as a result of changes in banking practices).

There is consequently a strong administrative argument for retaining the £3,000 disregard, and the tariff income approach, while at the same time setting the tariff rate at a more realistic and less penal rate.

These arguments apply not just to the new tax credits, but also to the housing and council tax benefit schemes, and the other welfare benefit schemes where similar changes are being contemplated.

Integrated tax credit and housing benefit reforms

The improvements to the WFTC scheme in recent years have reduced the range of circumstances where households also need to claim housing and council tax benefit. They have also reduced, but not eliminated, the circumstances where home buying households can be worse off in, rather than out of, work..

There is an important opportunity to further reduce the numbers of tenant households dependant on both tax credits and housing benefit, and the numbers of working home owner households with net incomes (after mortgage interest costs) below Income Support levels. This could be achieved by adding a small flat rate ‘housing credit’ element to the level of basic tax credit awards (of the order of some £15 per week). The cost of the housing element addition would, for tenant households, be partly offset by savings in housing benefit costs.

Detailed proposals for a reform along these lines are currently being developed for the Foundation, and will be completed within the next two months.

1 The implications for the UK are set out in **A credit to children: The UK's radical reform of children's benefits in an international perspective**, by Donald Hirsch. This report is published for the Foundation by York Publishing Services.
The full international study, including the country reports and comparative analysis, is published by the Caledon Institute as *Benefits for children: A four-country study* by Ken Battle, Jane Millar, Michael Mendelson, Daniel Meyer and Peter Whiteford. It also available from YPS. (Findings Ref: 090)

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2 Donald Hirsch and Fran Bennett, 2001 (forthcoming) *The Employment Tax Credit and Issues for the Future of In-Work Support* , York Publishing Services

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3 John Hills (1998) *Income and Wealth, the Latest Evidence*, Joseph Rowntree Foundation (Findings Ref: 368)

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4 Mohibur Rahman, Guy Palmer, Peter Kenway and Catherine Howarth (2000) *Monitoring poverty and social exclusion 2000*, Joseph Rowntree Foundation (Findings Ref: D20)

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5 David Gordon et al (2000) *Poverty and social exclusion in Britain*, York Publishing Services (Findings Ref: 930)

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6 Elaine Kempson (1996) *Life on a Low Income*, York Publishing Services (Findings Ref: 97)

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7 Sue Middleton, Karl Ashworth and Ian Braithwaite (1997) *Small fortunes: spending on children, childhood poverty and parental sacrifice*, Joseph Rowntree Foundation (Findings Ref: 118)

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8 Paul Gregg, Susan Harkness and Stephen Machin (1999), *Child development and family income*, York Publishing Services (Findings Ref: 389)

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9 Middleton et al, op cit

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10 Goode et al, 1998, *Purse or wallet? Gender inequalities and income distribution within families on benefit*, Policy Studies Institute (Findings Ref: 468)

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11 Hirsch, op cit

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12 Gordon et al, op cit, Kempson, op cit, H. Parker (ed, 1998) *Low Cost but Acceptable: A minimum income standard for the UK: Families with young children*, Bristol: Policy Press

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13 About 3 times as many women and 8 times as many men work 36-40 hours as 31-35 hours a week – Labour Force Survey as reported in *Social Trends 1999*

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14 Jane Millar, Steven Webb and Martin Kemp (1997) *Combining work and welfare,* York Publishing Services (Findings Ref: 132)

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15 See Michael White and John Forth(1998), *Pathways through unemployment: The effects of a flexible labour market*, York Publishing Services (Findings Ref: 568)

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