Reforming Tax Credits

The TUC response to *Improving Delivery and Choice*

Summary

This briefing presents the TUC's response to the consultation by HM Treasury and HM Revenue and Customs on proposals for improving the delivery of tax credits and extending the choices available to recipients.[1] The TUC believes that the options outlined in the HMT-HMRC consultation document should be judged according to how far they are likely to meet three objectives:

- Reducing poverty, especially child poverty.
- Reducing the number and size of overpayments.
- Increasing the availability and affordability of childcare.

Judged on this basis, it is possible to say that:

- Overall, tax credits have been a success, lifting thousands of families out of poverty. Far more families are helped than under the previous Family Credit system, and the amount by which they benefit is greater too.
- The Government's reform strategy should reduce the scale of the administrative problems that claimants have faced. These problems were significant; overpayments in particular have reduced the effectiveness of tax credits as an anti-poverty policy.
- The TUC strongly supports the introduction of a run-on for workers whose normal weekly hours of work fall below 30.
- The TUC supports the goal of targeting payments on families who need them at the time they need them. We believe, however, that a periodic top-up payment (from which overpayments can be deducted) would have the advantage of also helping families cope with times when their costs increase.
- In the longer term, the TUC would urge the Government to consult on a range of options for funding childcare; our ideal would be high quality provision available to all on the basis of need and free at point of use.
- If the tax credits continue to be affected by overpayments, there is a strong case for providing childcare subsidies to parents through a different scheme.
- The TUC does not support a system of childcare vouchers or payment of childcare costs in arrears.

Introduction and background

The Trades Union Congress is the voice of Britain at work, representing more than 6.4 million members in 58 trade unions. We welcome the opportunity to comment on this consultation as tax credits are an important source of income for many low paid union members.

There are currently two tax credits: Child Tax Credit and Working Tax Credit;[2] the Child Tax Credit is an integrated system of means-tested financial support for families with children, whilst the Working Tax Credit is designed to top up the earnings of low-income families. Together with the minimum wage, the tax credits lie at the heart of the strategy for reform of the tax and benefit system which the Government has been implementing since 1997, raising the incomes of low paid workers with children, and thus helping to make employment a more attractive option for people of working age. The childcare element of WTC is meant to help with childcare costs, which would otherwise discourage people from entering paid work.

The TUC and poverty[3]

The TUC has been a strong supporter of these objectives. Unions are enthusiastic supporters of the Government's goal of ending child poverty and the TUC is an active member of the End Child Poverty coalition. We are increasingly concerned that in-work poverty is at the heart of this country's overall poverty problem; it is always worth remembering that **a majority of poor children live in families where at least one of the adults has got a job:**

Table 1: composition of child poverty by families' economic status, 2005/6[4]

All adults in work	24%
At least one in work, but not all	33%
No adults in work	43%
Total	100%

Just as in-work poverty is inextricable from child poverty, so in-work poverty is enmeshed with the low pay suffered by many women workers. Four out of ten poor children live in households headed by a single mother and another three out of ten in households where the father is in employment but the mother has low or no income.[5] Women are more likely than men to suffer in-work poverty, partly because they are more likely to work in part-time jobs (four times as likely as men)[6] but even more important are the gender pay gaps between men and women regardless of the hours being worked, and the unjustifiable difference in the hourly rates paid for part-time and full-time work.[7] The result is a set of very large gender pay gaps:

Table 2: gender pay gaps, 2007[8]

Full-time pay for men	Full-time pay for women	Part-time pay for women	Full-time Gender Pay Gap	Part-time Gender Pay Gap
£14.98	£12.40	£9.65	17.2%	35.6%

The TUC believes that the best route to eliminating in-work poverty is by tackling low pay. But the elimination of low pay will take time, and there are working families where even a substantial pay increase would not be enough by itself to lift them out of poverty (some large families and families with special needs, for instance) so working benefits such as the tax credits have an important role.

We agree that tax credits have been successful in delivering greater financial support to low income families, particularly those with children. That is why the TUC has supported Working Tax Credit and Child Tax Credit (and WFTC and DPTC before them).[9] In February 2008 we published *The Tax Credit Success Story*,[10] which pointed out that **tax credits now deliver nearly £19 billion to low income families** and the number of families that are helped is three times as high as it was in 1997 - an extra 1.5 million families with children are being helped. Data published since then[11] has shown that **around 6 million families with 10 million children benefit from tax credits.**

Reducing poverty is the first standard we use to judge the reform proposals; the tax credits have, overall, been a success.

