Tax credits: improving delivery and choice – a discussion paper

The Modernisation of Britain's Tax and Benefit System

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Office of Public Sector Information
Information Policy Team
St Clements House
2-16 Colegate
Norwich
NR3 1BQ

Fax: 01603 723000
e-mail: HMSOlicensing@opsi.x.gsi.gov.uk

HM Treasury contacts

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If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861
E-mail: public.enquiries@hm-treasury.gov.uk

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1 EXECUTIVE SUMMARY

1.1 The Child and Working Tax Credits represent a central element in the long-term programme of reform of the UK tax and benefit system, which began in 1997. This was designed to tackle the prevailing trends of rising worklessness and increasing poverty among families with children by ensuring that:

- work paid more than welfare, so improving work incentives and supporting the Government's New Deal programmes;
- financial support was targeted at those who needed it most; and
- as many people as possible took up and benefited from the support they were entitled to.

1.2 The Government's policies to modernise the tax and benefit system constitute the most fundamental programme of welfare reform since the 1940s. The introduction of the Child and Working Tax Credits in April 2003 marked an important milestone in that evolving programme, briefly outlined in Chapter 2, which included the introduction of the National Minimum Wage, reforming aspects of the income tax and national insurance systems, and replacing Family Credit with the Working Families' Tax Credit.

1.3 These new tax credits were designed to provide:

- through the Child Tax Credit, the first single, integrated system of income-related financial support for families with children, which is independent of the parents' employment status and which eases the transition into paid employment by maintaining support as parents move into work;
- through the Working Tax Credit, financial support on top of earnings for low-income families. For the first time this extended in-work support to people without children, as well as those with children and, together with the National Minimum Wage, it guarantees a minimum level of income for those in work, helping to improve work incentives and relieve in-work poverty; and
- through the childcare element of the Working Tax Credit, substantial help with childcare costs, which can be a major barrier to work, helping to ensure that even parents on the lowest incomes can afford to pay for the childcare which enables them to work.

1.4 The tax credits system was also designed to deliver, for the first time, financial support which reflected families' current needs and resources, so directing most support at those who needed it most, and to respond quickly to changes in income and circumstances, so ensuring that families whose income fell could get more support without having to make separate, potentially stigmatising, claims for safety-net assistance.

1.5 In common with similar, responsive systems in Australia and New Zealand, this requires a reconciliation at the end of the tax year to make sure that families have received the tax credits they are entitled to. The challenge for such systems is to strike a balance which provides responsive support for families whose income falls while minimising end-year adjustments leading to overpayments and managing them sensitively when they do occur. Both Australia and New Zealand have introduced a number of reforms to make their tax credit systems work better, and the Government is determined to learn from their experiences, as well as experience in the UK, to further improve the UK's flexible system.

1.6 Some countries, notably Canada and the United States, have "fixed" systems of tax credits that do not provide for in-year increases in support to reflect changes in families' incomes or circumstances. Although such systems have the advantage of largely eliminating end-year adjustments, the Government's view is that these are outweighed by the loss of flexibility and the delay with which income falls and other changes would feed through to increased support for families.

1.7 In spite of some well-publicised delivery problems with the initial operation of the new system, tax credits have helped to bring about some very important achievements, which are set out in Chapter 3. These include:

- the highest ever levels of take-up of income-related support, with 82 per cent of eligible families claiming the Child Tax Credit and over 90 per cent of the money available being claimed;
- in April 2008 nearly 450,000 families benefiting from support for childcare costs through the Working Tax Credit: over 400,000 more than benefited from such support from Family Credit in 1997;
- very substantially increased guaranteed weekly incomes for people, currently £292 per week for a family with one child and one adult in work;
- 600,000 fewer children in relative poverty and 1.8 million fewer children in absolute poverty than in 1998-99;
- improved work incentives with, along with the Government's other tax and benefit reforms, nearly half a million fewer low-income families facing Marginal Deduction Rates of over 70 per cent than in April 1997;
- the introduction of in-work financial support for workers without children for the first time, with increasing numbers benefiting;
- four out of ten families with children now receiving more in tax credits and Child Benefit than they pay in tax; and
- almost 3 million more people in work than in spring 1997.

1.8 In addition, the improved targeting brought by the new tax credits has meant that families on the lowest incomes have benefited most from increased Government expenditure since 1997, with families with children in the poorest fifth of the population £4,100 better off per year in real terms. And the ability of tax credits to respond to changes in income has meant that some 720,000 families whose income fell in 2006-07 saw their entitlement to tax credits increase.

1.9 Although end-year adjustments leading to overpayments in the first years of the new system were unexpectedly high, statistics published on 20 May show that they have now fallen to less than half their level for 2003-04. As Chapter 4 explains this is the direct result of the implementation of the package of measures, announced in the 2005 Pre-Budget Report, to give customers greater certainty about their tax credit awards while maintaining the flexibility to quickly provide additional support for families whose income falls. The reduction in overpayments goes beyond the projection made at the time of the 2005 Pre-Budget Report that overpayments would be reduced by a third.

1.10 The Government remains committed to the current responsive system of tax credits, and is building on the success of the measures put in place since 2005 to improve the working of the tax credit system, particularly for those customers who find it difficult to navigate effectively. It has therefore developed a three-part strategy for improvement. This draws on lessons learnt from the first five years of tax credits in the UK, including through HM Revenue and Customs' (HMRC) Tax Credits Transformation Programme, and from the experience of similar systems in Australia and New Zealand. This strategy is explained in the concluding section of Chapter 4 and each of its strands is set out in the subsequent three chapters. It entails:

- continuing to improve the service HMRC provide to the diverse range of people receiving tax credits by tailoring support more closely to individuals' needs, to make the process of claiming, receiving and renewing tax credits easier for customers and to reduce the scope for error (Chapter 5);
- giving customers more control over their tax credits affairs, by providing them with greater certainty about their awards, and more choice about how they receive tax credits and how they repay any overpayments that might arise, while continuing to provide additional support where their income falls or their circumstances change. While the proposals outlined at this stage to give customers more choice are relatively modest, they could inform the direction of future policy development (Chapter 6); and
- setting out a range of possible options to simplify the delivery of childcare support through tax credits, to further reduce customer error (Chapter 7).

1.11 Some of these reforms are already being introduced, and are already delivering improvements for tax credit customers. Others will be brought forward in the next few years, while some of the proposed reforms, particularly to the system of childcare support, are much longer-term. Chapter 7 therefore discusses a broader range of policy proposals on which the Government is keen to seek views, in order to inform longer-term policy development.

1.12 From the outset, tax credits have been developed in consultation with organisations representing the interests of families who benefit from them. These organisations have also been closely involved in the various initiatives to improve the system since its introduction, and the Government would welcome their views, and those of other interested parties, on the various proposals in these three chapters.

How to respond

1.13 The Government invites responses to the issues raised in this discussion paper. A summary of questions is included at Annex C. The Government would welcome comments by 5 September 2008. Contact details are provided in Chapter 8.

2 THE CHILD AND WORKING TAX CREDITS

The Government believes that, for those who can, work is the most sustainable route out of poverty, and represents the best source of security and independence. The challenge facing the Government in 1997 was to reverse the rising trend of worklessness and child poverty by enhancing the incentives and support for individuals to return to work, and by increasing support for families with children.

This chapter sets out the significant reforms that have been introduced since 1997, to integrate the personal tax and benefit systems, to better tailor support towards the needs of individuals, and target it on those most in need, while supporting individuals to enter and progress in work.

THE CHALLENGE FOR GOVERNMENT

Rising worklessness

2.1 By the mid-1990s, despite falling unemployment, the number of households with no working adults was rising sharply, reaching just under 19 per cent in the middle of the decade. This trend was particularly marked for lone parents and their employment rate was very low compared to other industrialised countries: around 44 per cent in the UK against over 60 per cent in OECD countries in the mid-1990s.

Child poverty in the late 1990s

2.2 Although other industrialised countries were also experiencing rising rates of worklessness, the UK was exceptional in the concentration of worklessness in families with children. As a result, the UK had higher rates of child poverty than nearly all industrialised nations, and had witnessed the proportion of children living in poverty more than double since the late 1970s. Poverty affects children's lives today, and life chances for tomorrow: children who grow up in poverty can lack opportunities and endure hardship, deprivation and exclusion. That is why the Government is determined to tackle child poverty, and ensure that each child has the best start in life and opportunity to fulfil their potential.

Modernising the tax and benefit system

2.3 The challenge facing the Government was therefore to enhance the incentives and support for individuals to return to work, wherever possible, and to stay and progress in work. The tax and benefit system therefore had an important role to play if the trends of rising worklessness and poverty were to be reversed. The 1997 tax and benefit system:

- offered little support to people searching for a job and meant that when they entered work they often faced poor incentives to move into and stay in work, and progress up the earnings ladder. It placed a disproportionate burden of income tax and National Insurance Contributions on low-paid workers. And, without the underpinning of a National Minimum Wage, it could not guarantee a minimum income for people who worked;

- did not take account of families' needs during key transitions in their lives, such as moving into work or becoming a parent. It also failed to provide sufficient help with childcare costs, so often eroding any gains to work to a point where some parents were little better off in employment than on benefits;

- provided no financial support to low-income working adults without children, and had failed to ensure that financial support for out-of-work families with children kept up with rising national prosperity;
- was complicated by the fact that there were separate systems of support for families in- and out-of-work. This made entitlement to financial support difficult to understand, so that working age adults were often not aware of whether they would be better off in employment; and
- involved burdensome processes for claiming support, often with frequent and intrusive means testing. With support through the benefits system provided only to those on the lowest incomes, claiming was often perceived as stigmatising, perhaps explaining low rates of take-up of benefits and in particular in-work benefits like Family Credit.

Integrating tax and benefits

2.4 The Government therefore embarked on a long-term programme to reform the tax and benefit system to help tackle poverty and promote work incentives by:

- making sure work pays more than welfare, by reducing the tax burden on the low-paid and the number of low-income households on high Marginal Deduction Rates, supplementing income where appropriate to guarantee minimum incomes for workers and their families, and providing financial support to overcome barriers to work, such as childcare costs;
- targeting support on those who need it most, and making sure financial support can be increased quickly when families' circumstances change for the worse; and
- ensuring that people take up the support that they are entitled to, by making it clearer to them what support is available, limiting as far as possible the hassle of claiming, and by reducing the intrusiveness of income tests, so that stigma is diminished.

The first phase of reform

2.5 The first phase of this fundamental reform programme involved a wide range of policy initiatives, starting in 1997. This included introducing the New Deals, the National Minimum Wage, reforming aspects of the income tax and National Insurance systems and replacing Family Credit with the Working Families' Tax Credit. To focus ambitions, the Government accompanied these reforms with the pledge, first made in 1999, to eradicate child poverty in the UK within a generation.

Working Families' Tax Credit

2.6 The Working Families' Tax Credit was introduced in October 1999 as a first step to improving the incentives of adults with children to move into and progress in work, and to boost financial support for working families on low earnings. It guaranteed working families a minimum income, set above the level of the National Minimum Wage, so reducing the net tax burden on families, and raising the effective point at which they began to pay income tax to the highest level since the 1960s. It included a childcare tax credit, to remove the barrier to work posed by unaffordable childcare.

Box 2.1: Family Credit and Working Families' Tax Credit

Family Credit, introduced in April 1988, was a non-contributory social security benefit, designed to supplement the income of adults with children working at least 16 hours a week with a low income. This included some support for childcare costs through the "childcare disregard". The amount of Family Credit awarded to a family depended mainly on the number of children in the family and on joint household income after tax and national insurance.

The Working Families' Tax Credit, administered and paid by the Inland Revenue, replaced Family Credit in October 1999, and was a tax credit – rather than welfare benefit – available to working families on low or modest incomes. To reinforce the link between receipt of the credit and the rewards from work, and to reduce the stigma associated with claiming in-work support, from 2000, it was paid through the wage packet.

Like Family Credit, awards of the Working Families' Tax Credit were based on a 'snapshot' of income in the weeks before the claim, and were then paid for six months at a fixed rate, regardless of changes in income or some changes in family circumstances.

The Working Families' Tax Credit also included a "childcare tax credit". This replaced the childcare disregard in Family Credit with more visible and more generous support for childcare costs.

