

A One Parent Families|Gingerbread response to Tax Credits: Improving Delivery and Choice. May 2008

Executive Summary

Section one: Introduction

- One Parent Families|Gingerbread welcomes to the opportunity to comment on *Tax Credits: Improving Delivery and Choice*, and we welcome the Government's commitment to improving the tax credits system. Several of the reforms laid out in the discussion paper are both ambitious and long-term and they will have far reaching implications for lone parents.
- Tax credits have played a key role in tackling child poverty and helping lone parents move into work. To extend this progress it is vital that the Government sustains and increases this high level of investment and tackles a number of pre-existing problems with the system - many of which are not fully resolved by the measures outlined in this discussion paper.

Section two: Outstanding Issues

Fixed Awards, Inflexibility of the IT system, Right of Appeal and Benefit Interactions.

- The Government has dismissed the case for fixed awards in favour of retaining the principle of responsiveness. However, the responsiveness of the current system has been blunted by a number of recent reforms, without being accompanied by the benefits attached to a system of fixed awards. Furthermore, the annualised design of the current system can exacerbate already unstable income patterns for families on low incomes.
- While we recognise the difficulties associated with a return to fixed yearly awards, we think the Government is wrong to reject short-term fixed awards. Many of the proposals in this document (such as income banding) signal a move away from responsiveness, but fail to offer systematic protection from overpayments.
- There are a number of other pre-existing problems with the current system which this discussion paper does not fully resolve. In particular we believe that the Government should look again at introducing a pause on repayment and an independent right of appeal. Alongside this, there should be an overall review of the interactions between tax credits and the benefit system (this should include assessing any interactions which could be created by new reforms).

Section three: Proposed reforms to tax credits

Household breakup, repayment options, communication, tax credit run-ons, deferring end of year payments and income banding



- We are pleased to note that the Government is taking steps to protect claimants from their ex-partner's failure to engage with HMRC. To maximise the positive impact of this reform we would also like the option of settling joint claims to be well-publicised to claimants and advisers. Similarly, while more flexibility in terms of repayment methods is welcome, we hope that claimants will be able to opt out of repaying via PAYE easily should circumstances change.
- There have been notable improvements in the quality of HMRC's communication with claimants; but we recommend that the Government goes further by addressing the problems associated with award notices.
- We support the introduction of a run-on in WTC for claimants whose hours fall below 30 hours per week, and we also recommend extending the run-on in childcare support to provide continuity when parents leave work to eight weeks.
- Enabling claimants to defer some of their tax credit entitlement will no doubt provide much-needed security for those who have had negative experiences of incurring overpayments. However, we suspect that this will only apply to a small proportion of claimants. Most families on low incomes need access to their full entitlement to help them get by on a day to day basis.
- We do not believe that introducing a system of income banding for tax credits represents a systematic arrangement for 'holding back' a portion of entitlement. We suspect it would protect people from overpayments on a fairly arbitrary basis, dependent on where their actual income fell within a given band. We believe that determining the optimum width of the bands will be extremely difficult to achieve in practice. There is an inconsistency in the Government choosing a responsive model over a fixed system of tax credits in order to permit support to flex with income change, whilst putting forward a proposal which involves 'enforced under-payment'.

Section Four: Proposed reforms to the childcare element of WTC

- One Parent Families|Gingerbread has long lobbied for reform of the childcare element of WTC; in particular we recommended that childcare be taken out of the main tax credits system. We are pleased to see these new proposals, signalling the Government's willingness to tackle the shortcomings of the current system of support.
- The central flaw underpinning the design of the childcare element of WTC was an underestimation of the number of changes in circumstances and income experienced by families over a year. In contrast to the main system of tax credits, the evidence suggests that this is an area where a greater degree of responsiveness would be welcomed.
- Drawing on a more informed understanding about the problems families have encountered, the Government should target improvements in the following three areas: the lack of responsiveness in support, the complexity of the calculation to work out entitlement, and the lack of transparency which means making decisions about work is difficult.



- Based on feedback from lone parents, we believe that introducing a model where parents are asked to report their 'actual childcare costs' to HMRC has the most merit; providing that any problems associated with additional reporting and receiving payment in arrears can be resolved.
- While we do not advocate its introduction as a stand alone option, we suggest that introducing a system of 'income bands' might substantially enhance the transparency of an 'actual costs' model. This would enable parents to make more accurate predictions about the level of support they can expect to receive.
- We do not believe that any of the other three options - fixed awards running from September to September, payments to providers and a voucher system – represents the right way forward. Unless introduced in combination with another model they are unlikely to resolve the issues of responsiveness, transparency and complexity to a sufficient extent.

Conclusion

- Lone parents' experience of the Tax credits system has been characterised by instability and uncertainty. HMRC should therefore carefully evaluate any new reforms to ensure it has capacity to administer any reforms and the gains will be worthwhile.
- Many of the reforms laid out in this discussion paper have the potential to make a positive impact, and we look forward to contributing to a more detailed discussion about how they can be implemented effectively.

Section One: Introduction

1.1 One Parent Families|Gingerbread is the national charity representing the 1.9 million lone parents and their three million children in Britain. The charity aims to tackle the poverty, stigma and social exclusion still faced by too many one-parent families today.

1.2 The charity campaigns actively on policy issues, runs a help and advice line, and runs training and back to work programmes for lone parents. We receive an average of around 20,000 calls a year from lone parents, on a wide range of issues including benefits and tax credits, child maintenance, employment, housing, and family law. We also run the lone parent strand of Marks & Spencer's Marks & Start programme, providing training and work experience to help lone parents gain paid work.

