The Modernisation of Britain's Tax and Benefit System

Number Six

Tackling Poverty and Making Work Pay – Tax Credits for the 21st Century

HM Treasury
March 2000

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THE NEXT GENERATION OF TAX CREDITS

INTRODUCTION

1.1 The Government has set out its twin goals of:

- employment opportunity for all, the modern definition of full employment; and,
- tackling poverty, in particular, the commitment to abolish child poverty within a generation.

1.2 The key components of a strategy to achieve these goals include:

- providing a framework of macroeconomic stability and growth;
- promoting a flexible and adaptable labour market;
- encouraging investment in education and skills;
- helping move people from welfare to work through the New Deal; and,
- making work pay through reform of the tax and benefit system.

1.3 The purpose of modernising the tax and benefit systems is to recognise that whilst traditionally the two have evolved to meet different objectives, the tax system to raise revenue and the social security system to give money to people in financial need, in a modern economy they should together contribute to the common objectives of making work pay and tackling poverty.

1.4 In 1997 the Chancellor set out his ambition to support work through the pay packet and at the same time to provide improved support for families with children. To this end the Government is committed to a programme of tax and benefit reform which will continue through this Parliament and beyond. The first steps were taken with the introduction of the Working Families' Tax Credit and the decision to introduce a new Children's Tax Credit from April 2001.

1.5 Budget 99 set out the next stage in the Government's evolving reform agenda building on these earlier achievements:

- first, an integrated child credit which would bring together the different strands of support for children in the Working Families' Tax Credit, Income Support/Jobseeker's Allowance and the Children's Tax Credit, to create a seamless system of financial support for children which will be paid to the main carer, building upon the foundation of universal Child Benefit;
- secondly, an employment tax credit, which would complement the new child credit. The employment tax credit would be payable through the wage packet, and potentially would be available not only to families with children, as in the Working Families' Tax Credit, but extended to groups without children as well. It would provide a single, visible instrument, underpinned by the National Minimum Wage, to make work pay.

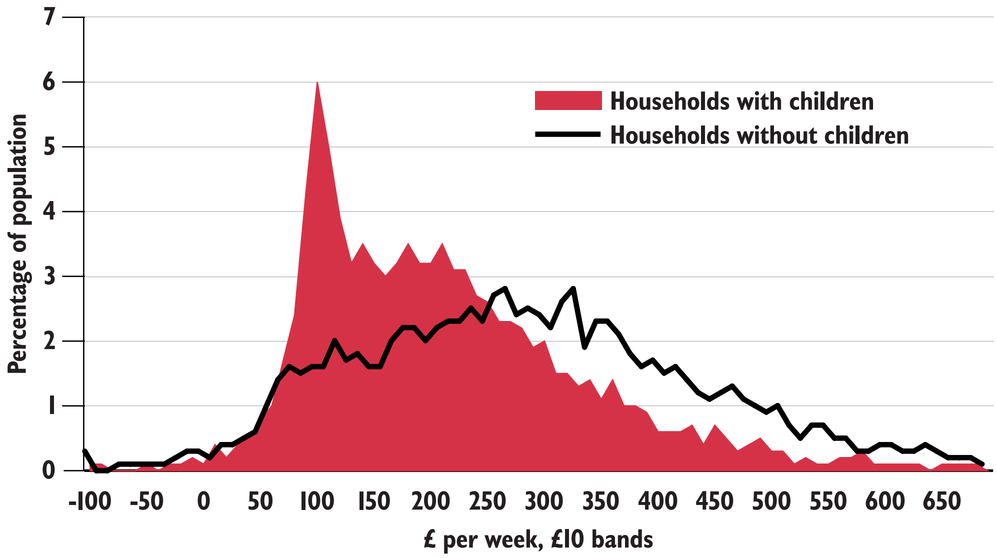
1.6 Budget 2000 confirmed the Government's decision to proceed with these reforms. This paper reports on how the reforms to date have already helped make work pay and improved support for children and sets out in more detail the proposals for and issues surrounding an integrated child credit and an employment tax credit.

2 SUPPORTING CHILDREN THROUGH AN INTEGRATED CHILD CREDIT

2.1 The Government's ambition is that every child should have the best possible start in life. The Treasury's paper, *Supporting Children Through the Tax and Benefit System*[1] showed that families with children have not had an equal share of the growth in incomes over the last 20 years. The average income of households with children, adjusted for household size, is nearly a third lower than for those without children, and this difference has been growing over time. As a result, children are now the group most likely to be in low-income households. Indeed, the number of children in households with incomes below 60 per cent median has trebled over the past three decades so that in 1997 a third of children lived in relative poverty.

Income distribution for individuals in households with and without children, 1997/98

Chart 2.1: Income distribution for individuals in households with and without children[1]



2.2 In addition, children and their parents are also more likely to be *persistently* poor than other working-age adults. In August 1999, nearly 800,000 children were living in families that have been on means-tested benefits for at least five years. Eleven per cent of children have spent the last seven years in households that are in the bottom three deciles of the income distribution.

2.3 The major cause of low incomes among families with children is worklessness. In Spring 1999, 2.2 million children, almost a fifth, lived in workless households. And work remains the surest route out of poverty for families. Around two thirds of families rising above the relative poverty line in any one year do so because a parent gets a job or the family's earnings increase.[2] Long periods of worklessness reduce the chances of a parent subsequently finding work, and lower their eventual earnings.

[1] Supporting Children Through the Tax and Benefit system, No. 5 in the Tax and Benefit Modernisation series, HM Treasury, November 1999.

[2] HM Treasury, Nov 1999, ob. cit.

2.4 Nevertheless, changes in the labour market have also increased the risk of poverty for children whose parents are in work. Certain groups are more likely to experience these problems: families with young children, large families, certain ethnic minority groups and lone-parent families.

2.5 Low incomes matter. Not only do they restrict families' immediate opportunities, but their effects reach into children's future adult lives and the lives of their children. Children from disadvantaged families are more likely as adults to live in social housing, be dependent on benefit, have a low income and, if female, be a teenage mother[3].

2.6 The Government recognises that the effects of poverty and low income on children's life chances are complex and multi-dimensional. There is no simple way to compensate people for lack of opportunity. It is therefore introducing policies to

- ensure a world class education system for all: so that those from poor backgrounds have the skills and education necessary to break the cycle of disadvantage;
- target special interventions at those in greatest need; and,
- harness the power and expertise of local communities and the voluntary sector.

