

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

From 2003, the Government plans to introduce the Employment Tax Credit, to extend help to a wider range of individuals and couples with earnings from work who are nonetheless living on low incomes. What place is there for such in-work supplements in tackling poverty and promoting opportunity? An analysis of evidence suggests the need to balance the decision to extend income top-ups with other policies in order to achieve these aims.

- f** The Employment Tax Credit as currently proposed will be available, like previous in-work top-ups, to families with children and disabled people, working 16 hours a week or more. But it will also be extended to cover childless individuals and couples over 25 with full-time jobs. It will be paid where total income for the individual or couple falls below set thresholds.
- f** The national extension of this form of income top-ups beyond parents and disabled people, though modest in scale at this stage, represents a new departure for the UK.
- f** In-work supplements may affect labour markets by improving the incentive to enter paid work, but also potentially reduce incentives to increase working hours and/or earnings.
- f** In-work supplements may also put downward pressure on wages. Historical and international evidence makes it hard to forecast these effects.
- f** A range of factors cause low income in work, relative to people's needs. In-work supplements may be trying to compensate for shortcomings and gaps in the labour market and social protection system to which other policies might be better suited.
- f** Joint assessment of income for couples claiming tax credits sits uneasily alongside a concern to create opportunities for individuals and the separate treatment of individuals in the income tax system. Tax credits can undoubtedly relieve hardship amongst single-earner couples on low incomes. They are not designed to achieve the more ambitious agenda of ensuring that each individual can realise their potential.
- f** The authors recognise that in-work top-ups can help relieve poverty and hardship for people on low incomes. They also draw attention to limitations and risks of such top-ups. They argue that any extension of such support should be implemented with caution, and complemented with a range of other policies.

## Background

In 2003, the Government plans to create two new tax credits, the Integrated Child Credit (ICC) and the Employment Tax Credit (ETC). The ICC will replace all the major payments designed to support the needs of children, except Child Benefit, and will be paid to the main carer. For poorer working families it will replace the children's element of the Working Families Tax Credit (WFTC). The adult element in WFTC, and also in the Disabled Person's Tax Credit (DPTC), will be replaced with the ETC.

The new system means that in-work support is being extended via the ETC to some groups of non-disabled people without children. And there will also be new methods of assessment and delivery for the new tax credits.

This change represents an important step in a long-term trend towards topping up low incomes for individuals and couples with earnings from work. It is the first time that more general support of this type has been paid on a national basis, not restricted to people with particular characteristics such as having children or a disability. Certain categories, however, will still be excluded from this wider entitlement: under-25s and part-time workers without children or disabilities. (The temporary payments which have been made recently to some over-50s re-entering paid work will also be converted to become part of the ETC.) Now is a moment to reflect on the overall purposes of such support, and how it relates to other

### Key features of planned ETC:

- paid only to individuals and couples with at least one person in paid work at the time of qualifying (though based on income in the previous tax year);
- for families with children and disabled people, it replaces the 'adult' portion of WFTC/DPTC, and may be higher for disabled people;
- extension to people without children or entitlement to disability benefits would bring in new (additional) beneficiaries;
- means-tested against income (joint income for couples) and tapered as income rises;
- likely to be age-limited – excluding young adults (under 25);
- likely to be hours-limited – excluding part-timers except for parents and disabled people (and possibly other limited groups such as carers in future);
- delivered through the pay-packet.

policies to help individuals and couples with some earnings but still living on low incomes.

## Income top-ups and the labour market

A number of countries have been introducing income top-ups designed to 'make work pay' for people on low earnings, and to help them escape poverty. So far, most of this assistance has gone to families with children, although an experimental Earnings Top-Up piloted in the UK recently demonstrated the potential for helping people without children on low in-work incomes. The Government's concern to tackle disincentives to work and in-work poverty amongst a wider group is welcome. However, there are some limitations, and some risks, in an increasing emphasis on using in-work top-ups of this kind to tackle these problems.

In-work supplements such as the Employment Tax Credit may potentially affect labour market behaviour, by:

- **Increasing labour supply**, by making it more worthwhile to work at a given wage rate. This is one of the Government's explicit aims for the ETC.
- **Reducing labour supply**, by making it less attractive to work more hours, because of the high rate at which extra income is recouped as the means-tested top-up is withdrawn, alongside additional tax and national insurance payments. Because couples' incomes are assessed jointly, this risk is particularly relevant to couples with one earner, where top-ups can make it less worthwhile for the second person to work part-time.
- **Exerting downward pressure on wage rates**. The availability of top-ups may depress wages over the long term, since it makes it more possible for employers to sustain low rates of pay.