1.3 We welcome the opportunity to comment on the proposals set out in this consultation paper. The proposals are wide ranging and, in several areas, ambitious. If implemented they would have considerable implications for millions of families and for lone parents in particular. Around 95 per cent of eligible lone parents are claiming tax creditsⁱ, and they also make up a substantial part of total income for those families (one study recently estimated around 30 per cent of a lone parent's incomeⁱⁱ). It is also worth noting that, to some extent, lone parents and couples are in different parts of the tax credits system; lone parents are more likely to be claiming the maximum WTC, the childcare element and the bonus paid to those working 30 hours or more.ⁱⁱⁱ



1.4 Consequently, some of the proposals set out in the discussion paper will be especially relevant to lone parents, and we were keen to canvass their views before responding. Drawing from our membership we received feedback from around 10 lone parents (the majority of this group filled in a detailed survey which asked them about their experiences of the system, and for their views on the proposed reforms). We also sought the views of our helpline advisers and tax credit trainers.

1.5 It is widely accepted that tax credits have played an important role in increasing lone-parent employment rates and in reducing in-work poverty. Brewer, Duncan and Shephard (2007)^{iv} estimate that the Working Families Tax Credit increased employment among lone mothers by around five percentage points. Tax credits have been an important factor in the reduction of child poverty among working lone-parent families, and much of the fall in child poverty rates since 2001 has been attributed to the impact of tax credits (Harker, 2006)^v. The lone parents who contributed to this consultation were keen to acknowledge how vital this support was in their day to day lives:

'the money from tax credits makes the difference between me being able to work in what is a relatively low paid job but still keep my head above water – just!'
Laura

1.6 If the Government's Child Poverty targets are to be met, then it is essential that this level of support is sustained and increased. But alongside renewed levels of investment, more work needs to be done to improve a system which unfortunately continues to create considerable frustration and sometimes even hardship for many families. It seems likely that at least two-fifths of lone parents receiving tax credits have been affected by overpayment or underpayment,^{vi} and trust needs to be rebuilt for many who have had negative experiences of communicating with the Revenue.

1.7 In combination with the Tax Credits Transformation programme, the proposals in *Tax Credits: Improving Delivery and Choice* will go a long way towards tackling these problems. However, before any profound reform is undertaken it will be important to address several pre-existing problems with the current system – a number of which we feel are not fully addressed in the discussion paper. In particular we are concerned that in an attempt to resolve the tension between responsiveness and certainty, the Government is at risk of *reducing* responsiveness and increasing complexity - without actually eliminating overpayments.

Section Two: Outstanding Issues ***Fixed Awards, Inflexibility of the IT system, Right of Appeal and Benefit Interactions.***

Fixed Awards

2.1 A commitment to balancing security with responsiveness is central to the design of the UK tax credits. But it is also very challenging to achieve in practice, as various reports highlighting problems with tax credits have shown.^{vii} Overpayments are an inbuilt feature of this annualised system. Several significant changes have been introduced to minimise their impact: the figures published this year by HMRC show the effect of the increased in-year income disregard, implemented in April 2006. The figures show a welcome reduction from 1.9 million overpaid awards to 1.3 million.

2.2 Unfortunately, the benefits of the income disregard appear to have been concentrated amongst higher income families. In 2006/07 29% of overpayments



were experienced by those with incomes below £10,000 (up from 22% in 2005/06). The amount HMRC still needs to claim back from families also rose from £3.9bn to £4.3bn between April 2007 and April 2008.^{viii} Despite sustained concern about the damaging impact of overpayments, the Government makes it clear in this discussion paper that fixed awards have been ruled out for this phase of tax credits reform:

'any advantages of a fixed system would be outweighed by the loss of flexibility and the delay with which income and other changes would feed through to awards (2.17)^{ix}

2.3 Reference is made to the 720,000 families claiming tax credits that have experienced income falls in 2006-07 (3.26). While it is certainly true that the responsiveness of the current system is appreciated by many claimants with fluctuating incomes; we do not agree that the Government is right to definitively dismiss the case for fixed awards. We believe that whereas support for childcare costs should become more responsive (see section 4); the Government should consider tipping the balance back towards stability in the main tax credit system. Pursuing reforms such as income banding is not the best way to offer claimants greater security. There are a number of reasons why the Government should not rule out fixed awards:

• *Recent changes to the tax credit system have blunted the 'responsiveness' principle*

2.4 The value of 'responsiveness' is the best argument against returning to a fixed model for tax credits. However, several recent changes have served to blunt the 'responsiveness' of the system, meaning we have moved closer to a fixed award model without the advantages of simplicity and straightforward protection from overpayments. From April 2007, when claimants report an income fall during the year, their tax credit payments are adjusted for the rest of the year to reflect their new income level, but they no longer receive a one-off payment for the earlier part of the year. As a result, in order to avoid an overpayment, the system has been made less responsive to income falls. Combined with the introduction of the £25,000 income disregard, this means that for families who experience an income rise or fall, tax credit awards are operating a little bit more like a system of fixed awards. These reforms have already moved us away from an annual, cumulative system of tax credits, meaning that a return to a fixed model might be less disruptive than previously thought.