Making work pay

2.7 The Government also recognises that families need a decent income. It is tackling the issue of skills and employability for parents through the New Deal and the lifelong-learning agenda. But people in work also need to find that work pays. Since May 1997, the Government has introduced:

- the National Minimum Wage to help guarantee fair minimum standards of pay. This will be uprated from £3.60 an hour to £3.70 from October 2000;
- a 10p rate of income tax to reduce the tax burden on the low paid;
- reforms to National Insurance which will take 1 million low-paid workers out of the NICs system while protecting their entitlement to benefits;
- the Working Families' Tax Credit, will deliver a minimum income of £214 a week from April 2001 for a family with someone in full-time employment;
- the Disabled Person's Tax Credit to make work pay for disabled people whether in work or returning to work;
- extra help with childcare costs for working families through the childcare tax credit in the WFTC, replacing the failed disregard in Family Credit. Since its introduction in October 1999, the childcare tax credit has already been claimed by over 90,000 families;
- a Job Grant to ease the transition between welfare and work. This, along with the extended payments scheme for Housing Benefit and Income Support for Mortgage Interest could mean an extra £300-400 for eligible parents.

2.8 The Working Families' Tax Credit is at the heart of these reforms. As a tax credit rather than a welfare benefit, it reduces the stigma associated with claiming in-work support, and by demonstrating the rewards of employment over welfare should encourage families to move into work. The Working Families' Tax Credit also ends the situation in Family Credit where 500,000 families were paying tax to the Inland Revenue at the same time as receiving benefits

[3] Hobcraft, J. (1998) "Intergenerational transmission and life course transmission of social exclusion: influences of childhood poverty, family and contact with the police. CASE paper 15.

through the social security system. By delivering a top-up to earnings through the pay packet, and by targeting help at low-income families, it is a decisive step towards achieving the Government's long-term goals.

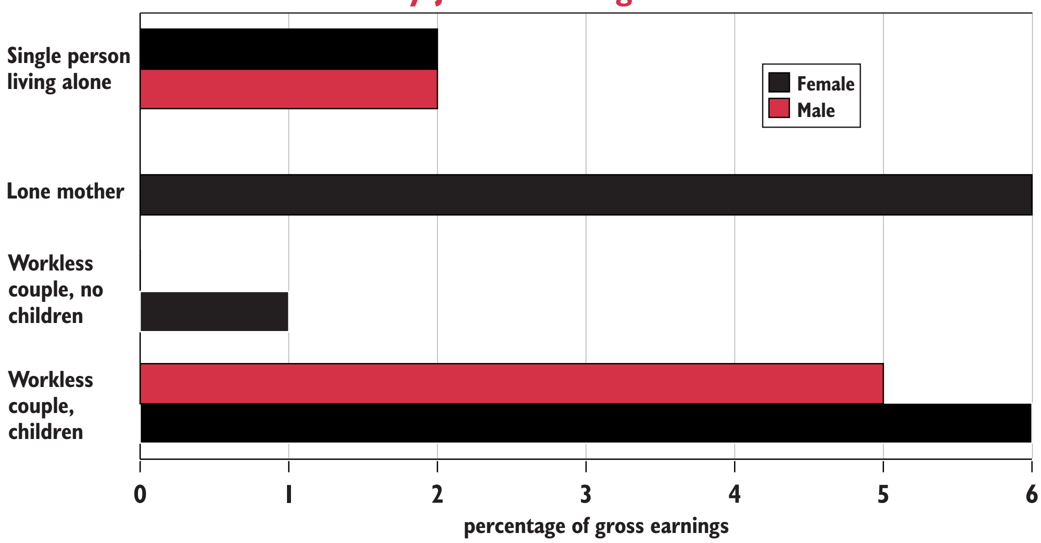
2.9 The Working Families' Tax Credit ensures that families are generally better off in work than on benefit and so tackles the unemployment trap. By April 2001, the minimum income guarantee will be £214 a week. Under the old system a couple with two young children would have had to have earned more than £260 a week in order to be £40 a week better off in work than on benefit. This is considerably more than the average wage on offer to parents returning to labour market after a spell out of work, which is around £160 a week. The Working Families' Tax Credit considerably improves the gain to work, so that even at typical entry-wage jobs the gain to work for such a family would be £40 a week.

2.10 The Working Families' Tax Credit also tackles the poverty trap inherent in Family Credit, whereby families were little, if at all, better off when they increased their earnings because up to 90 per cent of every extra pound they earned was taken away in tax or reduced benefits. The Working Families' Tax Credit will cut the number of families with marginal deduction rates of more than 70 per cent by two thirds.

2.11 Of course, financial incentives matter to all workers. The package of reforms the Government has introduced, including the cut in the basic rate of income tax, are benefiting not only families with children but all those on low and middle incomes. But the Government has targeted the most support on families with children.

2.12 Chart 2.2 illustrates how the reforms will benefit all workless households. It shows how much the gain to work will increase as a result of the Government's reforms if someone in the household takes a job. It assumes a realistic pattern of hours and wages which in practice, show different patterns for men and women. Compared with the situation in 1997, workless families with children will now keep on average 6 per cent more of their gross earnings if one of the adults moves into work.

Chart 2.2: Increase in the gain to work for workless households in entry-jobs following the Government's reforms



Note: The gain is expressed as the extra percentage of their gross earnings that the job-entrant gets to keep because the Government is now taking away less in taxes and reduced benefit income.

2.13 Recent studies have estimated the impact of the Government's reforms on the numbers of people seeking to enter work. Blundell et al[4] estimated that the Working Families' Tax Credit alone could increase the number of people seeking jobs by around 30,000. The table below shows Treasury estimates on a cautious basis of the whole package of reforms including not just the Working Families' Tax Credit but also cuts in income tax and National Insurance Contributions[5]. It does not take account of the measures announced in Budget 2000, or of the introduction of the childcare tax credit which should have an additional impact on employment.

Labour Supply Impact of the Government's Making Work Pay Package	
Singles	37,100
Lone parents	42,100
Couples, partner in work	17,300
Couples, both out of work	63,800
Total Effect	160,000[1]

[1]*Figures may not sum due to rounding.*

2.14 This shows that while all groups should increase participation as a result of the measures, the most significant effects are amongst those where the problem of worklessness and poverty is most acute. If translated into jobs, the effects in the table would mean a four per cent reduction in the numbers of workless households, a five per cent fall in the number of children in workless families, and a six per cent fall in the number of workless lone-parent households.[6]

Direct support for families

2.15 Policies to make work pay tackle poverty in two ways. They encourage more people to move into work, which is the most reliable long-term route out of poverty, and they provide more income to the working poor. The Working Families' Tax Credit, as well as tackling worklessness, will be worth an extra £24 a week for up to 1.4 million low to middle-income working families compared to the previous Family Credit regime. It will mean that a one-earner couple with 2 young children on £12,500 will be £2,600 a year better off by comparison.