Overpayments

Although tax credits are a strongly pro-poor policy, we are also aware of the multiple issues caused by tax credit overpayments – that is, claimants being paid too much in tax credits and having to make repayments, usually the following year. The way these have been recovered in the past and other administrative problems have led to confusion and long delays.

This can lead to low paid people finding that the tax credit system actually *reduces* their incomes, sometimes by large amounts, making budgeting almost impossible. It seems very unfair that a Government policy should reduce the income of any family below the level that very policy suggests is the minimum they should have to live on. The practical result has been that some low paid workers have been discouraged from claiming at all and others from renewing applications.

When this problem was at its worst, nearly one tax credit award in three was overpaid; 494,000 families faced repayments of more than £1,000 and 25,000 of more than £5,000. 363,000 of the families in this position had an income of less than £10,000.[12]

Minimising the number and size of overpayments is therefore the second standard the TUC uses to judge reform proposals.

The 2005 Pre-Budget Report announced a series of reforms that have made a lot of difference, especially a tenfold increase in the income disregard to £25,000 – the amount a family's income could increase during a year without affecting their tax credit entitlement. The revision of the disregard rule removed a lot of the overpayments caused by variations in income during the tax year and the complete reform package has substantially reduced the scale of overpayments; as a result, end of year adjustments leading to overpayments in 2006-7 stood at £1bn, down from £1.7bn in 2005-06 and £2.2bn in 2003-04.[13]

Many of the repayments that have had to be made since 2006 have related to overpayments made before then, but overpayments are still occurring – usually because claimants do not report changes in their circumstances in time. The discussion paper reports on measures that have been taken to improve the system, including the Tax Credits Transformation Programme (introduced in 2006) which 'nudges' claimants to provide information they may not have realised they needed to provide.

As a general comment, any changes that improve the amount of information and advice given to claimants can only be a good thing and the TUC strongly welcomes the planned linking of information from income tax and Child Benefit to avoid claimants having to make multiple contacts to different offices. We would support further simplification of award notices and clearer information about how awards are worked out: it is still too difficult for many claimants to identify errors in their awards, and this can be a significant cause of overpayments.

Unions continue to be concerned about the position of younger workers in occupations where earnings typically grow steadily from a very low starting point, who can find that their initial year one award is sharply reduced to take account of their higher earnings in year two. The consultation document considers various options for repaying overpayments such as through the PAYE system or as a lump sum, and having different ways of meeting their obligations could be very advantageous to workers caught out in this way.

The consultation document notes that the advantages of offering these extra choices have to be balanced against the risk of increased complexity in the system. The TUC agrees that clarity is important, but we think that extra choices could still be introduced if sufficient attention is paid to designing the procedures and documents at the initial stages of the claim. Clear information about possible reductions in awards in future years would enable workers to plan sensibly.

Run-ons

The 2005 PBR reforms have been effective, and when the legacy of pre-reform overpayments has been cleared we expect that the statistics will show further improvements. In addition, the Government's proposals for tax credit run-ons should help to eliminate overpayments caused by employment changes, most of which fall into two main categories:

- An employee's income rises, which would reduce the amount of tax credit they are entitled to directly.
- An employee's normal weekly hours of work fall below 30. This can either reduce their level of entitlement, as they no longer qualify for the extra payment for working over 30 hours a week in the Working Tax Credit; or it can lead to loss of entitlement altogether, as some groups (such as low paid adults with no children) only qualify for WTC if they work over this threshold.

Often workers do not realise (or forget) that these are changes that need to be reported. It is even more common for a worker's situation to be unclear, so they do not realise for some weeks that their circumstances have in fact changed (by which time an overpayment has accumulated).

The system already has run-ons, where the amount of tax credit a claimant is entitled to remains the same for some weeks after a change of circumstances – after the death of a child, for instance. The consultation document asks for comments on whether further run-ons should be introduced, especially for customers whose hours of work fall below 30 a week. **The TUC strongly supports this proposal, which addresses the more fluid nature of much modern employment.**

Not only do we think there is much merit in the idea of a run-on after a change of circumstances, but we would extend that somewhat. Many members find that jobs may come to an end unexpectedly or earlier than anticipated. We would therefore propose a run-on for a short period in cases where entitlement has actually ended, as for example where entitlement depends on meeting the 30 hour rule. In these cases, the possibility of a short run-on would enable members to adapt more easily to sudden income changes and also initiate benefit claims with more opportunity of avoiding gaps with nil income.