• *Tax Credits can exacerbate income instability*

2.5 The total income of a lone parent can be derived from multiple sources. It can include wages, CTC, WTC, the childcare element of WTC, income support or JSA, child benefit, housing benefit, or council tax benefit. There may also be child support payments from the separated partner. Sudden changes affecting one source of income can disrupt this delicate balance. While one of the aims of a responsive system is to 'smooth over' unexpected fluctuations in a claimant's income, recent HMRC commissioned CASE research^x suggests that, on a week to week basis, tax credits are failing to achieve this stabilising effect. Because of the way tax credits are designed (based on income across the year as a whole and adjustments during the year to try to ensure the correct total is paid by the end of it) they can be less effective at stabilising income in the short term. Sudden drops or increases can destabilise an already fragile balance of incomings and outgoings.



Fixed awards could provide claimants with a more reliable strand of income which might have the effect of 'smoothing out' other fluctuations.

• *There are alternative methods of protecting claimants whose incomes fall*

2.6 A number of problems created by fixed awards are outlined in the appendix to the discussion paper *'How would a fixed system of tax credits work?'* In particular, attention is drawn to the fact that in a yearly award, tax credits may not respond to income changes until up to 18 months after the event, and may not fully adjust for up to two and a half years.^{xi} We would support the adoption of a shorter term award (for example six months) to counteract this problem. This reflects the view put forward by the House of Commons Treasury Committee in 2006:

'End-of-year adjustments in tax credit entitlement may come too late for such families, and any demand for reimbursement is felt very keenly by them. We suggest that there is evidence that determining awards over shorter time periods would reflect the needs of lower income families more accurately than annual awards.'^{xii}

2.7 To better safeguard the income of those who experience a drop in-year, the Institute for Fiscal Studies suggested in their Green Budget of 2006 that:

'tax credits could operate as fixed awards only for claimants whose circumstances improved over time; this could be operationalised by having tax credits operate as a fixed award for all, but allowing families to re-claim during the period of the fixed award if they felt their circumstances justified a higher award. Such a reform might balance families' need for certainty with the desire to achieve responsiveness'^{xiii}

2.8 One option is for the Government to introduce a 'trigger' system to respond to drops in income – awards could be reassessed only when a claimant's income falls by a certain percentage. This corresponds to the planned reform to child maintenance, where a non-resident parent's payments will be fixed unless their income falls by 25 per cent or more in-year. Clearly, a number of valid questions about the design of fixed awards would remain; such as whether to continue using an annual measure of income or to return to using 'normal income' as was the case with WFTC. We do not underestimate the challenges faced by the Government when weighing up the relative merits of a fixed or a responsive system. Nevertheless, we believe there is a powerful case for continuing to explore the benefits of fixed awards as we enter into the next phase of tax credit reform.

Inflexibility of the IT system

2.9 We are concerned that there are several overdue reforms to the tax credits system which are still being delayed by technical difficulties. One Parent Families|Gingerbread has, in common with a range of other voluntary sector organisations^{xiv}, stated its support for the Ombudsman's recommendation to introduce a 30-day delay before HMRC starts to recover an overpayment from an ongoing award. In *Tax Credits: Improving Delivery and Choice* this particular change is rejected due to the constraints of the IT system:

'it has not been possible to implement the Ombudsman's proposal for a 30-day delay before HMRC starts to recover a tax credits overpayment from an ongoing award.'^{xv}



2.10 The same section goes on to describe another reform which it has not been possible to implement:

'And the current IT system can make it difficult to tell customers with certainty, at the time that a change is reported, how this will affect their entitlement to tax credits.'

2.11 Several of the lone parents we spoke to described how important it was to be able to predict the effects caused by reporting a change in circumstance. These two problems continue to cause people difficulties in their day to day experience of tax credits, and the remit of the Tax Credit Transformation programme should be extended to include tackling such issues. We recognise that, in the absence of a complete overhaul of the IT system, HMRC is limited in the number of improvements it can make. Nevertheless, we believe that such reforms are essential and the IT system should not be dictating policy in this respect. We hope that, as part of long term reform, there will also be substantial enhancement of IT capacity to ensure that the system is flexible enough to deliver further service improvements.

An independent right of appeal

2.12 Alongside making the case for a pause on repayments, One Parent Families|Gingerbread has also called for an independent right of appeal to an independent tribunal over a disputed overpayment.^{xvi} At the moment, a statutory right of appeal exists for the level of an award only, not for the existence and recovery of an overpayment. Currently HMRC administer this process. There have been notable improvements in overpayment reviews, and the revision of COP 26 has clarified the responsibilities of both HMRC and the claimant. Despite this we believe that this still represents inadequate provision – greater statutory rights are needed. This will be in the interests of HMRC (in terms of long term service improvements) and in the interests of individual claimants. As one lone parent - who had previously been employed as an advice worker - observed when responding to this consultation:

'Generally, people are also entirely ignorant or confused about how to disagree with a decision made by the Revenue. The rules are so complex and difficult to understand and bear no relation to the rules used by most other Government bodies such as the DWP.'

Laura

Interactions with benefits

2.13 Before proceeding with the proposals outlined in this discussion paper, HMRC should conduct a thorough assessment of the interactions between tax credits and other benefits and how these reforms in particular would impact on other benefits. There are already a range of unintended consequences associated with claiming tax credits (particularly in relation to housing benefit). One recent research report *Interact: benefits, tax credits and moving into work*, argues that systems such as tax credits should be designed around individual life events rather than technology, and that there should be a 'sounding board' or 'claimant advisory panel' to facilitate design and delivery.^{xvii} The research found that:

'Individuals face a range of interactions with the benefit, tax and tax credit systems as they move into, out of or towards paid work. These interactions



coincide with a range of structural and individual barriers and circumstances, which mean that consequences are not always predictable or in line with policy intent.^{xviii}

2.14 All of the proposals in this discussion paper should be ‘proofed’ for any potential interactions with benefits. We welcome the news that, as part of the Government’s wider Service Transformation agenda, the DWP and HMRC are identifying how closer working can improve customer service, launching a number of pilots focused on customers who frequently move in and out of work (5.11). This will be particularly important given the large scale reforms to Income Support and JSA which will undoubtedly result in greater number of lone parents moving between the benefit and tax credit systems.