2.16 Other measures in the last three Budgets have given further direct help to families with children, both in and out of work.

- **Increases in Child Benefit:** universal Child Benefit paid to the main carer is the foundation of the Government's support for families with children. By April 2000 it will be worth £15 a week for the eldest child and £10 for each subsequent child. This is a cash increase of £3.95 since May 1997, a real increase of 26 per cent.
- **Increases in Income Support:** By October 2000, the maximum support for children under-11 will have increased by over £14 a week compared to April 1997, a 72 per cent real increase.

2.17 Budget 1999 announced a new **Children's Tax Credit** to be introduced in April 2001. This will replace the Married Couple's Allowance and related allowances which are being abolished from April 2000. The Children's Tax Credit will benefit about five million families and will be worth up to £442 a year, more than twice the value of the old Married Couples Allowance. It will be withdrawn from families where someone is a higher-rate taxpayer. From April 2001, middle-income families with one child will receive £24 a week support for their

[4] Richard Blundell, Alan Duncan, et al (1998) "The Labour Market Impact of the Working Families' Tax Credit" Institute of Fiscal Studies

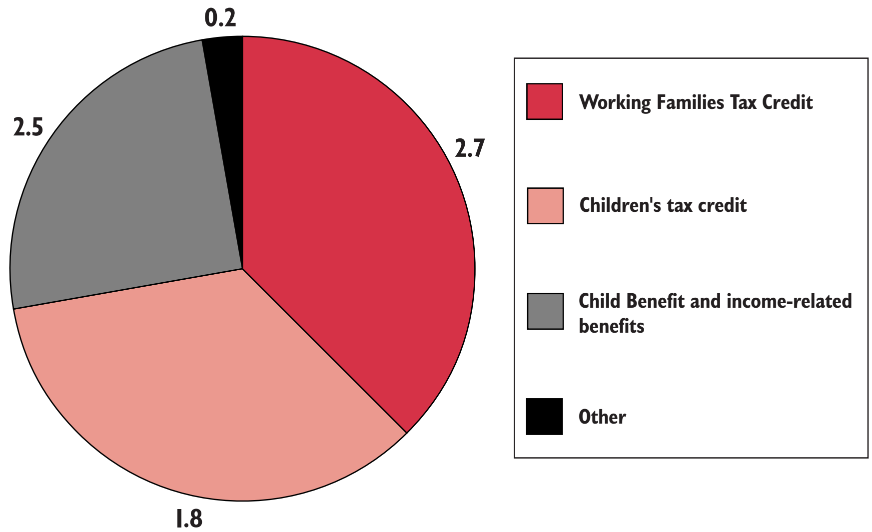
[5] The estimates are base on methodology used by the Institute of Fiscal Studies in a 1999 study by Gregg, Johnson and Reed, "Entering Work and the British Tax and Benefit System."

[6] None of these behavioural changes have been taken into account in the costings of the WFTC in the EFSR/FSBRs etc.

eldest child, including Child Benefit. The Children's Tax Credit provides support for children taking account of household circumstances, and is consistent with the principles of independent taxation. It is an important step in delivering a fairer tax system for families with children.

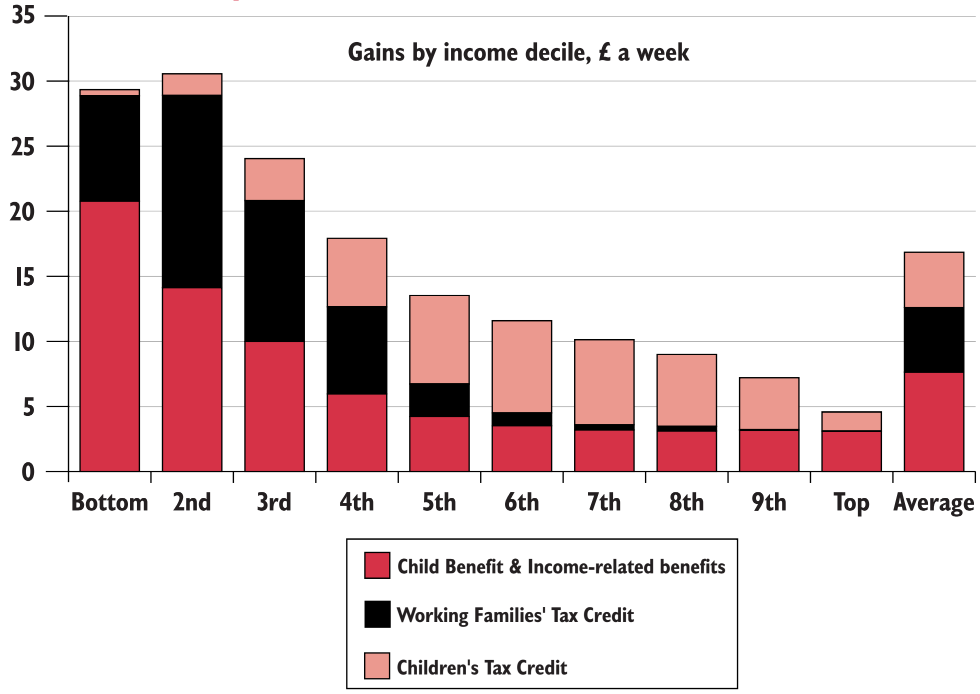
2.18 The measures over the Parliament will lift 1.2 million children out of poverty. By 2001 the Government will be spending an extra £7 billion a year in real terms on support for children.

Chart 2.3: Extra £7 billion of financial support for children



2.19 As the following chart shows, on average families with children will be £850 better off by the end of the Parliament from the tax and benefit changes. Those at the lowest end of the income distribution gain the most, the poorest fifth of families gain an average of £1,540 a year.

Chart 2.4: Gains for families as a result of children's measures by 2001



Next phase of reform

2.20 The reforms to date have gone a long way to achieving the Government's aims. They have established the principle that work must pay and be supported through the wage packet, and have improved support for all families with children, targeting extra resources on those most in need based on family circumstances.