Although the introduction of the Working Families' Tax Credit was an important step towards greater integration of the tax and benefit system, it retained many of the disadvantages of the benefit on which it was based:

- it could not adapt to a family's needs and circumstances as they changed during the year; and customers generally had to wait until the end of the six month award before they saw an increase in support;
- the short-term income snapshot on which the award was based was not necessarily very representative of the family's income over the six-month duration of the award or of their income over the whole year. And it created an opportunity for some people to manipulate their income at the time of claim to maximise their award;
- it involved two claims each year for a family continuing to claim; and
- it did not provide in-work support for workers without children.

Children's Tax Credit

2.7 In April 2001, the additional costs of raising a family were explicitly recognised by the tax system through the Children's Tax Credit, a tax allowance available to families paying income tax, announced in Budget 1999. The Children's Tax Credit replaced, and was more than double the value of, the Married Couple's Allowance and associated allowances. To allow more resources to be targeted on lower- and middle-income families, the credit was gradually withdrawn from families with a higher-rate taxpayer. However, like other income tax personal allowances, the Children's Tax Credit was only available to people with a tax liability and could not reach the lowest income families, and it could not reflect the joint income and other circumstances of the family unit. This meant that the support it provided could not be targeted on those families who needed it most.

Impact of reforms

2.8 Together these reforms have enabled the Government to make significant progress towards its aims of reducing poverty and improving work incentives. By November 2002, the Working Families' Tax Credit was providing financial support to over 600,000 extra families and had increased the average award by over 30 per cent in real terms compared with the Family Credit in 1997. In addition, as a result of improved gains to work, it is credited with helping to add around 5 percentage points to the lone parent employment rate.

Constraints on further reform

2.9 However, as Box 2.1 above suggests, the scope for further progress was limited by the characteristics and boundaries of the existing tax and benefit system. Neither system responded flexibly and quickly to changes in the family's income and circumstances, and some families, for example, student nurses with children, fell between the two systems and so got no support at all.

THE NEW TAX CREDITS SYSTEM

2.10 The second major phase of reform of the tax and benefit system, announced in Budget 2000, was designed to address these structural issues by introducing a new system of tax credits, which would form part of the personal tax system administered by HM Revenue and Customs (HMRC)[1]. These new tax credits, whose details were announced in Budget 2002 following extensive consultation, would:

- provide an integrated system of financial support for families with children, acting as a bridge between periods of employment and unemployment, or lower and higher income;
- sharpen the focus for financial support by separating support for adults from support for children in the family;
- be based on the family's current income and circumstances, so enabling their tax credits to respond quickly to any reductions in income or other changes in family circumstances that increased their tax credits entitlement;
- ensure that financial support was closely tailored to family resources, by being based on the joint incomes of the adults in the family, giving most support to those who need it most;
- form part of the personal tax system, so using recognised tax definitions of annual income, doing away with the need for six-monthly, or more frequent, claims and form-filling and eliminating the stigma associated with claiming benefits; and
- extend in-work support to low-paid workers without children and to people with children who fell between the gaps of the old system.

The Child and Working Tax Credits

2.11 The Child and Working Tax Credits, described in Box 2.2 below, provide:

- through the Child Tax Credit, for the first time a single, integrated system of income-related financial support for families with children easing the transition into paid employment by maintaining support as parents move into work;
- through the Working Tax Credit, financial support on top of earnings for low-income families. For the first time this extended in-work support to families and individuals without children, as well as families with children, and together with the National Minimum Wage, the Working Tax Credit guarantees a minimum level of income for those who work, helping to improve work incentives and relieve in-work poverty; and

[1] At the time of the announcement and until 2005, the Inland Revenue.

- through the childcare element of the Working Tax Credit, substantial help with childcare costs, which can be a major barrier to work. Families with childcare needs can have up to 80 per cent (initially 70 per cent) of their costs met, helping to ensure that even parents on the lowest incomes can afford to pay for the childcare which enables them to work.

Box 2.2: How tax credits work

The **Child Tax Credit** consists of a number of elements designed to acknowledge the circumstances of different families: a **family element** payable to around nine out of ten families in recognition of the responsibilities faced by all families with children (with a higher rate of support payable for the year following a child's birth); a **child element** for each child within the family; and **disabled child elements** for families caring for a child with a disability or severe disability.

The **Working Tax Credit** is designed to provide in-work support for families with children and workers with a disability working at least 16 hours per week and for workers, aged 25 or over, who have neither children nor a disability and work at least 30 hours per week. It also consists of elements reflecting different individual circumstances including: a **basic element** paid to all those eligible for the Working Tax Credit; a **lone parent and couples element** recognising the additional needs of these groups; a **30 hour element** as an incentive to increase hours worked; **and elements for disabled workers and**, in certain circumstances, **people aged 50 or over.**

To ensure support is targeted on those who need it most, tax credit entitlement is based on families' incomes and circumstances (for example, hours worked, number of children and childcare costs). So, an individual or couple's tax credits award is determined by a combination of their circumstances (which determine the elements they are eligible for) and their income (which determines whether they should get the tax credit in full or at a reduced rate).

Tax credit entitlement is based on **current year income and circumstances**, but draws on the previous year's income as a guide. This enables customers to report changes as they occur and have their award recalculated in year (subject to a disregard for in-year income increases) to reflect them. Awards paid during the tax year are therefore provisional until the end of year finalisation process. This is the process by which customers confirm their circumstances for the previous tax year; and their final tax credit entitlement for that period is determined and reconciled with what has been paid out over the course of that year.

Responsive to changes

2.12 As well as enabling tax credit awards to be tailored to meet individuals' particular circumstances, one of the Government's central objectives in designing the new system of tax credits was to ensure that it could flex with changes in income and circumstances. This would remedy one of the major shortcomings of the old system by adjusting the amount of support a family received to reflect those changes, particularly where a family's income fell, or their needs increased, for example with the birth of a child, without requiring a separate claim for (often stigmatising) safety-net assistance. The Child and Working Tax Credits provide that responsiveness within a single, integrated system, which alters tax credit entitlement as soon as HMRC is informed of changes, ensuring that support is well targeted on those who need it most.

2.13 Australia and New Zealand also have tax credits that respond to changes in a families' income and circumstances in the current tax year, these are described briefly in Box 2.3 below. Responsive systems involve a reconciliation at the end of the tax year to make sure that families have received the tax credits they were entitled to, no more and no less. If they have been paid less than their entitlement they will need to receive a top-up, if more they will need to repay the difference, either by reduced future awards or by other means. The challenge for such systems is to strike a balance which provides responsive support for families whose income falls while minimising end-year adjustments leading to overpayments and managing them sensitively when they do occur.

2.14 To reduce the likelihood and extent of end-year adjustments, the information about a family's income and circumstances, on which their award is based, needs to be kept up-to-date. That means families need to report changes, and HMRC need to act on the new information, promptly and accurately.

2.15 In addition to providing extensive customer support to help people understand their responsibilities and keep their awards up-to-date, other Governments which operate responsive tax credit systems generally adopt additional policy measures to help reduce the risk of people ending the year owing money. In Australia, for example, the Government delays paying part of the total amount of financial support due (the Family Tax Benefit supplements referred to in Box 2.3) until after the end of the tax year, in effect obliging families to "save" some of their entitlement until they are sure that they have not been paid too much.

2.16 The UK Government adopted a different approach. It introduced an in-year "disregard" of increases in a family's income if they amounted to less than £2,500. This innovative approach meant that the family's entitlement to tax credits for the current year would only be reduced if their income that year increased by more than £2,500 over what it had been the previous year. This income disregard was designed to reduce the scope for tax credits overpayments, particularly where an income change was reported late, and to enhance incentives to enter, and progress in, work. However, reductions in income were not subject to a disregard and families could ask to have their tax credits entitlement adjusted whenever their income fell, ensuring they could access additional support quickly.

Fixed awards mean delays responding to income falls

2.17 There is clearly a balance to be struck between the benefits for customers of a responsive system, and the reporting responsibilities that entails, and those of a fixed system, not designed to adjust financial support quickly to falls in family income. Some countries, notably Canada and the United States, have "fixed" systems of tax credits. Fixed systems, discussed in more detail in Annex A, do not generally provide for in-year adjustments to reflect changes in families' incomes or circumstances, but they do eliminate the risk of end-year overpayments. The Government decided, however, that 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:

- with a responsive system, families experiencing a fall in income can have their tax credit award adjusted almost immediately. A fixed system would not allow awards to respond to income and other life changes as they happened in the way that the current system can. As a result, awards would 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; and
- if the same tax credits elements were maintained, the Exchequer cost of such a system would generally be higher than that of a responsive system while being less effectively targeted. This means that those families most reliant on support would benefit least.

Box 2.3: Tax credits systems in Australia and New Zealand

Australia's Family Tax Benefit Programme was introduced in July 2000. It consists of two main credits: Family Tax Benefit Part A (a per child payment, intended to assist with the direct costs of raising children) and Family Tax Benefit Part B (which provides extra help to single parent families and two parent families with one main income). The rate of payment depends on the family's income (including that of children) in the year and the number and age of children.

Unlike the UK, most Australian families complete an annual tax return, with the Australian tax year running from July to June. The return for the year just ended is used to reconcile their Family Tax Benefit award for that year and to forecast income used to calculate the award for the coming tax year. The Family Tax Benefit responds to changes in circumstances and in-year changes in forecasts of family income. Forecast and actual family income are finally reconciled when the next tax return is made.

Levels of end-year adjustments leading to overpayments arising from the first year of the Australian system were higher than expected, and the Australian Government has therefore taken a number of steps to reduce them. In particular, Family Tax Benefit customers have been given more choice, with appropriate guidance, about how they receive their tax credit payments (including the option to get some payments fortnightly, and to receive the remainder of their entitlement in a lump sum at the end of the financial year once actual family income is known), and a significant number of customers have opted to defer some of their entitlement. These were supported by a series of initiatives to educate and support customers and reduce their risk of incurring an overpayment.

The Government also introduced end of year supplements for both parts of Family Tax Benefit, paid after customers have submitted their tax returns and completed the end of year reconciliation process, which partially or totally offset debts arising from reconciliation. These are regarded as a major cause of the decline in the number of customers with end-year overpayments, and in the total value of overpayments, in the Australian system.

The New Zealand system of support for families with children is known as "Working for Families Tax Credits". This includes two main credits: Family Tax Credit (a per child payment to low- and middle-income families whether in work or on a benefit); and In-Work Tax Credit (a per family payment for in-work families). Like Australia, payments are based on an income estimate, and awards respond to changes in circumstances including income. Most customers therefore have a final assessment at the end of the tax year that may result in an under- or overpayment. In addition, end-year discrepancies may also arise, for example, if there are changes in family composition.

The Working for Families system has a built-in tendency to underpay. For example, tax credit payments during the year are based on $1,500 income bands, on the assumption that the customer's income lies at the top of the relevant band. In contrast, the final assessment at the end of the year is based on the customers' actual income so that, all other things being equal, they receive a top-up at the end of the year.

Building on such measures, a number of policy and operational measures were introduced in response to the level of overpayments in the early years of tax credits, including systematic information sharing between Government departments and using monthly payroll data provided by employers to update income estimates. The Government is also tailoring the approach taken to the needs of different customers. For example, new customers are contacted to educate them about the system and help them manage their claim in future. And proactive contact is also made with customers identified as being at risk of incurring an overpayment. Like Australia, these measures have led to a significant decline in the number of customers with an end-year adjustment leading to an overpayment.

CONCLUSION

2.18 The current system therefore compares well against the alternatives in meeting the Government's objective of providing financial support which flexes quickly in response to falls in income and other changes in families' circumstances. And the Government has continued to monitor the balance between responsiveness and certainty. Since the start of tax credits in 2003, the Government has introduced further measures to reduce the likelihood of end-year adjustments, providing more certainty for customers, without reducing the system's ability to respond to falls in income. These measures and their effects are set out in Chapter 4.

3 ACHIEVING POLICY OBJECTIVES

The introduction of the Child and Working Tax Credits was a central element of the Government's reforms to make work pay and to guarantee minimum weekly incomes for families with and without children. To maximise the contribution tax credits could make to tackling poverty, the Government has always sought to make sure that take-up of tax credits is as high as possible. The tax credits system has also been designed to ensure that support is well targeted on those who need it most, in particular by assessing entitlement to support on a household basis; and tax credits help make work pay.

This chapter outlines the very significant progress that tax credits have made towards these policy objectives: work incentives have been improved; financial support for those on the lowest incomes has been increased; a fairer distribution of support across households has been achieved; and take-up of tax credits is significantly higher than take-up of predecessor forms of financial support.