Section three: Proposed reforms to tax credits

Household breakup, repayment options, communication, tax credit run-ons, deferring end of year payments, and income banding

Household breakup

3.1 In a letter to the Financial Secretary to the Treasury on 6th August 2007, One Parent Families|Gingerbread drew attention to HMRC’s policy for recovering an overpayment from a terminated couple award equally from both parties. We were deeply concerned by the fact that where this had not been possible, they were pursuing recovery from one party alone. Given that HMRC was likely to have the details of the main carer who was continuing to claim, this was having a disproportionate impact on lone parents. We welcome the fact that HMRC is taking steps to protect claimants from their ex-partner’s failure to engage (6.16). We think that this will be important during a particularly vulnerable period for many claimants.

3.2 As choosing to settle a joint award in this way is ‘optional’ we hope that this reform is widely publicised and understood by claimants and advisers alike. We also note that the guarantee does not operate in cases where the claimant has not provided up-to-date information prior to settling the claim. Given that it may not always be possible for claimants to have an accurate picture of their partner’s income when a relationship is in difficulties, HMRC should still look to operate a more active policy in recovering overpayments from ex-partners who are unwilling to engage. Continuing to seek recovery from the partner still claiming tax credits may serve to unfairly penalise those on a lower income.

Repayment options

3.3 We note with interest the proposal (6.22) to give claimants the option of repaying overpayments as a lump sum or as deductions from their wages via PAYE. While we welcome the additional flexibility this introduces, our consultations with lone parents indicates that in reality few will be in the position to settle with one lump sum. If claimants do elect to make repayments via PAYE, it will be important that, should circumstances change, people should be able to *opt out* of repaying via PAYE quickly and easily. We know that people on low incomes are likely to have fluctuating incomes and to experience frequent changes in circumstances (One Parent Families’ own 2005 research found that 47 per cent of lone parents in one sample had experienced between two and seven changes of circumstance that



would effect tax credit entitlement during the year, 36 per cent had experienced one)^{xix}. This is another proposal which would need to be 'proofed' against unforeseen interactions with the benefit system (for example, it is likely that PAYE deductions will affect the net earnings figure used to calculate Housing and Council Tax benefits).

Communication

3.4 We recognise HMRC's commitment to addressing ongoing communication problems with the Tax Credits Transformation Programme, and the commitment to sustain this in the discussion paper is welcome (4.3). The piloting of face-to-face visits, increased resources targeted at the helpline and the introduction of 'health-checks' should help vulnerable claimants in navigating a complex system. The increased accuracy in processing awards (rising from just under 79 per cent in 2003-04 to around 97 per cent in 2006-07) should also help to re-build trust. Nevertheless, for many this investment has not yet translated into positive experiences of contacting the Revenue, and we continue to hear concerns about the helpline, award notices and the range of ways it is possible to get in touch:

You can ring the helpline 3 times in the same day, with the same query, speak to 3 different people and get 3 completely different answers.'

Laura

'getting in touch with the Revenue at the best of times is very difficult and fraught with frustrations and contradictions.'

Jane

'I think you should be able to communicate with the Revenue online, or at least get more help online than is currently available.'

Aisha

'Award notices may as well be in French!'

Sandra

'The award notices are still hugely complicated and don't make sense. There is far too much text and not enough simple explanation, maybe using pictures to represent different sections, which would lead you through the form in a more logical way, would be a step forward.'

Louise

3.5 Based on the feedback we have received, we would therefore like to see additional improvements made to the award notice. One Citizen's Advice Bureau survey in 2007 found that over half of the respondents (58%) felt that they were difficult to understand^{xx}. Alongside the existing measures outlined in *Tax Credits: Improving Delivery and Choice* we feel that the Government could, and should, go further to improve communication with claimants; including offering claimants better online facilities.

Tax Credit Run-ons

3.6 The Government has asked for views on the introduction of tax credit run-ons, and in particular a run-on for those whose hours fall below 30 hours (6.11). In principle, run-ons should offer a safety net for claimants. Unfortunately, their experience of claiming them may be somewhat different. Claiming a run-on also



means that claimants are not eligible to claim benefits, meaning that interactions with the benefit system require closer examination before new run-ons are introduced.

3.7 On the provision that these interactions are assessed in more detail, a run-on in WTC for those whose hours fall below 30 hours represents a sensible extension of support. We would also like to re-iterate our support for a run-on in childcare support when employment ends to eight weeks (thus doubling the existing four week run-on of WTC after employment is terminated). Securing new work in time to meet childcare costs is a considerable challenge within a month. Having to terminate arrangements with childcare providers can cause disruption for child and parent alike. It is a particular problem for parents such as Manjeet, who experience unpredictable employment patterns:

'When I stop working I do not forgo the childcare as my child would lose his place and then when I start working again I would have to wait on a waiting list for a place to open up. So while I was not eligible for the working tax credit, I had to pay the entire fee for childcare myself as this suddenly disappeared from my tax credits.'

