Inland Revenue

The New Tax Credits: A Regulatory Impact Assessment

July 2002

1/ Introduction, purpose and effect

1.1 The Child Tax Credit and the Working Tax Credit are part of a series of reforms aimed at relieving child poverty and making work pay. These new tax credits will extend the coverage of payable tax credits, building upon the framework established in WFTC, DPTC and CTC. They will separate the support for working adults in a household from support for children, through distinct elements to:

- *tackle child poverty and provide financial support for households with children*, by providing a seamless, portable and secure system of support for households with children; and
- *relieve in-work poverty and enhance work incentives for workers facing disadvantage* with more financial help to those in low-paid work, whether or not with children.

1.2 The Child Tax Credit will provide a single payable tax credit for households with children. It will draw together the various strands of support for households with children that exist in the current tax and benefit regime and will provide support to households with children regardless of whether they are in work. The Working Tax Credit will extend payable tax credits to low-income working households without children and without a worker with a disability.

1.3 These new tax credits will replace the support currently available under WFTC, DPTC, the child elements of Income Support and Jobseekers Allowance, the Children's Tax Credit (which since April 2002 includes the new Baby Tax Credit for children under one), the Child Dependency Increases available in certain benefits and the New Deal 50 plus Employment Credit (EC50+)[1].

1.4 The RIA looks broadly at the overall effects of the proposals. In quantifying the costs and benefits of the Child Tax Credit and Working Tax Credit, the RIA does not attempt to estimate the impact of behavioural changes.

1.5 The RIA has been discussed and agreed with the Regulatory Impact Unit, Cabinet Office, and the Small Business Service.

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[1] Those in receipt of EC50+ or CDIs when the new tax credits are introduced will have their existing entitlement protected.

2/ Assessment of the Benefits & Costs of New Tax Credits

Benefits of the new tax credits to claimants

2.1 Support for families with children is currently provided through a number of channels. Working families may receive support through the Working Families' Tax Credit and the Children's Tax Credit, workers with disabilities may be supported by the Disabled Person's Tax Credit and those not in work may be supported through Income Support and JobSeekers Allowance. The Child Tax Credit, by bringing together the different elements of child-related support, will create a single streamlined system of support for families with children. It will be underpinned by a single set of rules and definitions making it easier for claimants to understand and for them to receive their entitlement. The Child Tax Credit is expected to benefit 5 ¾ m families with children.

2.2 The Child Tax Credit will remove the distinction in support available to families with children in remunerative work and those not in remunerative work. This will create a more secure system of support, especially for those families moving into and out of work. In removing this distinction, the Child Tax Credit will extend support to 100,000 families with children, such as students and student nurses, who currently do not meet the remunerative work test for WFTC and who are not eligible for help through Income Support or the JobSeekers Allowance.

2.3 The Child Tax Credit will provide a better targeted system of support for families with children. It will be paid directly to the main carer, ensuring that support for children is paid to the person mainly responsible for caring for the children. The Child Tax Credit will be paid directly into bank accounts, providing a secure, reliable and flexible method of delivering payments. Those unable to obtain a suitable bank account will be able to have their credits paid into a card account at the Post Office.

2.4 The Child Tax Credit will provide a more flexible system of support for families with children and will respond to changes in family circumstances. This flexibility will ensure that families receive the support they are entitled to, when they are entitled to it. This will benefit all families with children, especially the 1.4m families with children who currently receive WFTC and DPTC awards that are fixed for six months[2].

2.5 The Working Tax Credit will provide support for working households which have neither dependent children nor a worker with a disability or illness, provided the applicant is in full-time employment. This will increase work incentives[3] for all low-income households and boost the incomes of around

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[2] The WFTC population is forecast as 1.4m by 2003/04.

[3] Specifically, the Working Tax Credit will help tackle the unemployment trap that arises when the difference between in and out of work incomes is too small to provide an incentive for those currently out of work to take a job. The new tax credits will also help tackle the poverty trap which discourages those already in work, or with working partners, from working longer hours, moving to a better paid job or entering work, because higher in-work income is offset by reduced in-work support and higher tax and National Insurance Contributions.

300,000[4] low paid working households without children. In creating a single system of support for working households by uniting the adult elements in WFTC and DPTC, employers will be less able to identify from the tax credit alone whether the recipient has a disability, and workers with a disability should have less fear of discrimination. The Working Tax Credit will also tackle barriers to work faced by families with children by providing assistance with the costs of approved childcare.