TACKLING POVERTY

3.1 A key objective for tax credits was to tackle poverty by guaranteeing minimum levels of income for families in- and out-of-work. In addition, the Working Tax Credit extended eligibility for in-work financial support to people without children aged 25 and over. Along with the National Minimum Wage this means that, for the first time, in-work incomes are also guaranteed for childless individuals and, over the period since 1997, these minimum income guarantees have also increased substantially.

3.2 Table 3.1 below illustrates the growth since 1997 in guaranteed weekly incomes for those in and out-of-work as a result of these tax credits and their predecessors, and of the introduction of (and increases in) the National Minimum Wage.

Table 3.1: Weekly minimum income guarantees (MIGs)

	Apr-97	Apr-99	Apr-08
Family[1] with one child, full-time work	N/A	£182	£294
Single person, 25 or over, full-time work	N/A	£113	£191
Single disabled person in full-time work	N/A	£139	£237
Lone parent with one child, out of work	£77	£86	£135
Family with one child, out of work	£105	£115	£170

Assumes the prevailing rate of the National Minimum Wage and that the family is eligible for full Family Credit/Disability Working Allowance and Working Tax Credit/Child Tax Credit. Full-time work is assumed to be 35 hours. Part-time work is assumed to be 16 hours.

[1] *Applies to lone parent families and couples alike.*

Tackling child poverty

3.3 The tax credit system has played a key role in tackling child poverty and making progress towards meeting the Government's target to halve child poverty by 2010. Between 1998-99 and 2005-06 600,000 children were lifted out of poverty and 1.8 million children were lifted out of absolute poverty. In addition, the risk of children being in poverty has fallen from 26 to 22 per cent. The Government's reforms to the tax and benefit system have been crucial to these achievements: had the Government done nothing but simply uprate the 1997 tax and benefit system in line with prices, there might have been 1.7 million more children in poverty than there are today. Taken together reforms announced in Budget 2007, the 2007 Pre-Budget Report and Comprehensive Spending Review, and Budget 2008 will lift around a further 500,000 children out of poverty.

IMPROVING WORK INCENTIVES

Work is the best route out of poverty

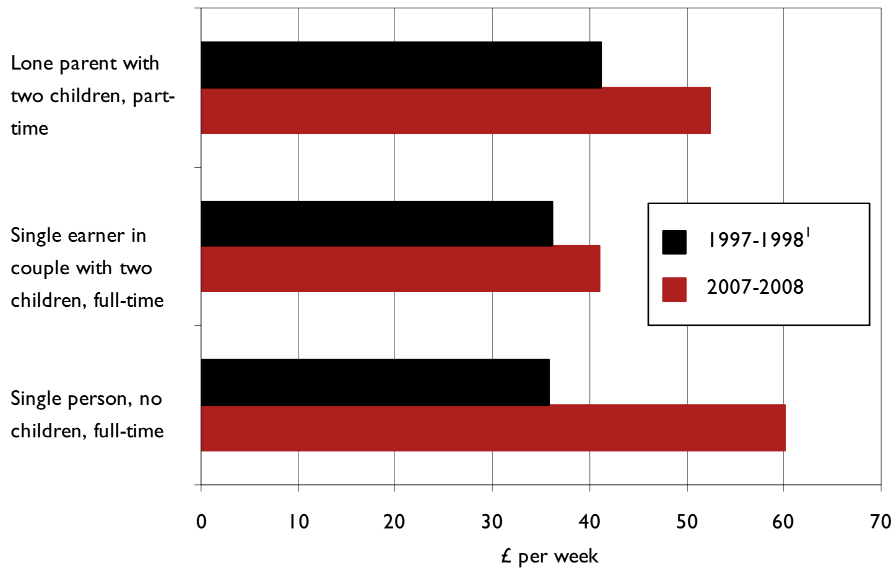
3.4 The Government believes that, for those who are able to, work is the best route out of poverty. Tax credits have played a very significant role in improving work incentives by reducing the overall tax burden on the low-paid and the number of low-income households on high Marginal Deduction Rates[2], so encouraging people into work and enabling them to move up the employment ladder.

3.5 In addition, Budget 2008 announced that, from October 2009, Child Benefit would be disregarded in calculating income for Housing and Council Tax Benefit purposes, improving work incentives for many of the lowest paid families and boosting their incomes. In effect this has allowed families that have not previously fully benefited from the increased generosity of tax credits, to do so to a greater extent in the future.

Improved gains to work

3.6 Chart 3.1 illustrates the improvements in gains to work as a result of the Government's tax and benefit reforms since 1997. Gains to work have improved for lone parents and single earners due to more generous support through tax credits, and for people without children because the introduction of the Working Tax Credit means they are entitled to in-work support for the first time. The chart shows that childless people, working full-time on the National Minimum Wage, have gained more than lone parents working part-time or single-earner couple families earning the minimum wage.

Chart 3.1: Gains to work for individuals in different family types on the National Minimum Wage (£5.52)



[1]Gains to work under indexed 1997-98 system of taxes and benefits

Source: HM Treasury calculations.

Improved incentives to progress in work

3.7 As a result of the introduction of tax credits, in combination with other reforms, individuals have improved incentives to progress in work. Table 3.2 shows that, as a result of the Government's reforms to the tax and benefit system, about half a million fewer low-income households face Marginal Deduction Rates in excess of 70 per cent now than in April 1997. The Government's reforms to the tax and benefit system have also sharply reduced the number of working families with the highest Marginal Deduction Rates, of over 90 per cent, from 130,000 to 30,000.

Table 3.2: The effect of the Government's reforms on high Marginal Deduction Rates

Marginal deduction rate[1]	Before Budget 1998	2002-03 system of tax and benefits	2008-09 system of tax and benefits
Over 100 per cent	5,000	0	0
Over 90 per cent	130,000	45,000	30,000
Over 80 per cent	300,000	210,000	150,000
Over 70 per cent	740,000	255,000	200,000
Over 60 per cent	760,000	940,000	1,875,000

[1]Marginal deduction rates are for working heads of non-pensioner families in receipt of income-related benefits or tax credits where at least one person works 16 hours or more a week, and the head of the family is not receiving pensioner or disability premia.

Note: Figures are cumulative. Before Budget 1998 figures based on 1997-98 estimates of caseload and take-up rates; estimates for the 2008-09 system of tax and benefits are based on tax credits caseloads in April 2007, and earlier data for housing and council tax benefits.

This table excludes the effect of the 13 May 2008 announcement on personal allowances.

Tax credits are more generous

3.8 The increase in the number of households facing Marginal Deduction Rates of between 60 and 70 per cent reflects the fact that tax credits are more generous, and wider in their scope, than previous systems of support. Because they are available to many more families, the withdrawal of support extends further up the income scale and, with the introduction of the Working Tax Credit, support has been extended to childless people who were not previously entitled to in-work support.

Marginal Deduction Rates give incomplete picture of work incentives

3.9 However, looking at Marginal Deduction Rates alone gives an incomplete picture of work incentives. They ignore some key features of the tax and benefit system, such as the effect of the tax credits income disregard, which allows people to increase their income during the year without having their tax credits withdrawn in the current year. In addition, they only look at marginal changes in income whereas, in reality, changes in income tend to be larger and can move people off the tax credits taper or entitle them to additional support (through, for example, the 30 hours element of the Working Tax Credit). This means that the choice for individuals tends to be not about earning at the marginal rate but about much larger movements in income, and that it may be more useful to look at empirical studies of the labour market impact of tax credits. The results of such studies are discussed at paragraphs 3.12 to 3.13.

[2] Marginal Deduction Rates measure how much of each additional pound of gross earnings is lost through higher taxes and withdrawn benefits or tax credits.

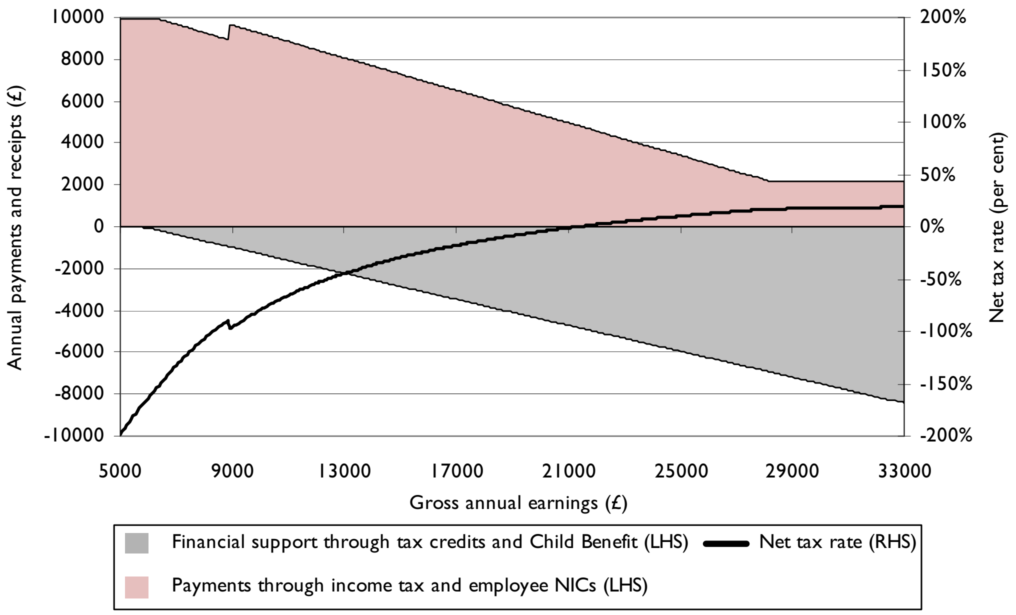
Reducing families' effective tax rates

3.10 Tax credits have also served to reduce the net tax burden on families. This net liability, and the effective tax rate paid, is calculated by setting the tax credits and Child Benefit payments received by a family against any income tax and National Insurance Contributions paid by them. The Child and Working Tax Credits mean that, including National Insurance Contributions, from April 2008:

- a single-earner family with one child receives more in tax credits and Child Benefit than they pay in tax until their income is £17,450;
- a family with two children receives more in tax credits and Child Benefit than they pay in tax until their income reaches £21,350; and
- a family with three children receives more in tax credits and Child Benefit than they pay in tax until their income reaches £25,250.

3.11 Taking into account both tax paid and financial support received, tax credits have therefore ensured that families with low incomes face an effective tax rate that is negative. This is illustrated in Chart 3.2, which shows how the effective tax rate of a single earner family with two children varies with annual income. Tax credits have helped ensure that since 1997 the number of families with children receiving more in tax credits and Child Benefit than they pay in tax has risen from under 2.5 million in 1997-98 to around 3 million, meaning that four out of ten families with children now pay no net tax.

Chart 3.2: Payments to and from the Exchequer and the net tax rate in 2008-09



Source: HM Treasury calculations.

Tax credits have increased employment among lone parents

3.12 A number of published studies[3] have assessed the labour market impact of the Government's tax and benefit reforms, focusing on the introduction of the Working Families' Tax Credit. These studies suggest that the reforms have increased the lone parent employment rate by around 5 percentage points. In addition, average hours are

[3] An overview of these studies is provided in Brewer, M. and Browne, J. (2006), *The effect of the Working Families' Tax Credit on labour market participation*, IFS Briefing Note No. 69.

estimated to have risen for lone mothers, perhaps reflecting enhanced incentives to cross the 16 and 30 hour tax credit thresholds to access more generous levels of support.

Employment has also increased among childless individuals

3.13 Research published by the Treasury at Budget 2008[4] found that the Working Tax Credit had increased employment among childless individuals. Whereas prior to the introduction of the Working Tax Credit the likelihood of young adults being employed worsened at the age of 25, that is no longer the case, and the research concluded that the introduction of the Working Tax Credit for childless individuals aged 25 and over had improved work incentives for that age group.

3.14 Overall, tax credits have played a major role in helping people into work and enabling them to progress in work, by ensuring that work pays more than welfare. Tax credits and economic stability have helped to increase the number of people in work by almost 3 million since spring 1997, while the number of unemployed people has fallen by around 400,000.

3.15 These findings are reinforced by HM Revenue and Customs' (HMRC) qualitative research with tax credit customers. This shows that tax credits have provided the financial impetus for some customers, particularly those with children who have benefited from additional support with childcare costs, to move into work.