In practice, there is some evidence that 'make work pay' schemes can modestly increase net labour supply. There have also been cases where reductions in hours appear to have followed from the introduction of top-ups. Effects on wages are much harder to pinpoint. Any labour market effects will depend to a considerable extent on the design of programmes, and on local labour market conditions. A top-up based on family income, and with relatively infrequent income assessments, is less likely than a top-up of individual pay to be seen as a direct wage subsidy, although payment through the pay packet carries a visible link to earnings.

## Income top-ups and the causes of low in-work income

In-work means-tested top-ups may be trying to deal with a number of different causes of low income relative to needs for individuals and couples with earnings from work – for example:

- for single-earner couples, they may be trying to compensate for one partner having no access to employment or income in their own right – perhaps through losing their job, or running out of benefit;
- where the main earner is female, they may be trying to compensate for gender inequalities in pay;
- for single people or couples, they may be trying to compensate for mortgage payments and other in-work costs which are high in relation to earnings.

In-work supplements given to people in these situations may be seen as multi-purpose benefits, flexibly providing extra resources for people with low total family income. Or they may be seen as attempting to cover for a variety of gaps and shortcomings in the rest of the labour market and social protection systems, which could be tackled head on rather than in the form of an earnings supplement.

## Assessment and delivery

A critical part of the new system of tax credits will be assessment and delivery.

First, there is an issue about the unit for income assessment. The Government wants ETC to be associated with in-work income, which is earned by individuals, and income tax, which is paid by individuals. But, like other tax credits and means-tested benefits, ETC will be assessed on joint income, and so will extend joint assessment to more people. Acquiring a second earner is often the most likely route out of in-work poverty for couples. But since potential 'second earners' tend to be particularly sensitive to disincentives, extending joint assessment may mean more people are discouraged from taking this route. Some features of ETC are intended to help tackle this problem, but it is difficult to solve it entirely under a means-tested system. More generally, the policy focus on 'workless households' so far has meant putting priority on getting one person into work. In the future, enhancing individual autonomy and life chances for both members of a couple needs greater attention.

Second, there are issues around the timing of assessments and awards. Two Government priorities are to have a simple, 'light touch' system of assessment, and to make the new tax credits sufficiently responsive to changing needs.

International experience has shown that claimants often welcome long assessment and award periods, as an alternative to the constant reassessment and intrusiveness that have prevailed in much of the means-tested benefits system. However, it is also important to enable people whose circumstances have worsened to make a revised claim in order to meet their needs in a timely fashion.

Present government proposals attempt to take on board these competing priorities, through annual awards based on income in the previous tax year, but with scope for readjustments where estimates of current year income are substantially different or circumstances change significantly. However, a corollary of responsiveness to worsening circumstances is that where income is substantially above that of the previous year, entitlement may go down, and some retrospective repayment of credits may arise. This could cause serious difficulties for some people on low incomes, particularly if the conditions for reconciling initial with final awards are not clear.

## Conclusion

Government concern about in-work poverty is welcome, and tax credits can help reduce such poverty for individuals and couples. The additional income they provide will be of significant help, including to groups who have not hitherto been a priority. But this analysis concludes that because of their limitations and risks, due emphasis on other policies is required which would reduce the need to use in-work top-ups. In particular:

- Further improvements in the minimum wage would help, as well as sustained efforts to tackle the gender pay gap.
- In-work supplements are better at helping people take the first step - into a job - than the second - into a better job. This means an emphasis on supporting career progression as well as job entry, and helping people acquire the skills/experience needed to improve earnings potential.
- Other shortcomings and gaps in the labour market and social protection system, which tax credits are trying to compensate for, could be tackled head on.

The present proposal to extend tax credits to non-disabled people without children is modest in scope; but many modest steps in one direction can eventually add up. Government interventions to 'make work pay' through supplementing in-work income are no substitute for policies to give workers the opportunity to lift themselves out of poverty through their earnings, raised as a result of investment in human capital, higher productivity and responsible behaviour by employers. In addition, a focus on helping 'workless households' to have at least one earner needs complementing by an approach which supports opportunities for worthwhile employment for all members of households, as well as enhancing employment and benefit rights, to give all individuals access to income and security and allow them to make provision for their future.

### About the project

As part of the Joseph Rowntree Foundation's ongoing programme of monitoring welfare reform, Donald Hirsch and Fran Bennett reviewed evidence and arguments around the proposed extension of tax credits. A seminar in May 2001 brought together leading experts in the field to discuss the issues, informed by an initial background paper and by papers from Frank Wilkinson of the University of Cambridge and from the OECD. A final report draws on the conclusions from this seminar and reproduces the papers presented there.

### How to get further information

The full report, *The Employment Tax Credit and issues for the future of in-work support* by Fran Bennett and Donald Hirsch, is published for the Foundation by YPS (ISBN 1 84263 035 0, price £9.95).