2.6 The claim and award process for the new tax credits will be simpler compared with the current regime. Both tax credits will be assessed on the same basis - against household annual gross income - and awards will run for up to twelve months. In applying for tax credits, claimants will be able to refer to and use income information already provided for tax purposes[5], such as P60s and Self Assessment returns, instead of being required to compute net earnings from payslips. This should make for an easier claims process. A single claim form will deliver both the Child Tax Credit and the Working Tax Credit, whereas at present an estimated 800,000 households have to apply for the WFTC/DPTC and CTC separately. Similarly, with awards running for up to 12 months, up to 1 million[6] households will make one fewer claim per year. Against this, some households will need to apply for tax credits annually, rather than make a one-off application spanning many years as sometimes can be the case for the CTC. However, after making their first claim, many of these households will benefit from an automatic claims process meaning that they will not need to complete a form each year.

2.7 An annual award based on gross household annual income will smooth out the inequalities in the current system. These are created by the snapshot system of assessment in WFTC and DPTC and the assessment of CTC against the income of the higher earner, rather than household income. Under the new tax credits, households with the same annual income and circumstances will receive the same tax credit regardless of the profile of their income. This will also eliminate uncertainty and through an annual system better reflect true household income and working patterns.

2.8 With assessment based on gross income, the new tax credits will improve the work incentives for those who pay no income tax or who pay income tax at the 10p rate and are caught in the poverty trap. More generally, assessment against gross income should improve the work incentives for the second adult in the household as the household will be able to take advantage of both NICs thresholds, income tax allowances and rate bands. In this way, the gross taper should lessen the unemployment trap for all tax credit recipients by reducing the average tax rate.

2.9 Other features of the new tax credits will benefit specific households within the new tax credit population. The payment for each disabled worker in a

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[4] This estimate refers to the steady-state caseload.

[5] This information is usually submitted to the Inland Revenue, with copies given to employees or produced by individuals themselves under Self Assessment.

[6] Based on information from the latest WFTC statistics which suggests that 1 million households apply for a second consecutive WFTC award within a twelve month period.

household will provide more generous support for workers with a disability or illness and will benefit households where both workers in a couple have a disability or illness. The childcare element in the Working Tax Credit will be more responsive to changes in childcare arrangements as it will be recalculated whenever a household makes significant changes to its childcare arrangements. Removing the requirement on childcare providers to certify a claim should make it easier for tax credit recipients to shop around for the childcare that best meets their requirements without stigma. The claims process faced by the self-employed will be simplified and made more consistent with the treatment in the tax system. Self-employed people will be assessed on their taxable profits.

2.10 These benefits are not easily quantifiable but they should benefit all families with children and low income working households. The new tax credits are an important element in the Government's strategy to eradicate child poverty. The new tax credits will play a central role in helping to meet the target to reduce by a quarter the number of children living in households with income of less than 60% median by 2004. Comments received as part of the consultation process were generally supportive of the changes.

Impact of the new tax credits on business

Benefits

2.11 The Child Tax Credit and Working Tax Credit will also benefit employers. The Working Tax Credit will improve the reward from work and employers may find that they have a larger and more diverse pool of labour from which to recruit, and may also find it easier to retain staff, reducing the costs and disruption caused by staff changes. The Child Tax Credit, by providing a bridge between in and out of work support for families with children may further improve work incentives and help create a more flexible workforce.

2.12 In the same way that WFTC and DPTC recipients who are employees currently receive their tax credits with their pay, the Working Tax Credit will normally be paid via the employer to employees. We estimate that the total number of individuals who will receive tax credits though the wage packet will be largely unchanged. The extension of the Working Tax Credit to working households without dependent children will bring in new tax credit recipients who will be paid their Working Tax Credit through the pay packet, but this will be offset by households who would previously have been paid WFTC or DPTC via the employer and who will receive the Child Tax Credit only[7] which will be paid direct. We estimate that the total number of employers paying tax credits will remain at around 300,000 during any one year[8].

2.13 Whilst the total number of households receiving tax credits via the employer will be unchanged, the actual recipients may change. As part of the

[7] The Working Tax Credit will be tapered away before the Child Tax Credit and the childcare element of the Working Tax Credit will be paid direct. This means that some families who currently receive WFTC or DPTC and who are paid via the employer will receive their new tax credit award direct.

[8] This estimate is based on information taken from WFTC administrative statistics combined with IDBR data.

consultation process, we investigated whether the profile of the expected Working Tax Credit population would differ as compared with the WFTC/DPTC population and whether this would change the profile of employers paying tax credits. On the best available information we do not think that this is the case.