2.21 However, the pace and scale of reform has been constrained by the tax and benefit structures and administrative systems which were already in place when the Government was elected. For example, the Working Families' Tax Credit is based on Family Credit, a social security benefit, and the Children's Tax Credit on the Married Couple's and related allowances. But as the Government begins to plan the next generation of tax credits there is much greater scope for creating a radically new system.

2.22 Using one system to achieve two objectives – in the case of the Working Families' Tax Credit, better work incentives and increased family support – can give rise to tensions. At the same time, using several different instruments to contribute towards a single goal – increased family support in Income Support, the Working Families' Tax Credit and the Children's Tax Credit can mean a duplication of effort.

2.23 In the next phase of reform the Government has announced its intention to:

- create an employment tax credit to be paid through the wage packet based on the adult allowance in the Working Families' Tax Credit and Disabled Person's Tax Credit; and,
- bring together the different strands of support for children in the Working Families' Tax Credit, in Income Support and in the Children's Tax Credit to create an integrated and seamless system of financial support for children.

An employment tax credit

2.24 An employment tax credit, paid through the wage packet to employees, will continue to make work pay for families on low incomes. It will also build on the Disabled Person's Tax Credit and the 50+ Employment Credit to extend in-work support to low income households without children. **Chapter 3 outlines how this could be done**.

An integrated child credit

2.25 An integrated child credit will create a seamless mechanism for channelling support to children as part of the Government's commitment to abolish child poverty. This will continue the process of reform begun with the introduction of the Working Families' Tax Credit and the Children's Tax Credit by providing:

- **a more transparent system of support for children**, helping parents understand what they can expect to receive, and facilitating public debate about the appropriate level of support in the context of the Government's commitment to abolish child poverty within a generation;
- **a portable and secure income bridge spanning welfare and work**, to improve work incentives. Survey evidence suggests that the financial disruption associated with moving off benefits into employment often discourages parents from making the transition into work. It would therefore go a step further than the minimum income guarantee delivered by the Working Families' Tax Credit;
- **a common framework for assessment and payment**, where all families will be part of the same system, rather than dealing with low-income families through the benefits system while giving tax allowances to the better off. Awards would be assessed on the joint income of couples;

- **a system where all support for children is paid to the main carer**, in line with universal Child Benefit;
- **efficiency gains** for Government and reduced hassle parents, from moving away from a system where support for children is delivered through four different mechanisms.

2.26 The new credit will build on the foundation of universal Child Benefit. Child Benefit is an effective way to reach families, and in recognition of its importance, the Government has increased it significantly in real terms in recent years. In designing the integrated child credit, the Government will consider how to build effective links with Child Benefit to help to deliver a joined-up service for families.

The new system

2.27 Chart 2.5 shows how support for the family through the tax and benefit system for a couple with one child will increase once the new Children's Tax Credit is introduced in April 2001. No decisions have yet been taken about the level of the integrated child credit. Chart 2.6 illustrates how the new system could look if introduced on the basis of current tax credit rates with an integrated child credit creating a seamless payment across the welfare to work divide.

Chart 2.5: The structure of financial support for families from April 2001

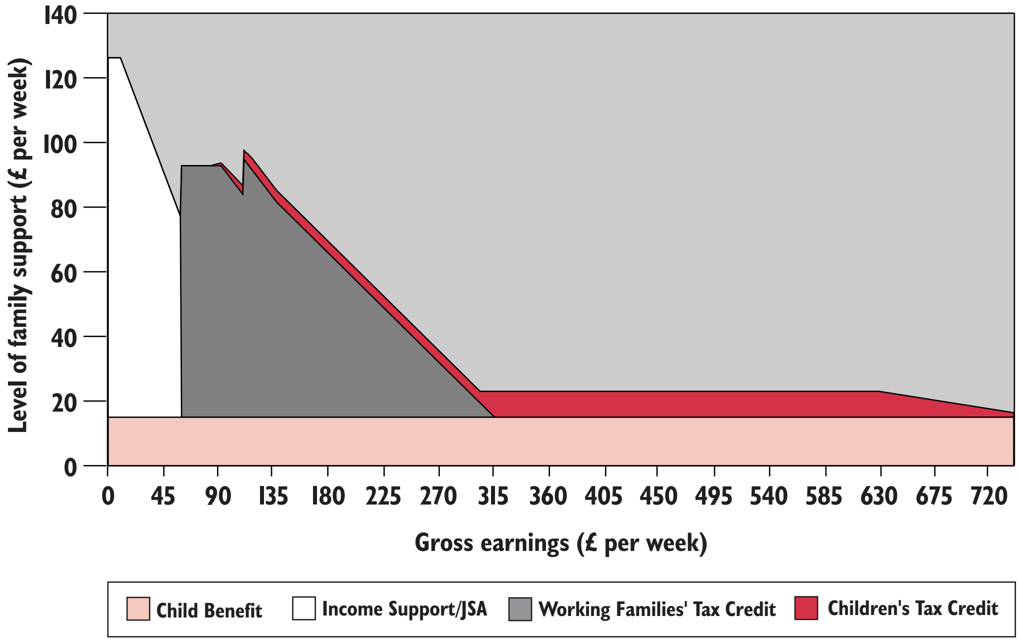
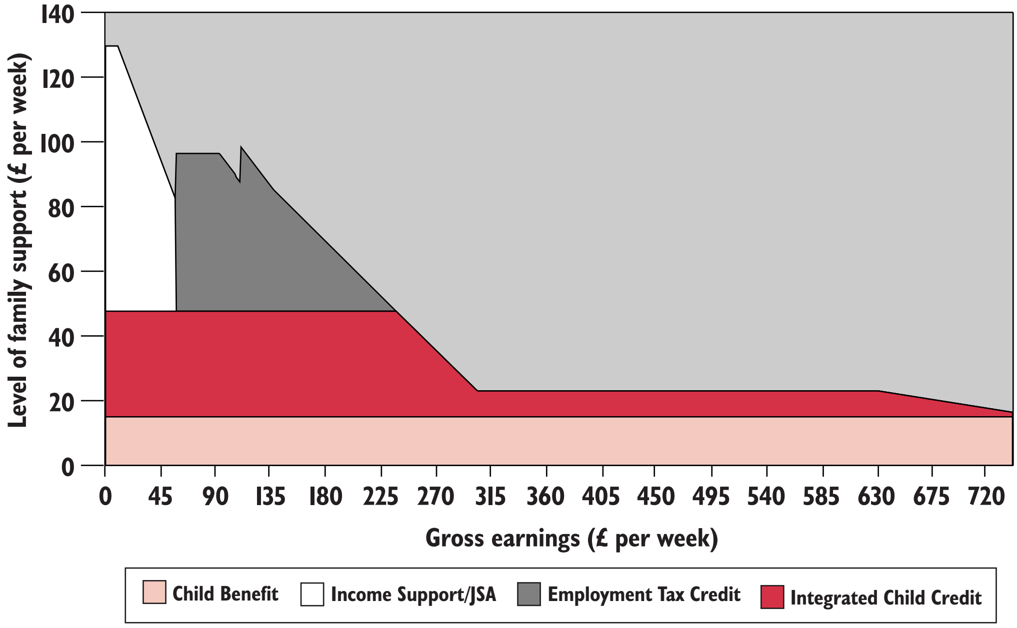