Manjeet

Deferring end of year payments

3.8 Drawing on the Australian model of tax credits, the Government proposes to give claimants the option of building up end-of-year top up payments - for example by deferring the family element until the end of the year (6.27). It is possible that this might be appropriate for a small number families or individuals in particular circumstances (or for those in slightly higher income brackets). While we welcome the introduction of more flexibility, we suspect that take up is unlikely to be widespread. Most evidence indicates that for families on low incomes, budgeting is done over shorter periods than the whole year. Recent research looking at income variation found this was particularly the case for groups with the most unpredictable income patterns:

'It appears that this group manages by tailoring spending to match variable incomes, often with little margin for error. By implication, incomes received over relatively short periods, such as a month or four weeks, may matter considerably for their living standards at that time, rather than income averaged over longer periods, such as a year.'^{xxi}

3.9 In the USA, the Earned Income Tax Credit is paid on a yearly basis. But as one academic has noted, the idea that a large number of low income families find a lump sum helpful in this way is misguided:

'One argument offered in support of large refunds is the opportunity they present for asset accumulation. This envisions lump sum payments being used more for investment purposes—education, home purchase, retirement—than current consumption. Although an admirable goal, evidence suggests it is not a truly realistic reflection of how low-income claimants use the majority of their refund dollars.'^{xxii}

3.10 We also asked a small number of lone parents whether they would want to take advantage of this option. While they could imagine that it might be suitable for some families, they described how important receiving their full entitlement was for getting by on a day-day basis:



'A lump sum at the end of the year would be nice, but that's no good if you're struggling for the rest of the year!'

Sandra

'I was told that I had been overpaid, and my benefit was cut by £20 a week to combat it. However, at the end of the tax year, they said that they hadn't paid me enough, and so I received a lump sum. It was nice to get that lump sum, but it would have been even nicer to have received the £20 each week so that I didn't need to eat Smartprice food for 3 months!'

Jane

3.11 Clearly, these responses cannot be regarded as representative of the views of all tax credit claimants. It is probable that those who have had negative experiences of overpayments might wish to defer a portion of their tax credits in order to avoid end-year adjustments. For this reason, this reform is a help. Priority must also be given to thinking about how these reforms can be communicated before implementation takes place.

Income Banding

3.12 Chapter Six of *Tax Credits: Improving delivery and choice* explores the problem of overpayments caused by over-estimating income falls in-year. With 270,000 households (6.3) over-estimating the extent of a decrease, this is clearly a significant problem; and the Government is right to recognise the difficulties faced by families with fluctuating incomes. The findings of the CASE research commissioned by HMRC also serve to underline how widespread unpredictable patterns of employment and income can be: with only 15 out of 90 respondents being able to accurately predict their income, even over the period of a month^{xxiii}. It also highlighted the fact that lone parents are less likely to report stable income patterns.

3.13 In theory, it would appear that income banding along the lines of the New Zealand model might accommodate these variations more effectively than the current system. While this reform does offer protection against overpayments, we do not feel that this protection should not come at the expense of simplicity (one of the most obvious advantages to a fixed system of awards). There are several other reasons why we are not in favour of a system of income banding:

- ***Width of the bands***

In the discussion paper the Government outlines the relative advantages and disadvantages of wide or narrow bands (box 6.2). We believe that to avoid claimants being significantly underpaid the bands should certainly not be set too widely – they would therefore need to be narrow. This would be a very delicate balance and inevitably, the narrower the bands, the less worthwhile this reform becomes.

- ***A 'random' impact?***

If HMRC believe that some form of 'holding back' arrangement is necessary then there may be ways of introducing this more systematically (as with the proposal to allow claimants to defer part of their award). An income banding model means that claimants would see varying levels of their award being held back – dependent simply on their position in a given band. Those whose income estimate was at the



very bottom of a band would be significantly underpaid compared to those at the top, thus offering protection on a fairly arbitrary basis.

• *Under-payment would not optional*

In our response to the Government's proposal to give claimants the opportunity to defer some of their award, we explain how important it is for some one parent families to receive every penny of their entitlement. As Laura explains when giving her views on income banding:

'No I wouldn't want to [be underpaid], as a single parent it is a vital part of my income.'

Laura

There is an inconsistency in the Government arguing, on the one hand, that the primary advantage of choosing a responsive model over a fixed system of tax credits is to permit support to flex with income change, whilst, on the other, putting forward a proposal which involves 'enforced under-payment'. This would further blunt the principle of responsiveness, without the full benefits of fixed awards. In addition, this mechanism might be particularly frustrating for those individuals who are able to accurately predict their income.

• *Could the same results be achieved using another method?*

Income bands are designed to counteract the problems faced by people who find it hard to estimate their income. As a result, the logical objective should be enabling people to make more conservative estimates of income falls. It might be equally effective if advisers (at HMRC and in the third sector) were better equipped to help claimants understand the implications of over or under estimating fluctuations in income.

3.14 The introduction of income bands could well prove difficult to implement, and such a move risks further complicating an already complex system. Whereas a change such as income banding might be challenging to communicate, the concept of fixed awards would be comparatively straightforward and easier for claimants to understand.

Section Four: Proposed reforms to the childcare element of WTC

Actual costs, income bands, fixed awards, payment to providers, vouchers.