2.14 The design of the new tax credits system has focused attention on removing any unnecessary compliance and other costs and minimising any additional work for employers. In particular, a number of features of the WFTC and DPTC system which employers have informed us create costs will be eliminated from the new tax credits.

2.15 First, the move to annual awards, renewable at the end of the tax year, will eliminate the work created by the current 6 monthly stops and starts when WFTC/DPTC awards are renewed. Employers will simply continue to pay tax credit at the rate the Revenue has given them until they are notified to change the rate. We estimate that this will save employers £9.5 million[I] per year. Second, Certificates of Payments will not need to be completed by employers when a recipient leaves employment, as entitlement to Working Tax Credit (unlike WFTC/DPTC) will cease automatically when the recipient ceases to work. We estimate that this will save employers £400,000 per year.[II]

2.16 Third, employers will not be required routinely to complete an earnings enquiry form as new tax credit claimants will use information already provided for tax purposes (such as P45, P60, Self Assessment Returns and P14/P60 information) when completing the claim form. We estimate that this will save employers £0.9 - £1.1 m per year.[III] Finally, the advance Revenue funding process will be simplified in a number of ways. With annual awards, advance Revenue funding paid to employers to cover an anticipated shortfall between tax, NICs and student loans receipts and tax credit payments, will run to the end of the tax year. Employers will need to apply only annually, rather than six monthly as at present, although they will need to tell the Revenue in-year if they need more or less funding that they initially asked for because their tax, NICs and student loan deductions have changed. However, the Revenue will make automatic adjustments to advance funding when there are changes in-year to the amount of tax credit an employer in receipt of advance funding has to pay.

Costs

2.17 The only change that might generate a cost for employers is that some employers might be asked to adjust the value of tax credit payments to a worker within the year, as the new tax credits system will respond to in-year changes in recipients' circumstances. The impact of this can only be estimated once the system is up and running and so will be assessed as part of the evaluation of the new tax credits.

2.18 Employers who run PAYE schemes will have to be prepared by 2003 for the introduction of the new tax credits. The system of paying Working Tax Credit through the payroll will be broadly similar to that used to pay WFTC & DPTC, so we do not expect employers that currently pay WFTC or DPTC will have to make any significant changes to their systems. Other employers may need to familiarise themselves with the new system. To allow employers time to adjust to the new system and to smooth the transition to the Working Tax Credit for claimants, payments of WFTC and DPTC by employers will gradually be phased out from 27 August 2002. All awards of WFTC and DPTC in place before 27 August will be paid as normal for the first 26 weeks, but the Inland Revenue will make the remaining payments up to 7 April 2003. Awards beginning on or after 27 August 2002 will be paid direct by the Inland Revenue.

2.19 Some employers may be asked to adjust the daily rate they pay to individuals part way through the year.

2.20 Overall we estimate that the new tax credits will be simpler for employers to operate and will reduce overall employer compliance costs by up to £11 million per year.

Impact on Childcare providers

2.21 At present, WFTC and DPTC applicants applying for the childcare tax credit are required to obtain written confirmation of their childcare arrangements from their childcare provider. This imposes a burden on childminders, many of which operate as small businesses. This will not be required under the new tax credits. Instead, tax credit recipients will be required to state their average weekly childcare costs as part of their tax credits claim. They will also have to provide contact details for their childcare provider so that the Revenue can contact the provider and check the details supplied by the claimant. Childcare providers will be asked to respond to a simple check in a percentage of cases, to confirm that a child is in their care and the costs of that care. The Revenue will also be able to make further checks with claimants if necessary. This should minimise burdens[9] but provide the assurance, called for by childminding organisations during the consultation process, that we only support the costs of childcare actually used by tax credit recipients.

Costs to Government

2.22 The new tax credits will require investment in the development of new IT and telephone systems. The Inland Revenue will be investing in new IT and telephone systems to ensure the delivery of the new tax credits; the Department for Work and Pensions (DWP) will be investing to ensure that existing IT systems are adapted for the changes in IS/JSA(IB) and HB/CTB which will be needed as IS/JSA becomes solely adult related.

[9] 145,000 families currently receive help with childcare costs through WFTC and DPTC. We do not have complete information on the number of children for whom help with childcare costs is provided, however, if we assume, as a minimum, that each childcare tax credit is paid in respect of one child cared for by one childcare provider, then over a year 290,000 childcare providers will be asked to certify childcare costs. If we assume that each form takes 5-10 minutes to complete, then the time saving from removing this requirement will be 24, 000 – 48,000 hours a year. If we also assume that at a minimum, childcare providers receive the National Minimum Wage this amounts to a cost saving of £100,000 - £200,000 per year.