Chart 2.6: An illustrative structure with an integrated child credit



2.28 The table below shows which elements of support might be included in the integrated child credit if it were based on the existing levels of the Working Families' Tax Credit and Children's Tax Credit. It illustrates how these could combine with Child Benefit in a new system to deliver maximum support for the first child of £50 a week.

Total support for a working family with children under 16 (£ per week)

	First child	Other children
Child Benefit	15.50	10.35
Elements of an integrated child credit		
Children's Tax Credit	8.50	
WFTC Child Credit	26.00	26.00
Maximum support	50.00	36.35

Note: Illustrative rates based on levels of WFTC, Children's Tax Credit and Child Benefit in April 2001, as announced in Budget 2000. The adult credit in the employment tax credit would be £49.50.

2.29 The Government's aim will be to introduce the new credits from 2003 (subject to the legislative timetable). The new credits will be administered and delivered by the Inland Revenue. This represents a further important step towards tax and benefit integration. It will recognise the fact that the Inland Revenue already collect income information on three quarters of the integrated child credit caseload, over 3.5 million families.

2.30 The aim is that once the reform is completed, families who are also claiming Income Support and Jobseeker's Allowance will only need to provide income and family details once, through, ONE the new agency for people of working age[7], with the relevant information being transferred electronically to the Inland Revenue. The Inland Revenue and the Department of Social Security will continue to work together to deliver a joined-up service for families.

[7] The Prime Minister announced on 16 March year the Government's intention to bring together the Employment Service and the Benefit's Agency responsibilities for working age adults.

3 Supporting work through an employment tax credit

3.1 By increasing employment opportunities for all, the Government is tackling worklessness – the most important cause of deprivation and poverty. Central to this strategy are policies to make work pay.

3.2 The Working Families' Tax Credit and the National Minimum Wage have for the first time guaranteed a minimum income for families in work. In the new system, an integrated child credit will provide the financial support for children, and would be complemented by an employment tax credit paid through the wage packet to ensure that families are better off in work than on benefit.

3.3 Through the Disabled Person's Tax Credit and the Employment Credit component of the New Deal 50plus, the Government has already extended the scope of in-work support to people without children. Reforms to National Insurance Contributions and income tax have helped all low paid households, with and without children. There is a strong case for extending the principle of more targeted support to working-age households without children, through an employment tax credit to make work pay.

Support for adults without children

3.4 More people are in employment today than ever before. Since May 1997, employment in the UK has risen by over 800,000 and the employment rate currently stands at 74.3 per cent. Nevertheless in Spring 1999, 6.7 million people below pensionable age – 4.5 million adults and over 2 million children – lived in households with no–one in work. As Martin Taylor identified, 'this increase in the number of workless households, not simply workless individuals, is a great cause for concern'[5].

3.5 While the unemployment trap was historically of particular importance for families with children, as earnings take no account of family size, worklessness remains an important issue for working-age households without dependent children. As chart 3.1 shows, the rate of worklessness has been consistently higher for working-age households without children than for households with children.

Why an employment tax credit for low income households without children?

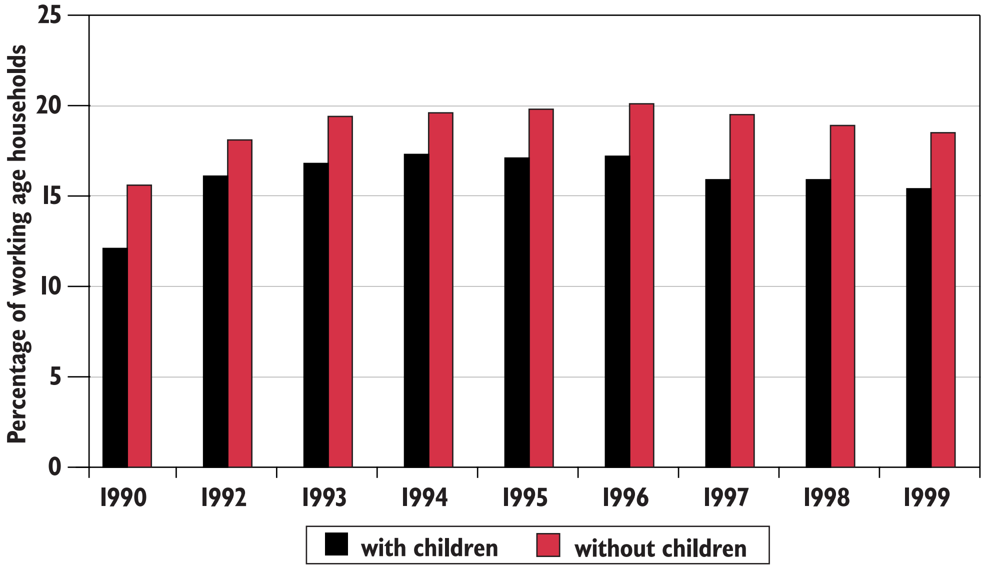
3.6 In this context the Government sees a strong case for supporting people without children through an employment tax credit. It would have two objectives:

- to **increase work incentives**, together with the minimum wage, for low-paid workers; and,
- to **relieve in–work poverty** in working households without children, as the Working Families' Tax Credit helps families with children.

3.7 It would extend the principle of the minimum income guarantee beyond families with children, giving a clear and demonstrable statement that work pays.

[5] Work Incentives: A report by Martin Taylor, No. 2 in The Modernisation of Britain's Tax and Benefit System series, March 1998.