Introduction

4.1 One Parent Families|Gingerbread has long lobbied for reform of the childcare element of WTC, and so we are pleased to see new evidence of the Government's willingness to tackle the shortcomings of the current system. In particular, we have recommended that childcare be taken out of the tax credits system on a number of occasions and we remain convinced that this would be sensible. Lone parents are more likely to receive the childcare element of WTC (22% compared with 3% of couples)^{xxiv} so the proposals in Chapter Seven of *Tax Credits: Improving Delivery and Choice* have particular significance for this group. As the discussion paper recognises, these reforms are distinctly long-term in nature, and so our approach is similarly exploratory. Without detailed HMRC modelling of the implications for different claimant groups it would be unwise to draw concrete conclusions about every option.



4.2 While it may lie beyond the remit of this discussion paper it is also important to consider other ways of alleviating the pressure placed on the tax credit system by accommodating childcare costs. Greater Governmental subsidies of the supply side would mean that families would not be responsible for meeting such a large proportion of childcare costs. Consequently, the system would not necessitate the transfer of such large sums of money between Government, families and providers, and – because individual costs would take up a smaller proportion of overall income - would give greater scope for families to ‘take the strain’ of a less responsive system, should their income drop. This vision has to some extent been taken up in the Government’s ten year childcare strategy, but we believe tackling the underlying problems of the childcare element of WTC will require further investment in childcare beyond tax credits.

4.3 We know that difficulties with the childcare element of WTC can have a destabilising effect on the whole process of claiming tax credits. Jane Millar’s research study into lone parents and employment found that:

‘Things were also more likely to go wrong when childcare tax credit was being claimed, with seven out of the nine women getting childcare tax credit reporting some problems. Whether things went wrong or not, the women did not always understand how their total payment broke down into the different elements^{xxv}.’

4.4 These difficulties are connected to the central flaw underpinning the design of the childcare element of WTC – the number of changes in circumstances and income experienced by families over year was severely underestimated. The result is a system which is responsive enough to create the impression of unpredictability, but not responsive enough to meet families’ varying childcare needs. Jane Millar’s study also quotes Baroness Hollis of Heigham, the Parliamentary Under-Secretary of State in the DWP as tax credits were being planned:

‘It is fair to say that when we introduced the Tax Credits Bill we did not predict that 50 per cent of lone parents would undergo more than a dozen changes in circumstance a year. Those include changes in childcare arrangements virtually every school holiday, changes in hours worked and sometimes a change of partner.’^{xxvi}

(Taken from a House of Lords debate 23 October 2006)

4.5 Fortunately, we now have more information about the needs of parents and their experience of the system as it stands. To analyse the options outlined in Chapter Seven of this discussion paper, it is important to start from an understanding of the ways in which the childcare element is not working for parents as it stands. Alongside the overarching aim to reduce overpayments which triggered by the childcare element of WTC, there are three other areas we should target for improvement:

- *Complexity of calculation*

4.6 HMRC acknowledges the difficulties experienced by parents in performing the averaging calculation for childcare, suggesting that a significant proportion make errors (7.4). Our own research from 2005 found that parents believe the current system is too difficult: just over a quarter of those in the sample struggled to perform the calculation, with lone parents reporting problems recalling how much was paid, understanding the instructions provided by the Revenue and actually performing the calculation’.^{xxvii} All respondents believed that the Revenue could provide assistance to make this process easier. The most commonly suggested



improvement to the system was reporting actual costs, followed by an easier method of calculation or someone to help with the calculations, and finally, clearer information.^{xxviii}

• *Lack of responsiveness*

4.7 At present, the fact that parents are expected to estimate their childcare costs over a year leads to a lack of 'fit' between actual costs at any one time and the amount paid by HMRC. This means parents often have to absorb the financial consequences of changes in use of childcare or of circumstance. One Parent Families research from 2005 found that of the 35 respondents who had claimed the childcare element, 19 (54 per cent) had found that the amount they paid for childcare had varied during the last 12 months. For the majority of this group the costs had increased.^{xxix} In the past, the lack of responsiveness of childcare costs was one of the major criticisms of the fixed nature of WFTC awards^{xxx}. The 4 week rule for changes in childcare costs also means that although increases in costs can be recouped, they must have been incurred for a month previously. For those on a low income, the current system does not constitute a high degree of responsiveness. From our consultation with parents it seems that the childcare support is one element of the current system that claimants do want to be more responsive.

• *The system is not transparent*

4.8 The Government notes that 'evidence is mixed on the importance customers attach to transparency' (box 7.4). While some claimants may prefer not to be drawn into the intricacies of calculating their award, it would seem that many find the current system excessively obscure and confusing. The amount received can appear unpredictable. There is now a separate section for the childcare element on the award notice, but some claimants are still uncertain as to whether support for childcare is part of Working Tax Credit or Child Tax Credit. This is because of the way in which the childcare element is paid with CTC despite being part of WTC. It was no doubt assumed that the main carer (and the recipient of CTC) would pay for the childcare, but this payment method may have the unintended consequence of confusing recipients further. The overall lack of transparency means it can also be difficult to predict the financial consequences of taking on more work or even starting work. As the Institute for Fiscal Studies recognised in 2005, this can cause real problems:

'it is likely that mothers who are thinking about returning to work and using formal childcare will find it hard to work out how much money they will be entitled to receive for childcare,'^{xxxi}

4.9 This could have the unintended consequence of interfering with the Government's efforts to tackle child poverty by getting mothers back into work or to encouraging them to progress in the workplace. The lack of transparency of the childcare element of WTC could also be contributing to the low take-up rates for this support. Any new reforms should ensure that parents feel empowered to make informed choices about work and their use of childcare. Basing our analysis on these existing problems (complexity, lack of responsiveness and lack of transparency) and on feedback from lone parents we will now consider each proposal in more detail.