HIGH LEVELS OF TAKE-UP

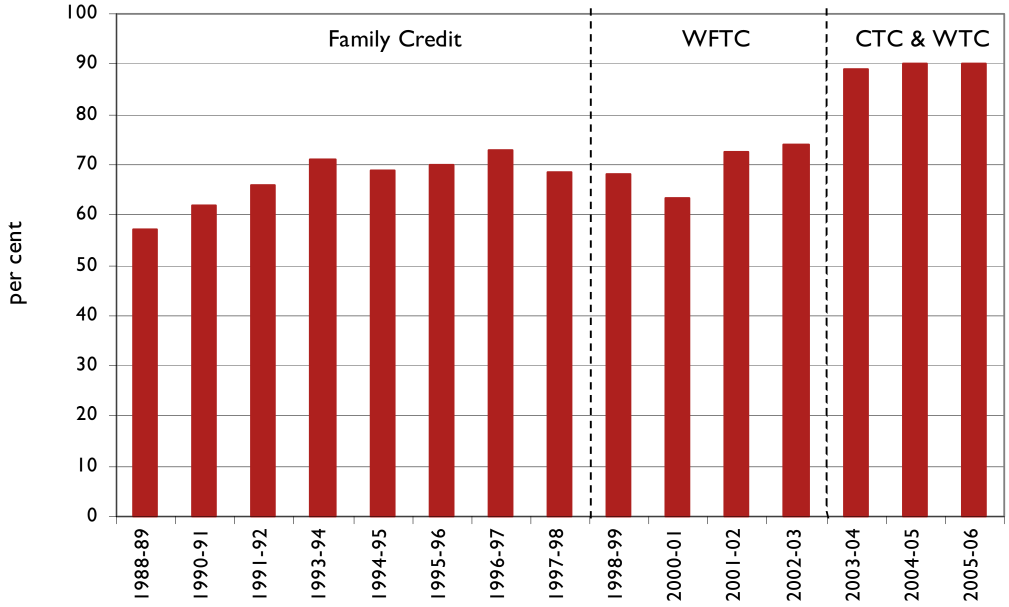
3.16 Around 6 million adults and 10 million children benefit from tax credits, including an increasing number of people without children.

High levels of take-up

3.17 Take-up of tax credits is a significant success story. As Chart 3.3 below illustrates, take-up is significantly higher than that of predecessor forms of support. This chart compares take-up of tax credits among low-income households, with levels of take-up of Family Credit (which was 57 per cent in the early years) and the Working Families' Tax Credit (which was 62-65 per cent). These high levels of take-up demonstrate the benefit so many families derive from tax credits.

[4] *Working Tax Credit and Labour Supply: an evaluation*

Chart 3.3: Take up of Family Credit, the Working Families' Tax Credit and the Child and Working Tax Credits



Source: Source: Child and Working Tax Credit take-up rates in 2005-2006.

Child Tax Credit

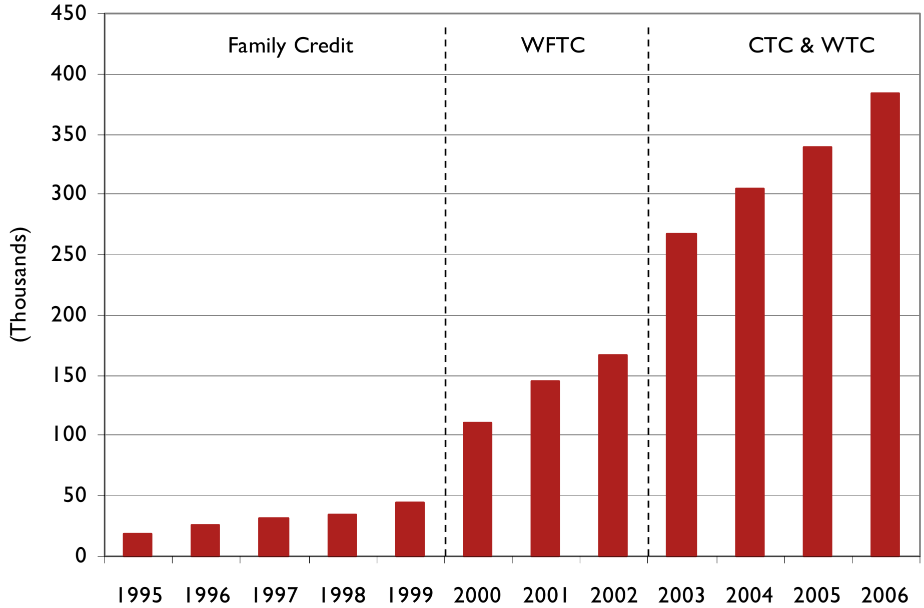
3.18 The latest figures show that in 2005-06 take-up of the Child Tax Credit among eligible families was 82 per cent, with over 90 per cent of the money available being claimed. Take-up among those on low incomes is now 90 per cent (96 per cent for those on incomes below £10,000) and among lone parents it is now 95 per cent.

More benefiting from childcare support

3.19 There are also very large, and increasing, numbers of families benefiting from support with childcare. Chart 3.4 shows that the numbers benefiting from childcare support have increased significantly since this was first introduced (as a childcare disregard as part of Family Credit) in 1994. In 2006-07 there were 384,000 families benefiting from the childcare element, receiving an average of £59 a week help with their childcare costs. This compares to 32,000 benefiting from the childcare disregard as part of Family Credit in 1997. Provisional data[5] for April 2008 suggests that this trend has continued, with an estimated 450,000 families benefiting from the childcare element at this point, compared to 414,000 in April 2007.

[5] This provisional data, which is measured on a snapshot basis, is not strictly comparable with the data on finalised awards for a given year, however comparisons between snapshots (e.g. April to April) do provide an indication of forward trends. A more detailed explanation is provided on HMRC's website at http://www.hmrc.gov.uk/stats/personal-tax-credits/cwtc-quarterly-stats.htm

Chart 3.4: Beneficiaries from childcare support in Family Credit, the Working Families' Tax Credit and the Child and Working Tax Credit



Source: HMRC analysis.

Working Tax Credit

3.20 Overall, take-up of the Working Tax Credit is also high (61 per cent in 2005-06, with over 82 per cent of the money being claimed); and in 2006-07 there were 2.6 million families benefiting from the Working Tax Credit. However, childless workers are particularly difficult to reach because they were not entitled to any in-work support prior to the introduction of the Working Tax Credit. In 2006-07 there were 305,000 people without children claiming the Working Tax Credit. Provisional data for April 2008 shows that there were 376,000 people without children claiming the Working Tax Credit, a 10 per cent increase on the numbers claiming in April 2007. So, while the number of people without children claiming the Working Tax Credit is rising, increasing take-up among this group remains a Government priority.

3.21 To determine the best way of targeting people without children, HMRC has undertaken research to explore why they have not claimed tax credits. This identified a lack of awareness of the Working Tax Credit and HMRC has therefore run specific advertising campaigns to encourage them to apply. These campaigns included delivering 2.8 million leaflets to homes in 35 selected areas targeting postcodes where there are high levels of eligibility for the Working Tax Credit, but where take-up is currently low. In addition, the campaign included radio advertising in 20 of the 35 selected areas, reaching around 7.5 million potential customers. To further increase awareness HMRC has also worked in partnership with employers in sectors with high levels of eligibility; with trades unions; and with Jobcentre Plus. This work is set out in Box 3.1. HMRC plans to repeat the campaign later this year, increasing its intensity. Over the next 12 months, HMRC will double expenditure on the Working Tax Credit campaign, and take-up among this group is expected to continue to rise.

Box 3.1: HMRC work to increase Working Tax Credit take-up

HMRC has worked in partnership with a number of employers to increase take-up of the Working Tax Credit. It has targeted over 140 employers, and has started work with a number of organisations, covering 120,000 employees. HMRC is also planning to undertake similar initiatives with local authorities to reach their workers during 2008-09.

HMRC has developed materials to promote the take up of the Working Tax Credit for use with all employers, such as posters and leaflets. Where larger employers want to develop bespoke materials, HMRC will work with them to develop co-branded internal marketing campaigns.

The type of campaign employers have chosen to run has varied and has included a range of activities such as promotion of the Working Tax Credit on intranet sites and in-house magazines, messages on payslips, and posters and leaflets in communal staff areas.

On 6 May, HMRC launched a pilot at five HMRC Enquiry Centres targeted at increasing take-up among customers visiting the centres and their friends, family or co-workers. HMRC is also working with DWP and Jobcentre Plus to further promote take-up of the Working Tax Credit.

HMRC has been working with trades unions to pass information on to their members about eligibility for tax credits. Usdaw has run a take-up campaign, which has involved distributing leaflets to members, including an article in their magazine, and giving shop stewards tax credits calculators to help their members decide whether they are entitled to tax credits. In addition, Unison has carried an article to encourage Working Tax Credit take-up.

TARGETING SUPPORT

Greatest support for those who need it most

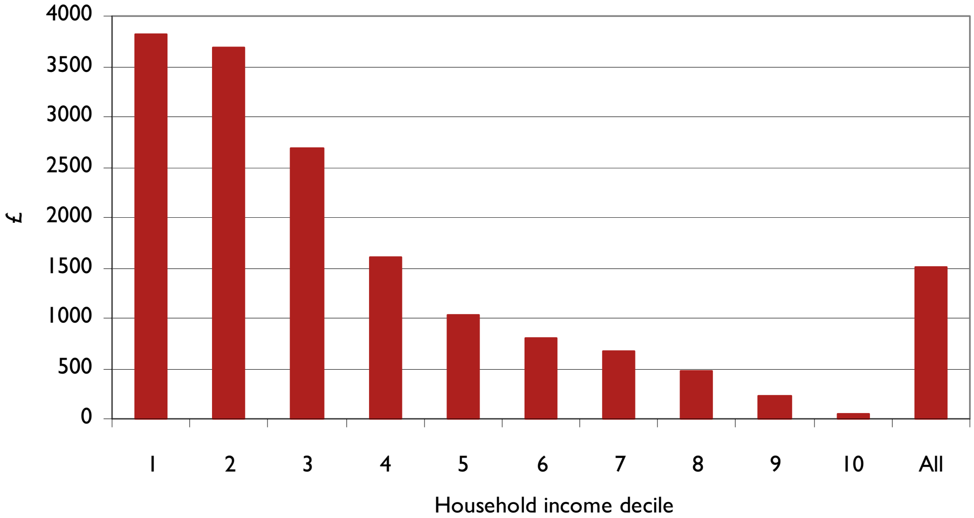
3.22 Tax credits are the most effective means of ensuring that support is well targeted on those who need it most. In particular, unlike the rest of the personal tax system, tax credit entitlement is based on household income and other circumstances of the family unit, rather than of each of the individuals that compose it. This enables financial support through tax credits to be focused on those families who need it most without cutting across the principle of independent taxation of individuals.

3.23 The family element of the Child Tax Credit offers support to just under nine out of ten families with children. Together with universal Child Benefit, this means that financial support is available to all families with children, in recognition of the costs and responsibilities that come with parenthood.

Progressive nature of the Child Tax Credit

3.24 Additional help to those who need it most, including families on lower incomes, and parents of disabled children, is provided through the "progressive" elements of the Child Tax Credit (the child and disabled child elements). This has ensured that those with the greatest needs have benefited most from the substantial increases in financial support that have accompanied the Government's reforms to the tax and benefit system. This is illustrated in Chart 3.5, which shows gains for all families with children from tax credits.

Chart 3.5: Gains for all families with children from tax credits since 1997[1]



[1] Note: Annual gains under projected 2008-09 tax and benefit system compared with support under indexed 1997-98 system.

Source: HM Treasury calculations.

3.25 The Government's reforms to the system of financial support for families, along with other changes to the personal tax and benefit system, mean that by October 2008 families with children will be on average £1,950 a year better off in real terms. Families with children in the poorest fifth of the population will be on average £4,100 a year better off in real terms.

Tax credits adjust quickly

3.26 In 2006-07 720,000 families claiming tax credits experienced income falls in year, including 410,000 families with incomes below £25,000 who had income falls of £1,000 or more. In addition, over 1 million non-financial changes of circumstance are reported each year that increase tax credit entitlement. Because tax credit payments are based on household income and circumstances in the current year, tax credits can quickly adjust to provide more support to those who need it most. Of the families experiencing income falls, a large number of families see an increase in tax credit entitlement of up to £1,000. This includes 100,000 families with incomes below £20,000 who see an increase between £500 and £1,000. More details of families experiencing income falls are included at Annex B.