Chart 3.1: Rate of worklessness amongst working-age households



Source: Labour Market Trends, January 2000

Employment tax credit and the minimum wage

3.8 The introduction of the National Minimum Wage in April 1999 has for the first time provided a statutory level beneath which pay cannot fall – removing the worst excesses of low pay. The Low Pay Commission estimates that, prior to its introduction in April 1999, more than 1.5 million people were earning less than the current level of the minimum wage, and so will have seen an increase in their returns to work.[6]

3.9 Around one quarter of individuals in the poorest households in 1996 were employees. The introduction of the minimum wage[7] has therefore had a significant impact on in-work poverty.

3.10 A coherent and principled strategy for attacking poverty and promoting work should combine in–work tax credits with a minimum wage at a prudent level, particularly where gains to work and incomes remain relatively low for some groups. This is for three reasons.

- Tax credits, as a complement to a minimum wage, are an effective way of tackling poverty. As demonstrated through the Working Families' Tax Credit, tax credits can be targeted on low income households, can be varied depending on family circumstances, and do not raise the direct cost of low-wage workers to employers.

- Tax credits can be combined with the minimum wage to avoid any adverse employment effects. Attempting to use minimum wages alone to generate an adequate in-work income that is responsive to the differing needs of varying family structures is problematic. For example, Gregg (1999)[8] has estimated that it would require a minimum wage of between £5 and £5.70 for one full-time worker in a couple to generate an income equal to half-average household income. A minimum wage set at this level could well have adverse consequences for the employment of low- skilled workers, particularly the young.

[6] The National Minimum Wage: The Story So Far, Second Report of the Low Pay Commission, February 2000

[7] See "The National Minimum Wage, Incomes and the Low Paid", Low Pay Commission, Occasional Paper 2, June 1999.

[8] Gregg (1999), "The Use of Wage Floors as Policy Tools", Paper presented to the OECD Workshop on Making Work Pay, September 1999.

- By improving the returns to work, tax credits make low-paid jobs more attractive to the unemployed. In the absence of a minimum wage, there would be an increased risk that some employers would try and take advantage of this by lowering wages. The national minimum wage, by setting a floor for wages, is essential to ensure that low-income workers enjoy the full benefit of the tax credit.

3.11 Together with the New Deal, the minimum wage and the employment tax credit provide a comprehensive strategy to move people from welfare and into work. Box 3.1 sets out how an employment tax credit would build on the New Deal.

Box 3.1: An employment tax credit and the New Deal

There is good evidence to suggest that financial incentives matter, particularly when the right financial rewards are combined with active help on training and job search. The Government's New Deal programme equips workless people with the skills they need to compete effectively for the jobs that a dynamic labour market creates. This active labour market programme ensures that those who are out of work are kept in contact with the labour market and do not drift into periods of long-term unemployment. An employment tax credit would complement the New Deal in three ways.

- **While the New Deal improves an individual's prospects for sustainable employment, an employment tax credit would increase the financial benefits of work, improving the incentive to take, and then to stay in, work. The combined impact of these two policies is likely to be greater than the sum of the individual parts.**
- **Although the New Deal has been very effective at re-attaching groups detached from the labour market, it does not help low-skilled people already in low-paid employment, some of whom may face persistent poverty and little prospect of improving their financial returns from work in the medium to long-term. An employment tax credit would help them.**
- **An employment tax credit would also offer additional in-work financial support to low–income households who may not have been eligible for, or benefited from, the New Deal. Some households may not have experienced periods of unemployment and others may not have met the qualifying conditions.**

An employment tax credit will have the potential to complement other more targeted sources of financial support for those moving from welfare to work, such as the new job grant.

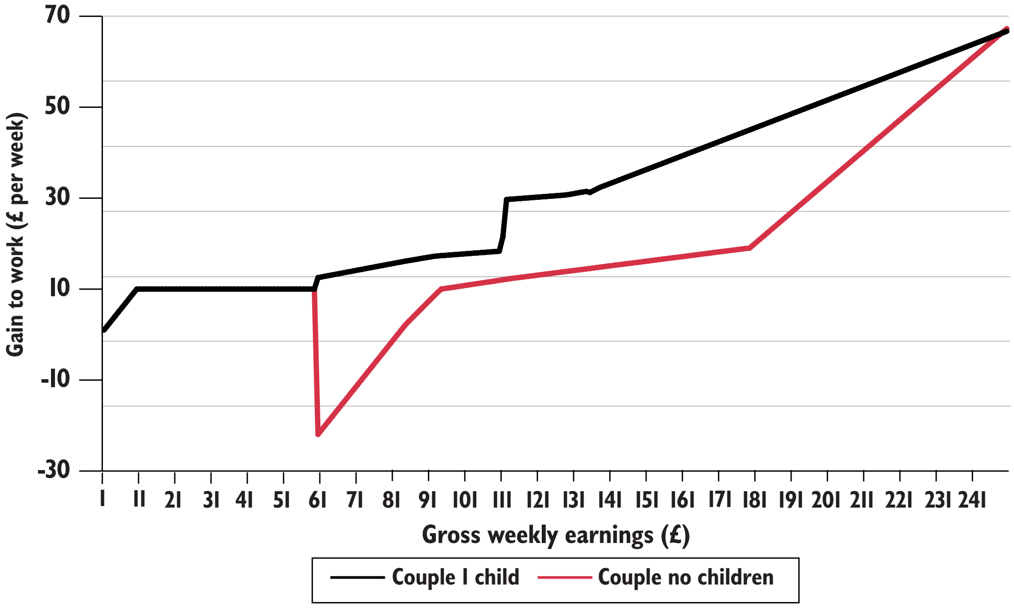
Improving work incentives for low-paid workers without children

3.12 As chapter 2 has shown, the National Minimum Wage and tax reforms have increased the gain to work for all workless households. However, as chart 3.2 shows for couples without children, the gains to work from low-paid jobs are still not large.

3.13 Research has suggested that people look to be around £40 better off in work[9]. For those without children, and particularly for couples who get more on benefit than single people, the gain to work can be some way below this level at the wages people typically command on leaving benefit. With one person working full-time at the median weekly earnings in entry-level jobs of £160, a couple without children in rented accommodation is only £15 a week better off than on benefit, before any costs of working are taken into account.

[9] Marsh et al (1998) "The Earnings Top-Up Baseline Surveys", Policy Studies Institute.

Chart 3.2: Gains to work for a couple with and without children



Note: In April 2001 prices includes Housing Benefit and Council Tax Benefit, assuming average rents and Council Tax.