Actual Costs

4.10 Following research into tax credits and lone parents in 2005 we argued that:



The central problem relating to the childcare element is budgeting across the year, when there are, in fact, periods of peak demand, such as school holidays. The solution that would benefit the most claimants is to allow them to report actual childcare costs. As these costs are subject to change, this solution presents an additional burden to an already stressed system, and implementation of this strategy would need careful forward planning^{xxxii}

4.11 Of all of the options proposed in the discussion paper we believe that asking parents to inform HMRC of the childcare costs they have incurred each month represents the most promising way forward. This option, with some qualifications, received the most support from the group of lone parents who responded to our consultation:

'This would make budgeting much easier; I only use childcare in the holidays and have to work overtime to fund this extra cost.'

Carol

'I think that's a fantastic idea, as I would be able to claim for my daughter's extra sessions when I've had to work overtime.'

Jane

4.12 As the Government readily acknowledges, there are also a number of easily identifiable drawbacks to this option. Firstly, the additional reporting burden which would fall to either provider or parent; secondly, the problem of families being paid in arrears; thirdly, the fact that this proposal would not eliminate overpayments. Finally, there would also be a substantial increase in the administration burden for HMRC, which raises questions about how smoothly this reform might be implemented. The lone parents we spoke to had reservations about how all these issues might be resolved:

'I am in touch with them [HMRC] every two weeks and I feel this is too much. It is simply too much admin to handle with all else, and each time there is a change I have to report it to Housing Benefits and sit in a queue in order to do so.'

Manjeet

'I don't mind at all [additional reporting], but changes would have to occur. I only have a mobile phone, not a landline. To call the Revenue is expensive from a mobile phone. I would like to see a way to contact the Revenue by email, or e-forms etc.'

Jane

'My providers want payment in advance. This would make it difficult.'

Carol

4.13 Despite payment in arrears an 'actual costs' system would still be more responsive than the current arrangement. Nevertheless, it is likely to cause parents on low incomes budgeting problems. To ease these we suggest the Government considers some providing form of 'float' to help families meet the up-front costs commonly demanded by providers. There is a precedent for this in a new DWP pilot (outlined in *Ready for work: full employment in our generation*).^{xxxiii} This pilot is helping parents in London meet the upfront costs of accessing childcare provision when moving into work; these can include registration fees, deposits and advance payments. Alternatively, parents could be asked to estimate their actual costs for the month ahead (even where childcare changes regularly this should be possible).



Variation in use from the last month's estimate could be reconciled in the following month's payment.

4.14 The concerns expressed by lone parents above regarding additional communication with HMRC are well-grounded, and it is clear that considerable improvements in extending modern communication methods are needed before this option is at all feasible. Given that support will be paid to parents, we think it is sensible for parents to report the childcare used, rather than providers getting in touch with the Revenue. Hopefully this would minimise the potential for disputes about over-payments. It is important to note that, should the Government opt for an actual-costs model, further work would be necessary to minimise overpayments. For example, it might be possible to ask claimants to confirm their (current) income at the same time as they report their actual childcare costs.

4.15 Overall, implementing a system of actual costs would go a long way to addressing the issues of **responsiveness** and **complexity** of the calculation, although it may be less effective at increasing **transparency**.

Income Bands

4.16 We believe that the second option proposed by the government (aligning claimants' level of entitlement to their position in an income band) has a great deal of merit, but we do not advocate its introduction as a stand alone option. The New Zealand system has the primary advantage of making entitlement more transparent, and as a result decisions about work are made more straightforward. This appealed to the lone parents who gave us their feedback:

'It would be a lot more helpful to see bands, and know exactly what you're entitled to in advance. It would be good to be able to estimate where you stand before changing your job or situation.'

Jane

4.17 We are pleased to note that the discussion paper proposes a model of subsidy based on a percentage of costs, which will ensure that variations in regional costs are reflected in support. However, a number of questions remain. Firstly, would the banding be based on the *past year's* income or the *current year's* income? To represent a meaningful guide to entitlement it should reflect current income. Secondly, to avoid 'cliff edges' how widely should bands be drawn? Here we encounter the same problem afflicting income banding for WTC - ensuring that bands are drawn at the optimum width is a delicate balancing act and would benefit some claimants on a fairly random basis. Thirdly, how would moving up a band impact on decisions about work? Lone parents we asked prioritised being able to make informed choices over the introduction of possible disincentives to progress in work:

'It would mean that I would assess my situation thoroughly before making a decision. I would much rather work than claim benefit, and if it meant I moved up a band but earned more at work, of course I would do that.'

Jane

4.18 In summary we feel that 'income bands' would primarily target the existing problem of **transparency**, without significantly impacting on the issues of **responsiveness** or **complexity**. Instead of rejecting this option in its entirety, we would suggest that it might be combined with the 'actual costs' option to enhance the transparency of that model.



Fixed awards - September to September

4.19 As we emphasised at the beginning of this section, childcare is one dimension of the tax credits system where claimants are likely to value responsiveness over certainty. Consequently, we are not optimistic about the prospect of a fixed award for childcare. We believe that calculating entitlement on the basis of last year's income will introduce an unwelcome level of inflexibility. Given that childcare costs commonly take up a large proportion of wages, even a small drop in income might lead to a parent being unable to afford childcare and so being forced to leave work.