CONCLUSION

3.27 The introduction of tax credits has shown the benefits of tax and benefit integration, and made significant progress towards the Government's policy objectives. However, the Government is aware that more needs to be done, in particular to improve customer service. Some customers have found it more difficult than expected to navigate the tax credits system, often because the support offered to them was insufficiently tailored to their needs. In addition, in the early years of the tax credits system, the level of end-year adjustments leading to overpayments was higher than expected.

3.28 The Government has already made significant progress in improving customer service and reducing overpayments, more than halving the level of overpayments since

2003-04, and is keen to build on this. The remainder of this discussion paper therefore outlines these improvements, and sets out the Government's proposals to build on them to deliver further benefits for tax credit customers.

4 IMPROVING TAX CREDITS

Tax credits have enabled very significant progress to be made towards the Government's policy objectives. However, the early stages of implementation were marked by a number of IT and other service delivery problems that have been well documented elsewhere.[a] In addition, the level of end-year adjustments leading to overpayments experienced in the first two years of the tax credits system proved higher than expected.

This chapter sets out the series of administrative enhancements and policy developments the Government has already introduced to improve the operation of the tax credits system. As a result of the changes described in this chapter, the tax credits system is now working well for the vast majority of families, and the statistics published on 20 May show a reduction of overpayments to less than half their level in 2003-04.

[a] See for example, Comptroller and Auditor General's Standard Report on the Accounts of the Inland Revenue 2002-03, 6 November 2003; House of Commons Committee of Public Accounts, 14th Report of the Session 2003-4 Inland Revenue: New Tax Credits, HC 89, 8 March 2004; and House of Commons Treasury Committee, 10th Report of the Session 2002-03, Inland Revenue Matters, HC 834, 23 July 2003.

IMPROVING CUSTOMER SERVICE

Improvements to the administration of tax credits

4.1 A detailed programme of administrative improvements to the tax credits system was announced in the former Paymaster General's statement to the House of Commons on 26 May 2005[6]. This included measures to improve HM Revenue and Customs' (HMRC) communications with families about their tax credit awards and procedures for recovering overpayments; and to reduce HMRC and customer error.

4.2 Since then significant progress has been made in each of these areas, as demonstrated by the increased accuracy in processing and calculating awards, which rose from just under 79 per cent in 2003-04 to around 97 per cent in 2006-07. In addition, in 2007-08 less than 5 per cent of overpayments where the customer disputed whether they should pay it back had an element of official error. In most of these cases the overpayment did not need to be paid back.

4.3 HMRC increased call centre capacity from 2006, improving the service given to customers. A survey showed that, in 2007-08, 88 per cent of tax credit customers were satisfied or very satisfied with the service they got from the tax credits helpline and in 2007-08 tax credit contact centres answered nearly 97 per cent of callers in the day they called. Looking to the future, HMRC is seeking to further improve the quality of its helpline service through better guidance and training for staff and by learning from feedback from voluntary organisations, customers and MPs.

The tax credits IT system

4.4 In the early stages of the tax credits system, a number of IT errors prevented the tax credits system from operating as envisaged and resulted, among other things, in unwarranted payments being made to some recipients. The tax credit IT system is now stable and is delivering the right payments to customers at the right time. However, it is inflexible and this is a significant constraint both on the scope for service improvement and policy development. While changes can be made, they require extensive analysis and testing before it is clear whether they can be implemented. As a result the

[6] Written Ministerial Statement given by the former Paymaster General, Dawn Primarolo on 26 May 2005, Official Report 22-3ws.

Government has not been able to make all the changes it has wanted to make to the IT system. For example, 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. 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.

Improved processes for disputed overpayments

4.5 The number of complaints and disputes about overpayments received by HMRC has fallen by around a third in the last year. In her last report, the Ombudsman[7] made a number of recommendations relating to how HMRC recovers tax credit overpayments. These were accepted in full by the Government and are already being implemented.

4.6 HMRC has improved its processes for dealing with disputed overpayments. HMRC's approach to recovering tax credit overpayments is set out in *Code of Practice 26: What happens if we have paid you too much tax credits?* This has been revised, in close consultation with the voluntary sector. The new test, which has been welcomed, makes decision making more objective by setting out clearly both HMRC's and the customer's respective responsibilities.

4.7 Under the new test, HMRC has 30 days to act on information provided by the customer. If HMRC fail to act within 30 days then any resulting overpayment after the 30 days will not need to be paid back. Customers are required to report changes of circumstances promptly, and check that their award notice properly reflects their family circumstances and income and that the amount paid into their bank account matches their award notice. Where a customer fulfils these responsibilities, an overpayment caused through an error by HMRC will not need to be paid back. And where a customer finds an error on an award notice and informs HMRC within 30 days, they will not be liable to repay any resulting overpayment.

4.8 In addition, the new Code of Practice clearly signposts people to contact HMRC if repayment of an overpayment, even at the lowest rate of recovery, would cause them hardship. HMRC continues to review its processes for dealing with customers who may experience hardship, and tries to tailor the approach it takes to accommodate the circumstances of individual customers where appropriate.

Further improvements planned

4.9 HMRC is keen to build on the improvements already made, and has therefore commissioned research to better understand the experiences of tax credits customers. The findings from this research are summarised in Box 4.1.

[7] Parliamentary and Health Service Ombudsman, *Tax credits: Getting it wrong?* 5th Report-Session 2006-2007, HC 1010, 8 October 2007.

Box 4.1: The customer experience: a summary of HMRC research

This research provides clear evidence of the continued support for tax credits and of the impact of service delivery improvements already made. However, it also identifies the need for further improvements to support some customers who continue to find the process of claiming and receiving tax credits more difficult. Chapter 5 sets out the new tailored services HMRC is introducing to help support these customers. The research found that:

- there was significant support for the financial assistance provided by tax credits. For recipients on lower incomes, tax credits made a crucial contribution to paying for essentials. For others, tax credits afforded a significantly better standard of living and a sense of financial security;
- tax credits had acted as an incentive to move into work, or stay in work, for some recipients, in particular those that benefited from the increased generosity of childcare support;
- most recipients found the claim form relatively easy to complete however, others had more difficulty and needed more help. Recipients reported that staff were generally friendly and knowledgeable; and
- awareness of tax credits and understanding of eligibility was good. However, recipients were less clear about how their award was calculated.

PROVIDING GREATER CERTAINTY FOR CUSTOMERS

4.10 The tax credit system introduced in 2003 struck a balance between responsiveness and certainty that the Government regarded as appropriate in light of the information available at that time. In particular, although it was based on detailed analysis, using data from the British Household Panel Survey, about income changes from one year to the next, there was only limited information on how families' incomes changed between and within tax years.

In-year fluctuations in income

4.11 The Government made clear at the time that tax credits were introduced that it would continue to keep that balance under review in the light of subsequent experience and emerging information. The information available to the Government has significantly increased since the introduction of tax credits. As well as data about the operation of the tax credits system, new evidence[8] on the pattern of family incomes during the year has shown that they are much more volatile in-year than previously thought. A brief summary of this research, which showed that only a quarter of families had incomes that could be classified as stable or broadly stable, is set out in Box 4.2.

[8] *Tracking Income: How Working Families' Incomes Vary through the Year*, John Hills, Rachel Smithies and Abigail McKnight, CASE, HMRC and ESRC, March 2006.

Box 4.2: Tracking Income: How Working Families' Incomes Vary Throughout the Year

This research from CASE at the London School of Economics, partly funded by HMRC and HM Treasury, tracked the household incomes of 93 families over 2003-04. This research aimed to reveal the range of income patterns across a whole year for a group of low- to middle-income working families with children. The largest component of the sample's net income was net pay, which made up 58 per cent of net income.

The cases in the study showed considerable differences in the income patterns they followed. While a few had regular and fairly constant income across the year, many had substantial variations during the course of it. The report defined eight different patterns that customers' incomes followed, ranging from 'highly stable' cases to 'highly erratic' (where there was no clear pattern in reported income across the year).

Only seven of the 93 families had incomes fitting a 'highly stable' pattern. The more common category was income described as 'stable with blips'; and more than a quarter of cases had 'erratic' or 'highly erratic' reported incomes. Couples were more likely than lone parents to be in the more stable categories. A higher proportion of tenants were in one of the two erratic categories than of owners.

Sources of end-year adjustments

4.12 In addition, the first two years of tax credits provided more information about the main sources of end-year adjustments leading to an overpayment. As set out in the Paymaster General's statement to the House of Commons on 5 December 2005[9], analysis of the data available at the time (based on end-year adjustments for 2003-04 and 2004-05) suggested that the main sources were:

- income rises from one year to the next where families have not notified HMRC during the year that their income has risen;
- families notifying HMRC of a fall in income during the year, but overestimating the extent to which their income has fallen;
- the renewal window. Between the end of the tax year and families renewing their awards, families are paid on a provisional basis using the latest entitlement information. In 2004 and 2005 the deadline for the return of end-of-year information was six months after the end of the tax year, meaning that families who had not provided new information during the tax year could be paid on the basis of information that was up to 18 months old; and
- delays reporting non-financial changes in circumstances.

2005 Pre Budget Report package has been successfully implemented

4.13 On the basis of this emerging evidence, and the experience of the first two years of tax credits, the 2005 Pre-Budget Report announced a package of further improvements (which are set out at paragraphs 4.14 to 4.19 below). This was designed to give customers greater certainty about their tax credit entitlement, while reflecting the Government's belief that such increased certainty should not come at the expense of providing the necessary support to those customers whose circumstances change for the worse. This package was scheduled to be introduced in stages, in part in recognition of the inflexibility of the IT system, and has now been fully implemented, significantly improving the way in which the system operates.

[9] Written Ministerial Statement given by the Paymaster General, Dawn Primarolo on 5 December 2005, Official Report 55-57ws

Automatic limits on recovery

4.14 In February 2006, HMRC widened the availability of additional payments to customers experiencing hardship following an in-year adjustment to their tax credit payments. Automatic limits on recovery were introduced in June 2007. This will lead to a small increase in overpayments as, for some people, the extent of in-year adjustment has been reduced. The Government believes, however, that this is the right approach to provide greater certainty during the year.

Increase in the income disregard

4.15 The income disregard was increased to £25,000 in April 2006. This has ensured that almost all families with increasing incomes will not have their tax credit entitlement reduced in the first year of the increase, further boosting work incentives and reducing overpayments. In 2006-07, around 570,000 fewer families were overpaid than in 2005-06, two thirds of whom had an income of less than £20,000 per annum.

Reduction in the renewal period

4.16 The renewal period has now been shortened to four months, reducing the time that recipients are paid on the basis of information rolled forward from the previous tax year, which is often out-of-date. This goes further than the commitment in the 2005 Pre-Budget Report to shorten this to five months, and followed the successful implementation of this commitment in 2006.

New reporting arrangements

4.17 In November 2006 new reporting arrangements were introduced. These reduced the time allowed to report a change that reduces tax credit entitlement from three months to one month, shortening the time when people could potentially be paid too much. They also widened the changes that must be reported to include working hours falling below the 16 or 30 hour thresholds, no longer having responsibility for a child or young person and a child or young person ceasing to qualify for support. This was supported by an advertising campaign, *"When Life Changes"*, on the TV, radio and in the press.

Helping customers who give incorrect income estimates

4.18 To tackle the problems associated with families overestimating income, from April 2007, when customers report an income fall during the year, their tax credit payments will be adjusted for the rest of the year to reflect their new income level, but they will no longer receive a one-off payment for the earlier part of the year. This helps customers who have difficulty providing accurate income estimates, or report changes of circumstance late. If this means customers were paid less than they were entitled to during the year, they would receive an end-year top-up payment in the usual way.

Helping customers to keep income estimates up-to-date

4.19 Since October 2007, if a customer has not provided HMRC with an up-to-date income estimate, HMRC has automatically applied an income uplift that is broadly in line with earnings growth, to the latest figure they hold. This reduces the likelihood of provisional payments being based on an incorrect income figure. If the customer subsequently supplies an updated income figure then this is used instead. In addition, key groups of tax credit recipients have been contacted to collect up-to-date income information before the start of the new tax year. Both measures will allow provisional payments up to the time of renewal to be set more accurately, helping to reduce overpayments.

Run-on of entitlement to Working Tax Credit

4.20 To further support these reforms, Budget 2007 announced that HMRC would introduce a four-week run-on of entitlement to Working Tax Credit from the day a customer ceases to work over 16 hours. This has been implemented, reducing the likelihood of overpayments occurring when people are no longer entitled to Working Tax Credit.