3.14 Worklessness is a particular problem for households with older workers. Older workers can suffer the highest penalty in terms of getting lower wages when they return to employment compared to their previous job. They are at greatest risk of drifting from unemployment into persistent economic inactivity[10].

Relief of in–work poverty

3.15 Low-income working households without children also fare less well on a comparison of effective disposable incomes. The table below compares the minimum income in April 2001 for households with someone in full-time work. The tables adjusts these incomes to better enable comparisons between different family types. It uses equivalisation factors commonly used when comparing household incomes. The adjustment factors used are quite broad and take no account of how in-work costs differ for different groups. Nonetheless, the table shows that a couple without children is worse off in work on a single minimum wage income than a couple with children.

After Housing Costs	Minimum Income Guarantee	Income adjusted for family type
Single person	£119	£195
Couple, no children	£119	£119
Couple, 1 child	£214	£174

3.16 In reality, many couples without children will be able to command higher incomes than this. The opportunities to progress in work and to have two incomes are not constrained by childcare responsibilities. However, analysis of the Family Expenditure Survey shows that there are still 1.25 million individuals in 700,000 households without dependent children where someone is in work but household income is below 60 per cent of the median.

[10]See for example Campbell (1999) 'Older Workers and the labour market' in 'Persistent Poverty and Lifetime Inequality: The Evidence', proceedings from a workshop held at HM Treasury, November 1999.

3.17 For many of these households a key factor is low employment. For example in around 40 per cent of single and couple households the worker is working less than 30 hours. But couples are much more likely to find themselves in poverty even where someone is in full-time work. Around 60 per cent of low-income couples have a full-time job compared to 35 per cent of singles. Low-income working couples are also more likely to be older. In 60 per cent of low-income couple households one or both partners is over 50.

3.18 Among the under-25s, people who have low incomes as individuals are less likely to be in poor households. Many young people on low incomes are still living with their parents, often in relatively well-off households.

3.19 Robust data on the persistence of in–work poverty is difficult to find. However, for young people, low pay is more likely to be transitory[11] and may be tackled through further training and education. For those working but in poverty in their fifties, the options for increasing income may be more limited.

Possible parameters of an employment tax credit

3.20 The analysis above suggests the following priorities for an employment tax credit.

- The older age-group – those over 45 or 50 – face some of the most acute work incentive problems. Their wage on re-entry to work is often low relative to what they earned in their previous job. The wages of older workers have also declined relative to those received by other workers. The employment credit component of the New Deal 50plus is an important new work incentive, giving extra financial support for a year for people who find work after six months or more on benefit. It does not however provide permanent support, nor does it help those already in work but with little or no opportunity to increase their incomes.
- For the younger age group, low pay is more likely to be transitory and less likely to be associated with low household income and poverty. Policies such as training, education and the New Deal may be more effective at tackling the underlying causes of low pay.
- Part-time employment, not just low wages, is a factor in working poverty for households without children.
- Couples without children are more likely to be in low-income households than single adults without children. Because benefits for couples are higher than for singles, couples are also more likely to find that when one of them gets a job, it does not pay very much more than benefit.

3.21 The employment tax credit will be administered by the Inland Revenue. Its introduction is closely linked with the development of the integrated child credit which will be introduced from 2003. Detailed decisions on eligibility and rates do not therefore need to be made at this stage. As and when it becomes available, evidence from other reforms to make work pay, and in particular the over-50s Employment Credit, will be used to inform these decisions.

3.22 A benchmark level of support provided by the employment tax credit for families *with* children and working people without children will be the adult credits in the Working Families' Tax Credit. Administration, income and assessment rules, and payment through the

[11] Richard Dickens (2000), 'Low Pay-No Pay Cycle', report to HM Treasury.

wage packet would be common to all recipients of the employment tax credit. However, details of eligibility, and the relative size of the credits for singles and for couples do not have to be the same for parents and non–parents.

3.23 The analysis above suggests that for people without children it may be appropriate to target resources on older age groups. There may also be a case for restricting support to households with someone in full-time work, for those without caring responsibilities or who are not eligible for the Disabled Person's Tax Credit.

3.24 To illustrate the potential scope of the employment tax credit, a credit based on the adult allowance in WFTC, with a lower rate for singles, available to households with someone over-25 and with a 30-hour eligibility rule, could reach around 300,000–400,000 households without children and would cost in the region of £300 million a year.

3.25 Such a credit would:

- deliver a minimum income guarantee of £165 for a couple without children and with someone in full-time work;
- double the gain to work for couples in rented accomodation on the Minimum Wage, and increase it by a third for singles; and,
- increase the incomes of the poorest households in work by around £20 a week on average for couples and £15 for singles. To the extent that it provided an incentive to increase hours worked to 30 hours or more for those who can, an employment tax credit along these lines could increase incomes further.

Building on the Employment Credit component of the New Deal 50plus

3.26 An employment tax credit along these lines would be the natural extension of the employment credit announced in Budget 99 introduced as part of the New Deal 50 plus in October 1999. Final decisions on the precise details of an employment tax credit will be taken nearer the time of its introduction.

4 How The New Credits Would Work

4.1 Chapters 2 and 3 outlined the rationale for an integrated child credit and an employment tax credit. This chapter sets out some of the key design issues.

Principles in designing the new credits

4.2 In designing the new credits the objectives must be to create a system which:

- **is simple for recipients to access and government to administer,** minimising the number of times people need to provide information and the amount of information they need to give;
- **is simple for people to understand** so that recipients are aware of both their entitlement and their responsibilities, for example when they need to report a change;
- **minimises the work required of employers** administering payment through the wage packet;
- **is targeted,** so that families receive the money to which they are entitled, neither being overpaid nor underpaid compared to their needs; and,
- **provides a safety net** if a family's income falls.

The current system

4.3 Each of the instruments in the current system – Income Support, the Working Families' Tax Credit and the Children's Tax Credit – balance these objectives in different ways. This reflects the particular needs of their different client groups and the incremental development of policy.

Income Support/JSA

4.4 Income Support/JSA is a weekly safety-net benefit where a wide range of changes in family circumstances and income should be reported immediately to ensure people's needs are met. This degree of adjustment would clearly be impractical in an integrated system used by around 6 million families.

Working Families' Tax Credit

4.5 The Working Families' Tax Credit is paid for six months based on a snapshot view of recent income. Once the award is set the credit is fixed, and does not respond to income changes until the end of the six month award. This is a relatively simple approach that provides certainty and encourages families to increase their earnings during the six months.