4.20 Furthermore, while the move to a September - September entitlement might seem to create a sensible link with the school year, we suspect that the attendant conflict with the tax year will only serve to confuse. In reality this change also does little to resolve the difficulty parents face in having to project their childcare costs for the year ahead. While a fixed award might improve the **transparency** of the childcare element of WTC, we feel it would be ineffective in tackling the **responsiveness** and the **complexity** of calculations.

Payments to providers

4.21 For many claimants - particularly those who have had negative experiences of being overpaid - the idea of shouldering less responsibility for meeting the entirety of childcare costs is an appealing one. While this reform might help with budgeting, to some extent the security this represents is illusory. Unless HMRC accept the case for meeting 100% of the childcare costs for families on a low income, parents will still be responsible for paying the same proportion of costs. Overall, the response to the idea of tax credit payments going directly to providers from lone parents was mixed:

'Personally I feel the payments to provider option makes the most sense as it would be clear how much contribution had to come from my own salary'
Sandra

'I understand some people might not want their childcare provider to know personal details, but provided that everything is dealt with confidentially, I don't see a big problem.'
Jane

'I would rather be in control than leave it to a provider to provide the details.'
Carol

4.22 This idea is also appealing to some providers who wish to eliminate fraud and who might prefer a 'guaranteed' source of income from HMRC as opposed to unpredictable payments from parents. However, difficulties in implementation might mean that payments were unstable (at least at the outset), and once again, parents would still be responsible for meeting the same proportion of childcare costs. On its own this option also offers no guarantee that overpayments would be avoided. Problems might arise if the provider had been paid too much. Would the resultant overpayment be recovered from the provider, or from the parent who had not received the money in the first place? So to avoid disputes, payment should only be made directly to providers if parents are protected from incurring overpayments.



4.23 Consequently, rather than channelling tax credits via providers, we think it makes more sense to subsidise childcare through alternative means (see the introduction to this section). We are also concerned that providers (especially small childminding businesses) who wish to avoid the additional administration involved in liaising with HMRC might be unwilling to offer their services to recipients of tax credits. There are possible parallels here with the reluctance of private landlords to provide accommodation for housing benefit claimants. It is crucial to avoid the emergence of a two tier system of childcare provision.

4.24 Unless combined with one of the first two options, this model does not sufficiently target the problem areas of **complexity, transparency or responsiveness**.

Vouchers or credit system

4.25 Of all the proposals put forward by HMRC, the idea of delivering support for childcare either through vouchers or a joint bank account is the most long-term and speculative. This proposal has the distinct advantage of further detaching support for childcare from the main body of tax credits, and it could help families to separate payments out for budgeting purposes. Encouragingly, the lone parents who contacted us were not concerned by the potential of stigma becoming attached to the use of vouchers. Receiving some support for childcare is now so common that few had worries about this dimension of the proposal.

4.26 Several of the lone parents we asked to evaluate this option did have difficulties envisaging how vouchers or a credit system might operate in practice. We also have reservations about the ability of HMRC to deliver payments in these ways. While these options might have a positive impact on how support is delivered in the long-term, there would be numerous obstacles in terms of implementation. For example: how would fraud be avoided? What are the logistical implications of a 'three way' bank account? If vouchers were used, how would overpayments be recovered? There also are risks that the use of vouchers might introduce greater complexity into an already confusing number of income strands. Once again, this option might need to be combined with another childcare model in order to have any substantial impact on the problems of **responsiveness, transparency or complexity** in the current system.

4.27 On balance we believe that implementing a system of **actual costs** for the childcare element of tax credits has the most to recommend it. This suggestion is based on the premise that parents' concerns about communicating with HMRC, being paid in arrears and incurring overpayments can be answered. If possible, we would also like the Government to investigate the scope for combining actual costs with income banding, to better enhance the transparency of support.

Conclusion

'I think things are moving in the right direction now, but more consultations like this would help the Revenue get a better understanding of changes that need to happen. After all, we're the ones using the service, so we know where the problems are!'

Jane



5.1 The lone parents who contacted us during the course of this consultation acknowledged several encouraging improvements in their experience of claiming tax credits over the past four years. Despite this, many described having turbulent and stressful relationships with the tax credit system; and so we are keen to ensure that any new reforms do not introduce additional instability into an already strained system. The Government should be convinced that new proposals (such as income banding for WTC) will be accompanied by significant gains before they are implemented.

5.2 We hope that alongside undertaking the ambitious policy reforms proposed in this discussion paper, the Government will take steps to address some of the other major issues which continue to cause frustration and difficulties for claimants (such as the right to an independent appeal, and introducing a pause on repayments). These issues continue to be large impediments to establishing a successful tax credits system, and they will need to be addressed at some point. We welcome the Government's efforts to reduce the number of tax credit overpayments, but we would observe that new reforms designed to tackle this problem should not come at the cost of increasing complexity. Neither should it be achieved, wherever possible, by underpaying claimants. For this reason, we hope that the Government will return to the question of short-term fixed awards in the future.

5.3 While the certainty attached to fixed term awards is attractive in terms of WTC; the long term reforms to the childcare element should target its lack of responsiveness. Several of the reforms laid out in Chapter Seven of HMRC's discussion paper could have a positive impact on this issue. However, before any of the proposals in this discussion paper are approved, the Government should be confident that they can be successfully implemented. Well-designed delivery is essential to building trust in the system of tax credits, and it is therefore key to achieving the Government's policy goals. We look forward to contributing to a more detailed discussion about how these proposals will work in practice.



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