Significant decline in the level of overpayments

4.21 As a result of the successful implementation of the package of measures announced in the 2005 Pre-Budget Report, the statistics published on 20 May show that the value of end-year adjustments leading to overpayments has more than halved from £2.2 billion in 2003-04 (around 18 per cent of payments), to £1 billion in 2006-07 (around 5 per cent of payments). This reduction in overpayments exceeds the expectations set out at the time of the 2005 Pre-Budget Report that overpayments would be reduced by a third. There has been a corresponding decline in the numbers of overpaid awards, from 1,879 thousand in 2003-04 to 1,291 thousand in 2006-07; and in the average amount overpaid which has also fallen from over £1,000 to just over £700.

4.22 In the 2005 Pre-Budget Report, the Government made clear it would continue to listen to the case for a system of fixed awards. A fixed system would significantly increase the time taken to respond to changes in circumstance. This would disadvantage the around 700,000 families each year who experience an income fall which increases their entitlement under the current system, including last year 410,000 families with incomes below £25,000 who had income falls of £1,000 or more. Moving to a system of fixed awards would therefore have significant downsides. Annex A sets out these consequences in more detail.

4.23 The Government therefore continues to believe that the judgement made at the time of the 2005 Pre-Budget Report, that the tax credit system needs to be capable of responding quickly when customers' circumstances change in a way that means they need more support, was the right one. The experience of the tax credits system to date and, in particular, information about income fluctuations experienced by customers (described in Chapter 3), has only served to confirm the importance of this flexibility.

LOOKING TO THE FUTURE

Further improvements planned

4.24 As ministers made clear during the debates on the Tax Credits Bill, the Government wanted the tax credits system to evolve with emerging experience and changing needs and to form a platform for continuing reform of the tax and benefit system. In particular, the Government wants to build on reforms announced at the 2005 Pre-Budget Report, learning from HMRC's research with tax credit customers, and the experience of Australia and New Zealand, who have tax credit systems broadly similar to our own.

4.25 While the service offered to tax credit customers has improved substantially, some customers still find the system difficult to navigate, and that is partly reflected in the error rates that have characterised the first few years of the new system. In 2004-05, the latest year for which statistics are available, around 90 per cent of tax credits were paid correctly to customers. But the level of error and fraud was around 8 per cent, of which the vast majority was customer error. This compares to 10-14 per cent under the Working Families' Tax Credit; and 9.2 per cent for Income Support, and 13.2 per cent for Jobseeker's Allowance, in 1997-98 when the Government first started collecting data on a systematic basis.

4.26 The main causes of error in the tax credit system are customers finding it difficult to estimate their income levels; apparent uncertainty over when, or indeed whether, they should be informing HMRC about relationship break-ups, new partners or changes to their working hours; and difficulties calculating predicted childcare costs.

More tailored customer support

4.27 The Government wants to **further improve the service customers receive by tailoring support to customers needs, making the process of claiming and receiving tax credits easier for customers, and reducing error.** HMRC set up the Tax Credits

Transformation Programme in 2006 and, building on the progress already made, it is starting to tailor support to customers' needs, to make the process of claiming and receiving tax credits easier for customers, and so reducing error and overpayments.

Greater certainty and more choice

4.28 The Government therefore wants to **retain this flexibility, with tax credits continuing to provide additional, timely support to customers whose income falls or whose circumstances change, while giving tax credit customers greater certainty and more choice in how they manage their tax credits affairs.** Along with support more closely tailored to customer needs this should help address the remaining causes of end-year adjustments leading to overpayments: late reporting of changes of circumstances; families notifying HMRC of a fall in income during the year, but overestimating the extent to which their income has fallen; paying tax credits on out-of-date information in the renewals window; and families failing to renew their tax credit award.

A simpler system

4.29 As well as offering additional support to help customers navigate the tax credit system, the Government also wants, where possible, to **simplify aspects of the tax credits system to make it easier to understand** and work with. In particular, the Government would like to explore the scope for simplifying the delivery of childcare support through the childcare element of the Working Tax Credit.

4.30 The remainder of this document therefore sets out a three-part strategy, which will be delivered in stages, to deliver further improvements for tax credit customers:

- Chapter 5 sets out the action HMRC is taking to tailor support to customers' needs, improving the customer experience and reducing customer error and overpayments;
- Chapter 6 sets out proposals to give customers greater certainty and choice, giving them more control over their tax credit affairs, while continuing to provide the necessary support to customers whose income falls or whose circumstances change; and
- Chapter 7 sets out proposals to deliver on the Government's objective of simplifying the tax credit system for customers to further reduce customer error, through simplifying the delivery of childcare support. Given the lead times involved, the ideas discussed here are much more tentative.

5 TAILORING SUPPORT TO CUSTOMERS' NEEDS

Just under nine out of ten families with children are entitled to tax credits, and customers' dependence on tax credits, as well as their ability to navigate the system effectively, therefore varies significantly. HM Revenue and Customs' (HMRC) Tax Credits Transformation Programme was established in 2006 to create a set of services and communication products that are tailored to customers' needs. This will help customers do the right things at the right time, helping keep their tax credit claim accurate and up-to-date.

These services build on the improvements made to date. Budget 2008 set out a further package of operational measures, learning from the experiences of Australia and New Zealand, to make it easier to claim and receive tax credits. The services announced in Budget 2008, and in this paper, are already delivering real improvements for tax credit customers, and will help them:

- to claim tax credits, whether for the first time or as a result of a household break-up;
- to keep their claims up-to-date, minimising their risk of being overpaid; and
- with the renewals process, particularly vulnerable customers.

THE TAX CREDITS TRANSFORMATION PROGRAMME

Assisted Claims

5.1 The evidence from customer surveys suggests that the majority of tax credit customers find the claim form straightforward. However, where customers make mistakes, this can lead to delays for them receiving the payments they are entitled to, or to them getting the wrong payments, which then need to be corrected at a later date.

5.2 To make claiming tax credits easier and quicker, the 700,000 customers who each year apply for tax credits will in future be offered a range of different services. These will be focused on customers' individual needs, and will range from simple reminders and pointers to help customers avoid common errors, to face-to-face visits to their home to help them complete the form. The more support the customer requires, the more intensive the intervention HMRC will offer. Budget 2008 announced that HMRC would start to offer these new services nationally in November and December 2008, including piloting face-to-face visits to customers' homes.

Household Breakdown Telephone Claims

5.3 Each year around 150,000 tax credit customers experience a household break-up. As tax credit entitlement is based on household income and circumstances, if a household breaks up, the existing joint claim ceases and a new claim must be made as a single person. HMRC has already introduced a new service to help customers to make new single claims by telephone, significantly reducing the time taken to get new claims into payment. Chapter 6 includes proposals to further improve customer service if customers have incurred an overpayment on their previous joint claim.

Proactive Questioning

5.4 HMRC's research with tax credit customers has demonstrated that customers are generally aware of the requirement to report changes in circumstances to ensure their tax credit award is correct. However, some customers did not have sufficient understanding of what changes they need to report, resulting each year in around 250,000 families reporting at least one significant[10] change after the year has ended.

5.5 Budget 2008 therefore announced that from September 2008, when customers contact HMRC to report a change in circumstances, it will ask them for additional information about their claim to help keep their award up-to-date. This will be focused on groups of customers who are claiming specific elements of tax credits, such as the childcare element, at the times when it is most likely that they will need to report changes. For example, customers will be asked for an up-to-date income estimate towards the end of the year, to ensure payments in the renewals window are as accurate as possible. This service is similar to the proactive support that has been given to customers in Australia and New Zealand to help them keep their tax credits awards up-to-date, reinforcing the Government's view that the personalised services being developed by HMRC are the correct approach.

"Health check"

5.6 To further help customers keep their awards up-to-date, by the end of 2008 HMRC will start to offer additional support to vulnerable customers who have not been in contact with HMRC regularly, and on customers who found the initial process of claiming tax credits more difficult. This "health check" will involve proactively contacting customers to check the details of their award and make any necessary updates. In addition, HMRC will contact new customers to improve their understanding of the tax credit system, and provide advice on any problems they have encountered.

Tax Credits and Child Benefit Information

5.7 HMRC will also make better use of the information it already holds, by ensuring that customers who receive tax credits and Child Benefit only have to report certain key information (such as a child leaving school or the birth of a new child) to HMRC once. In addition, they are testing whether the use of tax data that indicates that a customer has started a new job could help customers keep their awards up-to-date. If the customer has not already reported a change in employment to tax credits staff, HMRC will contact the customer and update their tax credit award as necessary. **HMRC plans to pilot this service in November 2008 and roll it out nationally in April 2009.**

Reach out Renewals

5.8 Some customers do not renew their tax credit award by the deadline and, in 2007, more than 200,000 families had their tax credit award ended because they failed to do this. Budget 2008 therefore announced that HMRC would proactively contact vulnerable customers during the 2008 renewals window, to offer them additional support to renew their claims. Where customers fail to renew in time, and are still eligible to receive tax credits, HMRC will also help them to get back into payment quicker. This outreach work has already started.

Working with Children's Centres

5.9 HMRC is also testing new ways of keeping in contact with tax credit customers. Children's Centres provide a one-stop shop for families with children under five years, bringing together childcare, early education, healthcare, family support and Jobcentre Plus services, and so represent an opportunity for HMRC to keep in contact with a key group of tax credit customers. HMRC will therefore be piloting different ways of delivering advice and services, including through more easily accessible literature and guidance, and set-piece events at which customers can ask for advice, including through HMRC advisors visiting centres at specific, advertised times. These pilots have already started.

[10] A significant change is one that would potentially affect the customers' tax credits award rather than, for example, updating contact details.

5.10 HMRC will also be piloting new services to engage with tax credit customers and offer them the opportunity to take advantage of a series of services designed to help them avoid end-year adjustments leading to overpayments. Work is underway to identify those individuals, including both new and existing tax credit customers, who will benefit most from these services, and how best to engage with them.

In and Out of Work Pilots

5.11 As part of the Government's wider Service Transformation agenda, the Department for Work and Pensions (DWP) and HMRC are identifying where closer working can improve customer service. One of the key outputs has been a series of pilots focused on customers who frequently move in- and out-of-work. Such customers are required to deal not only with DWP and HMRC but also, very often, with their local authority, to secure their entitlement to working age benefits, tax credits and Housing Benefit. This can result in them having to provide duplicate information to different organisations, and in delays in receiving the payments they are entitled to.

5.12 There are now six pilots up and running in Lambeth, Sedgemoor, West Lothian, West Somerset, Merthyr Tydfil and Liverpool. These are providing a joined up service to mutual customers reducing the amount of contact they have with Government by collecting the necessary information only once, at the first point of contact. Customers participating in the pilot have said that those improvements will encourage them to take up work. The pilots have also made improvements in the speed of benefit and tax credit payment. The Government will be evaluating the impact of these pilots with a view to rolling them out nationally.

Improved communications products

5.13 Communications with customers will be increasingly tailored to specific events, to make sure they have the information they need, when they need it. New products are being user-tested by customers to ensure they are straightforward and accessible. As a first step, HMRC has launched a simple web-tool to help customers to understand whether they are entitled to tax credits. There is also a simplified guide to help tax credit customers complete their claim forms accurately. The product is currently being tested with customers and will be launched in April 2009.

5.14 These services will also be underpinned by new services to protect people's identities by the end of 2008; and IT support for tax credit staff, including in contact centres, to help them tailor the support they offer to the specific needs of the customer they are dealing with. HMRC plans to provide this IT support for contact centre advisors during 2009.

5.15 Box 5.1 sets out the lessons learnt to date from work to develop the new services offered by the Tax Credits Transformation Programme.

Box 5.1: The Tax Credits Transformation Programme

In March 2007, HMRC piloted the Household Breakdown Telephone Claims service to get new claims into payment faster when couples break up. Some 90 per cent of pilot customers were back in award within five days, significantly faster than for the control group. Most customers preferred the new service, finding it more efficient and easier to use. This service was implemented to support customers experiencing a household break-up from November 2007.

In March 2007, HMRC piloted the Proactive Questioning service to give customers more support in keeping their tax credit claims up-to-date. This involved asking customers who were calling the tax credits helpline to report a change of circumstance, whether they had any additional changes to report. 34 per cent of individuals in the pilot reported at least one additional change of circumstance and there was a 24 per cent increase in the average number of changes reported. This service will be rolled out from September 2008.