Run-ons would benefit workers with fluctuating hours, especially those who are self-employed, work for employment agencies or who have complicated shift patterns. TUC would also urge HMRC to consider replacing the 30 hour threshold with a lower one, possibly 24 hours. The 30 hour threshold is high enough to maximise the number of workers who find that their hours are above it one week, below it the next. The TUC is concerned that part-time workers are particularly likely to find themselves in in-work poverty, and that failing to qualify for tax credit support may exacerbate this problem.

Design changes

There is still room for increasing the effectiveness of the system by addressing administrative problems – such as the delays caused by processing changes of circumstances. However, when every administrative enhancement has been introduced there will still be overpayments.

This is because tax credit *entitlement* is based on this year's income, but the amount of tax credit *actually paid* is usually based on last year's income. The tax credits system therefore depends on a 'reconciliation' at the end of the tax year, to make sure that families whose pre-tax credit income went down during the year (or whose family needs increased) get the extra tax credits they are entitled to, and those whose incomes went up (or family needs came down) pay back any overpayment that they received.

This aspect of the overpayments problem cannot be addressed through administrative reform; it needs changes to the design of the system.

Up to this point we have stressed overpayments as an issue for tax credit reform. If that was the only concern, the next steps could be decided on fairly easily. Tax credits could be paid in arrears, when a family's circumstances and income for the year in question had been established – the only overpayments would be those caused by maladministration or the claimant failing to provide accurate information. Alternatively, tax credit entitlement could be established for a fixed period, with families entitled to benefit from any increase in their income, but also having to deal with falling non-tax credit income without any help from the system (this is how the old Family Credit system worked before tax credits.)

But reducing poverty is an even more important objective than minimising overpayments and the problem with these options is that they would make tax credits less effective at dealing with poverty. Most of the deprivation faced by poor families relates to weekly bills, such as food, heating, housing or clothing, and most of the tax credits should take the form of weekly payments set at a level to meet these weekly needs.

It is particularly troubling if families in poverty face deteriorating circumstances and there is an unnecessary delay before the system of social assistance is able to help them. **The TUC therefore agrees with the Government that reform should not make the system less responsive, so that families whose income drops face delays in getting the extra tax credits to which they are entitled**. We would therefore resist paying tax credits in arrears, or based on the previous year's circumstances, or for fixed periods without the ability to take worsening circumstances into account. One of the problems of the old Family Credit system, which had six-monthly assessments, was that a fall in income during that period (or an increase in the family's needs) could force families into the position where they had to consider giving up paid work.

Lump sum payments

Most of a poor family's needs have to be met weekly, but there is a case for less frequent lump sums as part of the mix. The TUC has been very influenced by Save the Children's campaign for seasonal grants for low income families.[14] SCF have pointed out that poor families – who can find it impossible to save for a rainy day – often lack the resources to cope with times when a lump sum is needed.

This problem is at its worst during the summer and Christmas holidays. Parents with experience of poverty often say that one of the most stressful features of that experience is seeing their children deprived at Christmas; children in poverty often miss out on summer activities and back-to-school costs can be a nightmare for poor families.

SCF have called for grants of £100, paid in November and June. Save the Children surveyed more than 500 low income parents and 71 per cent said they would prefer such a programme to a benefit increase of £3.85 a week (which would be worth slightly more).

The Government has asked for views on the merits of the Australian tax credit model, in which there is an end-of-year supplement, of AU$600 per child. Any overpayment is deducted from this lump sum first, so comparatively few families face deductions from their weekly income. AU$600 is worth about £280 – a very similar sum to the total value of the seasonal grants proposed by SCF.

The TUC believes that there is a powerful case for seasonal grants; if tax credits are increased (as we think they should be) the Government should consider introducing these increases as lump sums. As the policy would also minimise the scale of overpayments there is an opportunity for joined-up policy making that deserves further attention. HMRC and HMT might resist two lump sum payments, which would be more expensive to administer than a single payment at the end of the tax year, but the anti-poverty case for such a structure is strong.