2.23 This investment will replace existing and dated IT systems and allow for better integration with other complementary systems of support so as to provide a better service for recipients and to minimise the administrative cost to Government. We estimate that Government will invest £430m in securing modern IT and telephone systems and in training staff to administer the new tax credits and deliver a high quality service to new tax credit recipients. These costs were agreed as part of SR2000 and the investment will deliver a system that supports families with children and low-income workers, and will provide a more secure system of payment that reduces payment fraud.

2.24 Once the new tax credits are established, Inland Revenue expects to incur recurring costs of £300m per year to administer the Child and Working Tax Credit to a population of 6 million. This is before offsetting savings from the administration of the current system of support for families with children, including £140m from the costs of administering the WFTC, and does not take account of the savings in greater efficiency and reduced fraud from moving to payment by ACT.

In summary,

- All families with children will benefit from the creation of a single system of support for children, underpinned by a common set of rules and definitions.

- The Child Tax Credit will create a more secure system of support for families, removing the distinction between support paid to working and non-working families with children and thereby extend support to all low and moderate income families with children.

- The Working Tax Credit will provide support for working households and help improve work incentives for all. Through a single tax credit that does not differentiate between those with and without children and disabilities, the threat of discrimination in the workplace should be further reduced.

- Employer costs will be reduced by **£11** million per year.

- Childcare providers will not be asked to certify claims for the childcare element of WTC, thus eliminating the administrative burden imposed on them by WFTC.

- Investment in the new tax credits system will deliver a higher quality service to recipients.

3/ Securing Compliance

3.1 It is important that new tax credits are paid only to those who are genuinely entitled, and that the system is as secure against fraud as practicable. The more supporting information claimants are required to provide, the more checks are able to be carried out, but the greater the danger that those genuinely entitled will be put off by the complexity of the claims process.

3.2 We believe that we have got this balance broadly right for WFTC, but there are a number of changes with new tax credits which should both reduce the administrative burden on claimants, employers and childcare providers, and maintain or enhance the security of the system.

3.3 Income for new tax credits will be based on gross annual income, unlike WFTC, which is based on take-home pay. This means that employed claimants will no longer have to do a calculation based on a number of payslips, but can simply use the figure from their P60. The self-employed can use the same income figure that they submit for tax purposes. As well as making things easier for claimants, this will reduce administrative costs for Inland Revenue as checks will be made against tax systems.

3.4 Currently, claimants must supply details of income from their employer and, if claiming the childcare tax credit, information from their childcare provider. While this makes the application process more involved, and in some cases can delay it, the compliance benefits of such checks are debatable. Claimants will still be required to supply details of their employer and, if applicable, their childcare provider, and these will be subject to targeted checks. This approach removes the requirement on childcare providers to certify an application & places the onus on claimants to keep records of childcare costs.

3.5 This, along with the Revenue's ability to check against information provided for tax purposes will provide a more effective way of spotting false applications, as well as reducing the overall administrative burden on claimants, employers and childcare providers.

3.6 The computer system being introduced for new tax credits will allow automated risk assessment. This will allow the Revenue to better select applications for enquiry, increasing the overall effectiveness of compliance activity, while reducing the likelihood that genuine claimants will be subject to the inconvenience of an enquiry.

4/ Impact on Small Business

4.1 We think that the implementation costs of the new tax credits to small employers should be less than under WFTC/DPTC. All the changes compared with the WFTC/DPTC regime will benefit small employers.

4.2 As the system of paying Working Tax Credit through the payroll will be broadly the same as that used to pay WFTC and DPTC, we expect that the transition from the existing tax credits to the new tax credits will not require employers to make significant changes to their systems. To assist employers in planning for and making these changes, payments of WFTC and DPTC awards by employers will be gradually phased out from 27 August 2002.

5/ Equality Issues

5.1 In addition to assessing the regulatory impact of the new tax credits, we have assessed whether the New Tax Credits might have any differential impacts on the equality of treatment between various groups in society. This has been carried out in accordance with Cabinet Office guidelines and our duties under s75 of the Northern Ireland Act 1998.

5.2 We believe that this policy should generally have a positive impact on all potential recipients, improving the position of some of the more disadvantaged groups in society.