4.6 In the new integrated system it might not be desirable to ask all families to renew awards every six months, particularly when the majority of awards are likely to be unchanged. Experience from Family Credit suggests that even among low-income families, around 60 per cent of claimants renew their awards and see a change in payment of less than £10 a week.

Children's Tax Credit

4.7 As a reduction in income tax the Children's Tax Credit will be given on an annual basis. For most taxpaying families, the credit will be a flat-rate reduction in their tax bill and unaffected by their level of income. For the minority of families with a higher rate taxpayer, the reduction in the income tax bill provided by the Children's Tax Credit is finalised through Self Assessment, when that person's actual income for the year is known.

Design Issues for the new credits

4.8 Each of these approaches balances in a different way the need for responsiveness on the one hand, and the process of administrative intervention on the other. The design of the new system, and in particular the integrated child credit, will span a wide range of the income distribution and must ensure a safety net for those on lower incomes while minimising bureaucracy and form-filling. The key design parameters will be:

- the length of the award and the period of assessment;
- the degree to which the credits respond to changes in household circumstances during an award; and
- the interactions between the employment tax credit and the integrated child credit.

The length of the award and period of assessment

4.9 There is a case for setting annual awards rather than a six-monthly award as is the case with the Working Families' Tax Credit. Basing awards on income during the year could ensure that credit payments match families' actual needs. An annual award would minimise administrative work for both the public and the government. It also means that information on incomes could be verified against data collected for income tax purposes. This would also open up the possibility that in the longer term the Inland Revenue could use the income data it collects from employers to assess credit awards and do away with the need for many families to provide such information directly each year.

Responsiveness

4.10 However, a longer award would require greater potential responsiveness within year to changes in circumstances to ensure a safety net if family income fell significantly or the household's composition changed, for example on the birth of a child. It might also need to adjust in-year so that families did not face significant under or over-payments at the end of the award. There would be issues about how far the credits should reflect less dramatic increases and falls in income.

4.11 Allowing greater responsiveness could involve more contact with the Inland Revenue for some families, but it would mean that support more accurately reflected their situation. A key issue will be how to combine this responsiveness with a system which is simple, and in which people can understand both their entitlements and responsibilities.

Intreractions between an employment tax credit and an integrated child credit

4.12 The employment tax credit and integrated child credit will be created by splitting the Working Families' Tax Credit into separate adult and child payments, and the child payments would be integrated with those in Income Support and the Children's Tax Credit. Therefore, though the employment tax credit and the integrated child credit will be two separate instruments, in practice the two will be closely linked. As families move up the income distribution, their employment tax credit will be tapered away first. They will continue to get the maximum entitlement to the integrated child credit until all the employment tax credit has been exhausted. At the point the employment tax credit is exhausted the integrated child credit will begin to be reduced. Amongst the current Working Families' Tax Credit caseload, those on lower incomes will be in receipt of both the employment tax credit and integrated child credit. Those at the higher end will be floated off the employment tax credit and will only get the integrated child credit. But even though there will be two instruments the new system will replicate the single seamless taper in the Working Families' Tax Credit. This will avoid a situation where both credits are being withdrawn at the same time and the reduction in tax credit payments exceeds any increase in income, leaving families worse off, the poverty trap.

4.13 To guarantee that the system works smoothly, the two credits will need to be designed around the same broad parameters. The design of the credits will need to take particular account of the needs of low-income households with and without children.

Employers

4.14 The design of a new employment tax credit will also need to take account of the needs of the employers paying in-work support through the wage packet. The design of the Working Families' Tax Credit has already been informed by consultation with employers and other interested organisations, and the new system will draw on the experience of paying support through the wage packet from April 2000. Subject to the final parameters it is expected that the number of employees receiving tax credits through the wage packet will be broadly similar under the next generation of tax credits. This is because, as explained above, some families currently in receipt of Working Families' Tax Credit will only receive the integrated child credit and this would be paid direct to the main carer. In addition some of those eligible for an employment tax credit will be self-employed.

Treatment of income and capital

4.15 The next phase of modernisation offers an opportunity for a thorough review of the treatment of income and capital in assessing a person's or family's entitlement to support. The current rules applied in Income Support and those inherited from Family Credit by the Working Families' Tax Credit have developed over a considerable period of time and reflect a process of incremental change. The modernisation of IT systems offers an opportunity to rethink the way the system works. A modern system should be simple and aim to promote work, fairness and incentives to save.

4.16 The major reform set out in this paper raises many other policy issues both in its design and in the consequential impact it would have on the rest of the tax and benefit system. These will need to be considered as the work on the new credits develops.

Gateways – accessing the credits

4.17 Consistent its modernising agenda, the Government's aim for a new tax and benefit system will be to ensure that people are not having to to provide the same information to several agencies simultaneously to access the support to which they are entitled. There will be potential for efficiency gains for the public and the government where information, such as incomes or the presence of children, is at present, collected separately by different government departments.

- Families entitled to Income Support as well as the integrated child credit should not have to provide the same income information separately both to ONE, the new working age agency, and to the Inland Revenue. In the future families should need to provide information only once for Income Support. Where relevant to the integrated child credit, this information should be transferred directly to the Inland Revenue. Developing these links will be crucial to the design of the new credit and to providing an effective safety net.
- An integrated child credit will build on the foundation of universal Child Benefit. There will be considerable scope for handling claims to an integrated child credit through the gateway of Child Benefit and for developing a shared database.
- People considering a move into work who may be entitled to support through the employment tax credit should be able to file a claim for the tax credit through their personal advisor without having to deal separately with the Inland Revenue.

4.18 All this suggests that any new system developed by the Inland Revenue for the new tax credits will need to reflect these modernisation objectives through close cooperation with other agencies and stakeholders.

Methods of payment

4.19 The Government is already committed, as part of its modernisation programme, to phasing out payment of benefits by paper-based methods, such as Giro cheques and order books, from 2003 and introducing much greater use of electronic methods of payment. This will deliver a faster, safer, more efficient service. Consistent with this the new credits, when introduced from 2003, will aim to rely on electronic payment. Any development will take into account the needs of those who do not have a bank account.

Conclusion

4.20 This paper has set out what the Government has already achieved in delivering its policy objectives to tackle poverty and to make work pay. It has also set out the Government's plans for the next stage in modernising the tax and benefit system to deliver a system fit for the 21st century, building on the reforms so far. The scale of change involved will be considerable. Work is continuing and the Government will continue to consult as the policy develops in the run-up to 2003.

Printed in the UK by the Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office
03/00 19585 495677