An income bands system

The consultation document also asks for views on the New Zealand system, where a claimant's tax credit entitlement is based on a table that puts income in a series of in NZ$1,500 bands, and it is assumed that their income is at the top of the relevant band. At the end of the tax year, as in the UK, the final assessment is based on the claimant's actual income.

As a result, people who have reported their changes of circumstances on time are less likely to have to repay overpayments; most get a small lump sum. This would also be helpful for people who find it difficult to assess their incomes accurately. The size of the bands would be a very important issue: the wider the band, the less likely people would be to have received overpayments, but the average amount by which the level of tax credit they receive would be reduced would be greater.

The small lump sum that most people would receive under this sum could play a similar role to the seasonal grants we favour, but the likelihood of receiving an adequate lump sum would bear no relation to need, and we do not currently see the need to adopt a banding system like that of New Zealand.

Tax credits and childcare

The final section of the consultation document is devoted to the use of tax credits to support childcare. Unions value childcare and support the Government's efforts to increase its availability.

We know that the lack of suitable affordable childcare is an important barrier to employment. A study of parents in England carried out in 2004-5 found that, of those not in employment, a large minority of those in couples and a majority of lone parents would do so if they could arrange reliable quality childcare:[15]

Table 3: whether respondent would work if they could arrange reliable and quality childcare, by family working status

	Couple – one working	Couple – neither working	Lone parent not working
Agree strongly	13%	19%	26%
Agree	27%	27%	34%

Neither agree nor disagree	12%	18%	15%
Disagree	30%	21%	17%
Disagree strongly	18%	16%	8%

We also know that high quality childcare is good for children, improving their education outcomes, concentration independence, self-confidence and ability to make friends. US evidence suggests that older children may do badly if they have to look after themselves and do not benefit from good services.[16]

The TUC's third standard for judging tax credit reform proposals is therefore that they should increase the availability and affordability of high quality childcare.

When it comes to maximising take-up free provision is probably a better strategy than subsidies through the tax credit system. Take-up of the 12½ hours' free early years provision is very high, running at 100 per cent for four year olds and 96 per cent for three year olds,[17] whereas take-up of the childcare element of Working Tax Credit runs at about 10 per cent.[18] In England, an average full-time nursery place for a child under two costs £159 per week, and for a child aged over 2 £149, an out-of-school club will cost £43 a week on average.[19] As Working Tax Credit covers 80 per cent of allowable childcare costs up to £175 for a single child and £300 for two or more, a family that qualifies for this support can find itself still having to meet substantial childcare costs:

Table 4: childcare costs for different sized families

	Total cost	Amount to be met by family receiving full WTC support	Equivalent to number of hours' work at minimum wage
One child, aged 18 months	£159	£31.80	5.8
Two children, aged 1 and 3	£308	£68.00	12.3
Three children, aged 1, 3 and 4	£457	£217.00	39.3
Three children, aged 3, 4 and 8	£341	£101.00	18.3

For low paid workers, even with WTC support, if they have children who need a full week's provision, childcare can clearly be a tremendous burden, even if they are old enough to need an after school club, rather than nursery care.

As the Institute for Fiscal Studies has noted, when the price of childcare falls (because, for instance, of a subsidy like that provided by tax credits) parents tend to respond by buying more childcare, rather than by switching to higher quality providers,[20] which suggests that the objective of a *high quality* childcare system can best be met by intervention on the supply side, where the Government can control quality directly. **The TUC's ideal childcare system would therefore be publicly provided and free at the point of use.**

Unfortunately, this option is not offered in the consultation document. The document does, however, consider some of the problems with providing support through tax credits. The Government is concerned that some people have found the system based on WTC complex and difficult to use: it can be hard to calculate childcare costs accurately and claimants may not realise how much of the WTC they receive is meant to help with childcare as it is not identified separately.

If the Government wishes to subsidise childcare costs, rather than provide it free of charge, it would be best to subsidise both the providers and the consumers of the service, but WTC may not be the best way to do this. In addition to the issues raised in the consultation document, the TUC is concerned that overpayments can be a particular problem for parents with childcare costs. If a family has to pay back a substantial overpayment it may simply be impossible for them to continue to pay their childcare bills. For this reason we think there may well be strong case for separating childcare from the tax credit system altogether.