6/ Consultation

6.1 Discussions with interest groups, based around the series of papers on 'The Modernisation of Britain's Tax and Benefit System' published by the Treasury, informed the initial development work on the new tax credits. This work was also informed by analysis and research on the impact and effect of the current system of support for families with children and workers. This led to the publication on the 19 July 2001 of the formal consultation paper - 'New Tax Credits: Supporting families, making work pay and tackling poverty' – and a series of formal consultation meetings around the United Kingdom. The formal consultation period ended on the 12 October.

6.2 The consultation paper was very well received and over 170 written responses to the paper have been sent to the Revenue, from a wide range of organisations and individuals. Generally these responses have supported both the objectives of this further phase in the reform of the tax and benefits system, and the detailed proposals put forward.

7/ Monitoring and Review

7.1 Inland Revenue plans to monitor and evaluate the new tax credits. As part of the evaluation, the impact of the new tax credits will be assessed and compared against the assessment in this RIA.

Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo
PayMaster General
Her Majesty's Treasury

Date: July 2002

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Appendix 1

Estimates of the population affected by the new tax credits are derived from the Treasury's tax and benefit model, IGoTM, and based on data from the 1999/2000 Family Resources Survey (FRS), uprated to 2001-02 and grossed to reflect the United Kingdom. The FRS is an annual survey of private households' income in the Great Britain and covers approximately 25,000 households.

The Regulatory Impact Assessment uses the following abbreviations:

CDI	Child Dependency Increases payable in Incapacity Benefit, Invalid Care Allowance, Retirement Pension, residual Severe Disablement Allowance and Widowed Mothers/Parent Allowance.
CTC	Children's Tax Credit, an income tax relief for people with children. It can reduce the amount of income tax paid by up to £529 in 2002/03. There is an additional £520 of Children's Tax Credit for families with a baby born on or after 6 April 2002 in the tax year of their child's birth. This means that for these families the Children's Tax Credit is worth up to £1049 in 2002-03.
CTB	Council Tax Benefit
DPTC	Disabled Person's Tax Credit, the tax credit for workers with a disability or long-term illness that puts them at a disadvantage in the labour market.
DWP	Department for Work and Pensions
EC50+	The employment credit paid through the New Deal 50+ scheme by the Department for Work and Pensions
HB	Housing Benefit
IS	Income Support
JSA (IB)	Income-based Jobseeker's Allowance, being the means tested element of Jobseeker's Allowance. As premia are awarded in JSA(IB) on an identical basis to IS, it is only this element of JSA which will be affected by the new tax credits changes.
PAYE	Pay As You Earn, the system of tax collection for employees
WFTC	Working Families' Tax Credit, the tax credit for working households with children.

[1] At present, around 1 million WFTC & DPTC recipients who are paid via the employer renew their tax credit award each year. We have assumed that the move from a 6-month award to a 12-month award period will eliminate around half of all renewals. We have also assumed that removing the need to stop payments in advance of a renewal will halve the time taken by an employer to stop and then restart an award, implying a cost saving for the remaining 500,000 renewals.

The WFTC & DPTC RIA estimated that around 35% of tax credit recipients paid via the employer work for small or medium-sized employers, and that to manually stop or start a tax credit would involve around 30 minutes work by a proprietor or adviser at a cost of £20 per hour. For large employers with more sophisticated systems, a stop or start is likely to take no more than 30 minutes for a payroll operator, at £10 per hour. On this basis, reducing the need for stops & starts will decrease employer costs by an estimated £9.5 million per year.

[ii] In the WFTC & DPTC RIA, it was assumed that Certificates of Payments would always be completed manually, and would take 30 minutes to complete, at £20 per hour.
As part of the consultation process we investigated whether these assumptions still held. Comments we received suggested that these assumptions were correct for small firms, but not for large firms. Large firms were likely to have certificates of payments produced automatically which would only require printing out and posting, taking up to 15 minutes with a wage rate of £10 per hour.
By 2002-03, we estimate that 85,000 Certificates of Payments will be issued each year under WFTC & DPTC.
On the basis of differential costs for large and small employers and assuming that 65% of tax credit recipients paid via the employer work for large businesses, this would imply a reduction in costs of compliance for large businesses of up to £138,125 and for small firms of up to £297,500. An overall reduction in costs of £400,000

[iii] Around 40% of applications require an earnings enquiry form to be filled out. By 2003/4 we might expect 100,000 – 120,000 earnings enquiries per year. On the assumption that it takes 45mins to an hour to complete an earnings enquiry form and that at on average 35% of these would be directed to small firms at a cost of £20/hr and 65% to large firms at a cost of £10/hr, removing the need for routine earnings enquiries should save employers £0.9 m-£1.1m.