In 2007 HMRC piloted the Reach out Renewals service to help vulnerable customers renew their tax credits awards quicker. The pilot prevented between £3m and £5m of overpayments. Customers were very positive about the pilot, as well as demonstrating increased knowledge of, and confidence in, the tax credit system. HMRC is delivering this support to vulnerable customers during the 2008 renewals period.

In autumn 2007 HMRC piloted the Tax Credits and Child Benefit Alignment service to ensure customers only have to report certain key information to HMRC once. Customers were in favour of aligning these processes, saying it had saved them time and effort. From September 2008, HMRC will begin implementing aligned services for all tax credits and Child Benefit customers.

In late 2007 HMRC piloted the first level of the Assisted Claims service to help new tax credit customers get into payment faster, with fewer mistakes. Early evaluation found that there was a 9 per cent fall in customers failing to fill in their income details correctly as a result of the pilot, and a slight reduction in the number of claim forms without a signature and bank details. Further pilots will test more personalised targeted assistance during the claims process. Extra support services will be available for customers in a phased delivery from November 2008.

In February 2008 HMRC piloted the Health check service, making contact with customers who had not contacted HMRC over the past six months. Early reports from the evaluation found that up to 55 per cent of the customers identified as needing help had an unreported change.

SUMMARY

5.16 As outlined in this chapter, HMRC is introducing a range of tailored services, to make the process of claiming and receiving tax credits easier for customers. These are already making significant improvements to the customer experience of tax credits.

5.17 Chapters 6 and 7 set out the next stages of the Government's proposed reforms, building on these improvements, to give customers more control over their tax credit affairs, by providing greater certainty and choice for customers, while continuing to provide the necessary support to customers whose income falls or whose circumstances change; and setting out proposals to simplify the delivery of childcare support.

6 GIVING CUSTOMERS MORE CHOICE AND CERTAINTY

This chapter sets out the next stage of the Government's proposed policy reforms to the tax credits system: proposals to give customers more control over their tax credit affairs, by providing greater certainty and choice, while continuing to provide the necessary support to customers whose income falls or whose circumstances change. These proposals build on the policy reforms to give customers more certainty that were announced in the 2005 Pre-Budget Report, and have now been successfully delivered, and on the customer service improvements set out in Chapters 4 and 5.

GIVING CUSTOMERS GREATER CERTAINTY

6.1 The Government is keen to explore the possibility of introducing changes that give customers even greater certainty over their tax credits awards, and this section therefore seeks views on two options designed to change the way the system responds to changes in income and other non-financial circumstances respectively.

Responding to changes in income

6.2 Tax credit entitlement is based on current year income and circumstances, but draws on the previous year's income as a guide. This means customers can report changes as they occur and have their awards recalculated to reflect them.

Problems estimating income

6.3 However, some customers have problems estimating their income accurately when it rises or falls in-year. HMRC is notified of approximately 1 million income estimates each year by in-work families with children getting more than the family element of the Child Tax Credit, and families without children getting Working Tax Credit. In 2006-07 400,000 households reported an income fall, of which 270,000 overestimated the extent of that fall; and 600,000 households reported an increase in income, of which 300,000 households underestimated the extent of this increase. This outcome is reinforced by HMRC's research with tax credit customers, which has indicated that, while around nine in ten tax credit recipients were able to provide an estimate of their household income within a given range, they were less able to give an estimate of household income when asked for an exact figure.

6.4 If a household reports an income change in year, subject to the operation of the £25,000 disregard, their tax credit award will be based on this amount for the remainder of that year, and also at the start of the following year until that income figure is confirmed or replaced. If they wrongly estimate their income, this can therefore lead to an overpayment in the current year (if they overestimate an income fall) and in the renewals window (if customers do not report an income increase during the year or they underestimate their income rise).

Simpler ways of estimating income

6.5 One possible option to further reduce overpayments in the renewal window could be to adopt an "income bands" approach, similar to that used in New Zealand (explained in Box 6.1).

Box 6.1: The New Zealand system of income bands

During the year, the amount of tax credits that customers receive is based on a table that encompasses an income range in $1,500 bands (with an assumption made that the customer's income lies at the top of the relevant band). In contrast, the final assessment at the end of the tax year is done on the basis of the customer's actual income, just as in the UK.

Adjusting up customers' income estimates results in, all other things being equal, customers' tax credit payments being slightly reduced during the year. Once their tax credit award is finalised, this is offset against any overpayment that may have been incurred during the year. Where customers have reported all changes promptly and accurately, the use of income bands will result in customers getting a lump sum payment at the end of the year to top-up the award.

In New Zealand, income estimates are also kept up-to-date using information provided by employers, reflecting a very different and, more intensive, approach to communication between employers and the tax department than is found in the UK.

6.6 The UK system differs from the New Zealand system of tax credits in various respects. In particular, since the income disregard reduces the impact of overpayments resulting from customers underestimating income rises, in practice, a system of income bands would not be as effective in the UK at reducing overpayments as it is in New Zealand, since it would mainly affect awards in the renewal window.

6.7 Adopting an income bands system in the UK would mean that when a customer reported an income estimate, their income estimate would be placed at the top of the income band in which it fell (the width of the income bands would have to be considered very carefully: the illustration in Box 6.2 assumes a band width of £500). The customers' revised tax credit award would then be calculated on that basis.

Further help for customers who give inaccurate income estimates, or report changes late

6.8 Using income bands would, potentially, make it easier for customers who find it difficult to give an accurate income estimate. It would mean that awards would not fully adjust to income changes in year and, other things being equal, customers would build up an end-year top-up payment. If customers wrongly estimated their income or reported a change of circumstance late, instead of receiving an end-year top-up payment, this would be offset against any potential overpayment. However where customers reported all changes promptly and accurately, more people would receive end-year top-up payments. The wider the income band, the greater the impact on overpayments, but the greater the proportion of customers getting an end-year top-up payment. This trade-off is explored in more detail in Box 6.2. The impact on overpayments, takes into account the impact of the £25,000 disregard.

Box 6.2: Impact on overpayments of an income bands system

If in-year income estimates were rounded up to the nearest £500, HMRC estimates that this would reduce overpayments by around £10 million in the current year; however, there would also be an increase in underpayments of around £5 million. If in-year income estimates were rounded up to the nearest £2,000, this would reduce overpayments by around £30 million in the current year, but would increase underpayments by around £25 million. In the following year, income banding should further reduce overpayments in the renewals window, but would again increase underpayments.

If in-year income estimates were rounded to the nearest £500, almost three quarters of low- and middle-income households who reported a fall in income, would have their entitlement reduced by less than £100, compared to if income estimates were not rounded. However, if in-year estimates were rounded up to the nearest £2,000, only 35 per cent would have their entitlement reduced by less than £100; while 16 per cent would have their entitlement reduced by between £500 and £1,000.

Question 6.1: The Government would be interested in views on the benefits, in a UK context, of introducing a system of income bands.

Responding to changes in non-financial circumstances

6.9 Entitlement to tax credits depends on a number of non-financial circumstances, namely hours worked, the numbers and ages of any children, the amount of any eligible childcare costs and whether the customer or any of their children have a disability.

Run-ons of entitlement

6.10 For some changes of circumstance, there are run-ons of entitlement in place. This means that, for a set period after a change, the customer's entitlement to tax credits continues as though that change had not occurred. There are currently run-ons in place following:

- the death of a child, where a six week run-on is in place;
- a customer ceasing to work 16 hours a week, where a four week run-on in entitlement to Working Tax Credit is in place;
- changes in childcare costs because changes for less than four consecutive weeks, and the first four weeks of any longer change, are ignored;
- a 16 year old leaving school, as the Child Tax Credit is paid until 1 September following a child's 16th birthday; and
- temporary absences from the UK, as absences of less than eight weeks, and the first eight weeks of any longer absence, are ignored.

Giving greater certainty to customers

6.11 These prevent customers from incurring an end-year adjustment leading to an overpayment if they delay reporting changes. The case for further run-ons of entitlement needs to be balanced against the Exchequer cost. However, the Government believes there may be circumstances where further run-ons are merited. In particular, the Government is considering introducing a further run-on of entitlement for customers whose hours fall below 30 hours a week.

Question 6.2: The Government would therefore welcome views on whether further run-ons of entitlement should be introduced, including for customers whose hours fall below 30 hours a week.

Claiming the disability element

6.12 Normally claims for tax credits, and increases in entitlement, can be backdated for up to three months before the point when HM Revenue and Customs (HMRC) receive a tax credits claim or is informed of a change in circumstance. The rules for the disability elements of tax credits allow longer periods of backdating and, in consultation with stakeholders, **the Government is currently examining ways of simplifying these rules to make the process of claiming the disabled elements easier.**

GIVING CUSTOMERS GREATER CHOICE

Increased choice

6.13 As well as giving customers greater certainty over the amount of support they receive from tax credits, the Government would also like to give customers greater choice, as part of a strategy of encouraging customers to take more control of their tax credit awards. The Government will therefore be introducing improved processes for when a household breaks-up, and more flexible options for customers to pay back any debts they have incurred. In addition, the Government is seeking views on a potential longer-term option to offer customers more choice over how they receive their tax credit awards.

More support when a household break-ups

6.14 Because tax credit entitlement is based on household income and circumstances, if a household breaks up their existing joint award ceases and new claims must be made. As set out in Chapter 5, new services have already been introduced to ensure that, when a household breaks up, any new single claim gets back into payment quickly and customers do not have a break in their payments.

Faster outcomes if households' break up

6.15 However, currently customers have to wait until the end of the tax year before they can finalise their old joint award and settle any under- or overpayment. HMRC's research with customers has found that they tended to prefer to finalise the old joint claim around the time it is closed. Customers tend to find the current process confusing as they assume their responsibilities towards the old claim end when they inform HMRC of the household break-up. **During 2009-10 HMRC will start to give customers who wish to do so the opportunity to resolve any issues relating to their old joint award, at the time that they report a household break-up.** This would include calculating any under- or overpayment that is outstanding on the old joint award, for example if they have delayed informing HMRC of a household break-up.

More certainty for customers experiencing a household break-up

6.16 Customers who take up this opportunity to settle their old joint award will be offered a guarantee that, provided the information they have given to HMRC is accurate and up-to-date, they will not incur any further overpayment at the end of the year, even if their financial circumstances improve. In cases where only one party to the old joint award engages with HMRC, this guarantee will apply to that partner and they will not be affected by their ex-partner's failure to engage. If the customer's financial circumstances deteriorate (for example, if they experience an income fall) they will be able to revisit their award, and may be entitled to receive an end-year top-up payment. Customers experiencing a household break-up will therefore receive any underpayment on the old joint award at the end of the year. Box 6.3 uses an example, to illustrate how these new processes will work in practice.

Box 6.3: New arrangements for dealing with household break-ups

Sam and Alex separate on 1 October 2008. On 1 November Sam phones HMRC to tell them that she and Alex have separated and to make a claim for tax credits as a single person. Because of the time between their separation and her phoning HMRC there is an overpayment of £450. As Sam's new claim as a single person can be backdated by up to three months she will also receive a back payment on her new single claim covering the period between 1 October and 1 November.

Currently, Sam and Alex would have to wait until their 2008-09 award was finalised in summer 2009 before they were informed about the overpayment on their old joint award. They would then be offered the choice of paying this back as a lump sum or by instalments.

Under the new arrangements, HMRC will check with Sam when she reports the separation that there are no other changes in her circumstances that could cause an under- or overpayment. Provided there are no such changes, HMRC will confirm the overpayment of £450 and that she is liable to pay half the overpayment on her old joint award. If there are any other changes these will be taken into account in calculating the amount Sam owes to, or is owed by, HMRC.

Sam will be given the choice of delaying repayment until the 2008-09 award is finalised in summer 2009, or of paying the £225 before then either in a lump sum or by instalments. If Alex also makes contact with HMRC he will be offered the same advice; if not HMRC would try to contact him. Alex's behaviour following the reported break-up will not affect Sam's position, nor vice versa.

6.17 While some customers may prefer to start paying any overpayment debt back at the time that the break-up is reported, as part of a more general resolution of their financial affairs, the Government recognises that this will not be appropriate for all customers. The guidance given to customers will therefore make clear that there is no obligation to repay any overpayment until the end of the year. More detail on the Government's proposals for more flexible options for paying back debt is included in the following section.