Considered in this light, there is a great deal to be said for New Zealand's means-tested childcare subsidy. This subsidy is not part of the NZ tax credit system, but it does work on the same 'income band' approach. Claimants are put in one of three income bands, and the subsidy per hour that they get follows from this. This would be simpler and easier to understand, but HMT is concerned that it could lead to 'cliff edges' in entitlement that could act as a disincentive to progression in employment. Of course, the more generous the system was made, and the closer it came to being free, the less this would be a problem.

The TUC is much less impressed by three other options for reform set out in the consultation document:

- Instead of requiring families to calculate how much they will spend, WTC could repay a claim based on how much was actually spent in the last month.
- An even simpler version would be to base entitlement to childcare support on how much was actually spent in the last school year. Earlier in this response we agreed with the Government that it is important that poor families should be helped to meet their needs as soon as those needs emerge, and that there could be considerable hardship otherwise. As inflation begins to rise again this is the worst possible time to introduce such an approach. **The TUC opposes options which require childcare subsidies to be paid in arrears or based on out of date spending figures.**
- Childcare support is currently provided as cash paid to the parents, but it could be paid directly to the childcare provider or in the form of vouchers. **The TUC would not welcome any system which told providers how much support parents received, as this could be very stigmatising. The electronic system described in the consultation document would address this objection, but would be complicated and the recent history of IT projects does inspire confidence.**

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1 The consultation document is available at http://www.hm-treasury.gov.uk/media/D/3/tax_credits_no12.pdf
2 Child Tax Credit and Working Tax Credit replaced Working Families Tax Credit and Disabled Person's Tax in 2003. WFTC and DPTC replaced Family Credit Disability Working Allowance in 1999.
3 The argument in this section is set out at greater length in *The Iron Triangle*, TUC, June 2008, http://www.tuc.org.uk/welfare/tuc-14982-f0.cfm
4 *Households Below Average Income (HBAI) 1994/95-2005/06*, DWP, 2007, table 4.3.
5 Background Briefing for the Keeping Mum campaign, Fawcett Society, 2008, http://www.fawcettsociety.org.uk/index.asp?PageID=647
6 At the end of 2007, according to LFS data, 42.4% of women's jobs were part-time, compared with 11.3% of men's jobs.
7 In 2007, the mean hourly rate for full-time jobs was £13.96, whilst that for part-time jobs was £9.89. Annual Survey of Hours and Earnings, ONS, 2007, table 1.5a.
8 Calculated from Annual Survey of Hours and Earnings, ONS, 2007, table 1.6a.
[9] The structure of tax credits is more generous than that of Family Credit, the social security benefit which preceded them. There are many features, such as the formula for calculating childcare expenses or the fact that eligibility is calculated on the basis of post-pension contribution income, which make WTC and CTC unusually generous for means-tested benefits.
10 Available at http://www.tuc.org.uk/welfare/tuc-14334-f0.cfm
11 Available at http://www.hmrc.gov.uk/stats/personal-tax-credits/cwtc-quarterly-stats.htm
12 *Tax credits: Getting it wrong?* Parliamentary and Health Service Ombudsman, 2007, available at www.ombudsman.org.uk/improving_services/special_reports/pca/taxcredits07/index.html

13 http://www.hmrc.gov.uk/stats/personal-tax-credits/cwtc-quarterly-stats.htm
14 A briefing on this campaign is available at http://www.savethechildren.org.uk/en/docs/seasonal-grants-brief.pdf
15 *Childcare and Early Years Provision: A Study of Parents' Use, Views and Experience,* Caroline Bryson, Anne Kazimirski and Helen Southwood, National Centre for Social Research, DfES Research Report RR723, 2006, table 6.14. http://www.dcsf.gov.uk/research/data/uploadfiles/RR723.pdf
16 *Childcare Nation? Summary,* National Centre for Social Research and Daycare Trust, 2007, p 2.
17 *Childcare for All?,* Daycare Trust, 2005, p 3,
http://www.daycaretrust.org.uk/mod/fileman/files/Childcare_briefing_note_Nov_05.pdf
18 *Childcare and Early Years Survey 2007: Parents' Use, Views and Experiences,* Anne Kazimirski, Ruth Smith, Sarah Butt, Eleanor Ireland and Eva Lloyd, National Centre for Social Research, DCSF Research Report -RR025, 2008,
table 5.18, http://www.dcsf.gov.uk/research/data/uploadfiles/DCSF-RR025A.pdf
19 *Childcare Costs Survey*, Daycare Trust, 2008, p 2.
20 *Green Budget*, 2006, IFS, p 158.