Repaying overpayments

6.18 Where customers are still receiving tax credits, any overpayment incurred is collected from their ongoing tax credit awards, and there are reduced recovery rates in place for those on low incomes. Where customers are no longer receiving tax credits, any overpayments are recovered directly from the customer, with 12-month instalment plans routinely available and longer repayment periods where necessary.

More choice for customers

6.19 The original design of tax credits allowed for the recovery of tax credit overpayments through the Pay As You Earn (PAYE) system. It was unfortunately not possible to deliver this facility earlier, however, the Government is now in a position to trial recovery via PAYE. This will give customers more choice over how they repay any overpayments incurred, improving customer service.

Trialling recovery via PAYE

6.20 Under the PAYE system employers deduct a set amount of tax from their employees' wages to ensure that, as far as possible, employees pay the tax they owe evenly over the course of the year. The amount of tax deducted is calculated by reference to a specific code number. This code can be increased to reduce the tax paid, for example, where someone is entitled to additional allowances, or reduced to increase the tax paid, for example, to recover an underpayment of tax from a previous year.

6.21 Adjusting this code could be a convenient way for customers who are in regular employment to repay a tax credit overpayment. This option is likely to be particularly attractive for customers whose overpayment relates to a tax credit award that has ended, as recovering debts via PAYE would allow them, to some extent, to replicate what happens now when an overpayment is recovered from an ongoing tax credits award.

6.22 When an overpayment arises, and the customer no longer receives tax credits, they will be offered the current options of repaying an overpayment as a lump sum or by instalments, alongside a further new option of repaying by deductions from their wages through an adjustment to their PAYE code. If customers choose to repay an overpayment through the PAYE system they would begin doing so from the April after they made this choice. The repayment should then be made evenly throughout that tax year. **Next April, HMRC will start to trial the recovery of overpayment debt using the customer's PAYE tax code.** More detail on this trial is set out in Box 6.4 below.

Box 6.4: Recovering tax credit debt via PAYE

In April 2009 HMRC will start to trial the recovery of overpayment debt, using the PAYE system. This will help to assess HMRC's ability to recover tax credit overpayments via PAYE and test the customer response to that method of recovery. The trial will cover 5,000 customers who are in stable employment and whose overpayment debt is less than £500. It will offer customers whose tax credit award has ended the option of paying back debt via PAYE as an alternative to the current arrangements. The recovery of debts in this way will be managed to prevent customer hardship.

If customers wish, they will also be able to offset any tax repayment against their tax credits overpayment debt. The trial will therefore give customers further choice in how they repay their debt, and will introduce a new option that is potentially less onerous for the customer than existing methods of recovery. HMRC will carefully evaluate the trial, and will look to offer customers the choice in the future of having their overpayment debts recovered via PAYE.

More options for repaying debt

6.23 In addition, only customers who are no longer receiving tax credits are currently offered the option of repaying their overpayment as a lump sum. This may be particularly useful for customers who have experienced a household break-up and have incurred an overpayment on their old joint award. Many customers would not be able (or wish) to repay their overpayment as a lump sum. However, for those who choose to take this option up it can give them more control over how and when they repay their debt thus improving customer service.

6.24 Similarly, some customers who are still receiving tax credits, may prefer to repay an overpayment as a lump sum rather than to have it recovered from their ongoing award. Although this option is not currently proactively offered to customers, each year around 7,000 tax credit customers with ongoing awards choose to repay their overpayment in this way. This indicates that, if this option were offered and publicised, certain customers might find it useful in helping to manage their overpayment debt. **HMRC will therefore offer all customers the option of repaying debt as a lump sum.**

Guidance for customers

6.25 To enable customers to take advantage of these choices in the way that best suits their individual circumstances, tax credit contact centre advisers will be equipped to advise customers on the effects of choosing each of these options.

End of year top-ups

6.26 A key element of the Australian reforms to reduce end-year adjustments has been the introduction of end-year supplements to Parts A and B of the Family Tax Benefit. These are part of the total tax credits award and are only payable at the end of the year, when the customers' income and circumstances for the previous year are known with certainty. They are offset against any overpayment that may have arisen, helping to reduce customers' risk of incurring an overpayment overall. Customers are also encouraged to build on this, for example, by deferring some of their tax credits award until the end of the year if they think their income or circumstances may change over the course of the year. More detail on the Australian model is provided in Box 6.5 below.

Box 6.5: The Australian system of end-year supplements

The Australian system of tax credits includes a per child payment of AU$600 per year that is paid as a lump sum after customers have lodged their tax returns and their tax credit award has been finalised. Some families get an additional per family payment of AU$300 per year that is paid in the same way. The supplements are used to partially or totally offset any overpayment incurred, markedly reducing the number of tax credit customers who incurred a debt.

In addition to the supplement payments, customers have more choice about how they receive their tax credit payments (including the option to receive some payments fortnightly, and the remainder of their entitlement in a lump sum at the end of the financial year, once the actual family income is known). Guidance has been developed to help customers to take the most appropriate choices for them, and a significant number of customers have opted to defer some of their entitlement.

End-year top-ups

6.27 The 2005 Pre-Budget Report included measures that will result in customers deferring some of their tax credit entitlement until the end of the year, to help customers who give an inaccurate income estimate or report changes late. As a result, over time, the Government expects the level of underpayments in the system to increase slightly, increasing the numbers of customers getting an end-year top-up payment.

6.28 The current tax credits IT system does not have the flexibility to allow arrangements where part of the tax credit award is deferred until the end of the year, which would give customers more choice about how they receive their tax credits awards. However, the Government is seeking views on the merits of moving towards such choice in the longer-term.

6.29 This could be a significant help to customers in minimising their risk of incurring an end-year adjustment leading to an overpayment. However, increasing choice could increase complexity in the system, which if customers are not given sufficient support, could reduce customer service. Providing appropriate support would require investment in IT so that HMRC tax credit advisers are able to advise customers effectively.

Question 6.3: The Government is therefore seeking views on whether, in the longer-term, further reforms should be introduced, building on those introduced to date, to help customers build up end-year top-up payments by, following the Australian example, giving customers more choices about how they receive their awards. An

example of such choice could be to allow customers to choose to defer some or all of the family element until the end of the year.

SUMMARY

6.30 This chapter has set out the next stage of the Government's proposed reforms to the tax credit system, building on the policy reforms to give customers more certainty laid out in the 2005 Pre-Budget Report, and now successfully delivered, and on the customer service improvements set out in Chapters 4 and 5.

6.31 Taken together, these reforms have the potential to bring about a step change in the way that customers experience the tax credit system, and to further reduce end-year adjustments leading to overpayments. They also indicate the broad direction of the Government's strategy towards giving customers more control and choice over how they receive their tax credit awards, and repay any overpayment debt.

6.32 The Government is already taking steps to deliver on this strategy by introducing new options for paying back overpayment debt. However, further steps to give customers more choice, particularly over how they receive their awards, involve balancing the benefits of increased choice against any additional complexity those choices might entail for customers. Before proceeding with further reforms, the Government is therefore keen to better understand how customers are likely to perceive the advantages and disadvantages of this approach.

Question 6.4: The Government is therefore interested in views on whether the advantages of giving customers more choice are outweighed by the risk of increased complexity in the system.

7 REFORMING THE DELIVERY OF CHILDCARE SUPPORT THROUGH TAX CREDITS

The Government is interested in exploring options for simplifying the delivery of childcare support through the childcare element of the Working Tax Credit. The evidence suggest that some customers, and particularly those with complex work patterns and childcare arrangements, may find the current system difficult to use. However, simplifying the delivery of the childcare element presents some difficult choices and trade-offs. This chapter outlines some possible ways forward for simplifying delivery of the childcare element and invites views on the various approaches to reform.

As well as maintaining the close links to work, through linking receipt of childcare support with eligibility for the Working Tax Credit, the Government wants any new system to retain the current system's objective of affordability of childcare for parents, particularly those in high-cost areas such as London. This means that any new system would, like the current system, need to be responsive to the costs parents face; and maintain incentives for parents to choose the best value form of childcare. This will maintain the positive impact that the current system has had on work incentives and is key to ensuring affordable childcare, not only for those in receipt of financial support, but for parents as a whole.

7.1 *'A ten year strategy for childcare'*[11] set out the Government's vision that every child should get the best start in life and to give parents more choice about how to balance work and family life. This strategy focuses on four key themes: choice; availability; quality; and affordability. Affordable childcare is important because supporting parents into employment and helping them to remain and progress in work is a crucial aspect of the Government's child poverty strategy, and affordable childcare is supported through financial support for parents and direct funding of the sector. While the childcare element of the Working Tax Credit represents a major component of the financial help available to parents, it is one part of the overall strategy, and this chapter looks solely at improving the delivery of the childcare element of the Working Tax Credit.

7.2 One of the most significant costs of entering and remaining in employment faced by families with children is the cost of childcare. The childcare element of the Working Tax Credit is designed to help working families by making registered childcare more affordable, helping them to find a high-quality childcare place that meets their needs. The childcare element is more generous and benefits more families than any previous system of support and has been a key driver in helping parents move into work, and to stay and progress in work. The Government is keen to build on this progress to ensure that all those families entitled to it claim this support.

SUPPORTING WORKING FAMILIES

7.3 The childcare element is part of the Working Tax Credit, reinforcing the role it plays in supporting working parents with their childcare needs. For couples to qualify for the childcare element they must both be working at least 16 hours a week (or one be working at least 16 hours and the other incapable of looking after the children, for example, because they are in hospital). Similarly, a lone parent must also work at least

[11] *Choice for parents, the best start for children: a ten year strategy for childcare,* December 2004, HM Treasury, Department for Education and Skills, Department for Work and Pensions, and Department for Trade and Industry.

16 hours to qualify. This reflects the fact that this support is intended to remove barriers to work: childcare costs are not normally a barrier for single earner couples.

More generous support with childcare costs

7.4 Compared to previous systems of support, the childcare element is significantly more generous and benefits many more families, as set out in Box 7.1.

Box 7.1: Prior systems of childcare support

Support for childcare was first introduced in 1994, as a childcare disregard in Family Credit. Under this system, income spent on childcare was disregarded for the purposes of calculating a family's Family Credit award. Disregarding the income spent on childcare costs, up to limits of £60 for one child and £100 for two or more children, increased Family Credit awards for many families. However, this system provided no additional support for families on the lowest incomes who were already in receipt of the maximum award. In total, only 32,000 families were benefiting from the disregard in 1997.

The childcare tax credit was established in 1999, as part of the introduction of the Working Families' Tax Credit. This created a more generous and better targeted vehicle for delivering support to working families, and was designed to help with childcare affordability. The childcare tax credit provided support for up to 70 per cent of eligible childcare costs (up to limits on those costs of £135 a week for one child and £200 for families with two or more children[12]). It also substantially improved the support available to the lowest income families, who did not benefit from the disregard in Family Credit. Over 160,000 families were benefiting from the childcare tax credit in 2002, receiving on average £40 a week in childcare support, over double the average support received in 1997, in real terms.

Further increases in support

7.5 Since the introduction of tax credits in April 2003, the amount of childcare support provided has been increased significantly. In April 2005 the maximum allowable costs were increased from £135 to £175 per week for families with one child; and from £200 to £300 for families with two or more children. In addition, in April 2006 the proportion of childcare costs covered was increased from 70 to 80 per cent. Most claims are significantly below these thresholds, with over 80 per cent of all claims reporting childcare costs below £150 per week.

Increasing numbers benefiting from childcare support

7.6 As a result of this increased generosity an increasing number of families are benefiting from support with childcare costs. As demonstrated in Chapter 3, the numbers benefiting have increased significantly since such support was first introduced. In 2006-07 there were 384,000 families benefiting from the childcare element, receiving an average of £59 a week help with their childcare costs. This compares to 32,000 benefiting from the childcare disregard as part of Family Credit in 1997. Provisional data for April 2008 suggests that this trend has continued, with an estimated 450,000 families benefiting from the childcare element at this point compared to 414,000 in April 2007.

7.7 As entitlement to childcare support is based on the individual childcare costs for each customer, families that incur higher childcare costs, up to the thresholds, receive more support than families with the same circumstance but lower childcare costs. Tailoring support in this way helps to ensure that families in the highest cost regions receive the largest payments. For example, provisional data for April 2008 suggests that the average help with childcare costs is nearly £90 a week in London, compared to just over £56 a week in the South West.

[12] Initially the limits were £100 and £150 respectively.

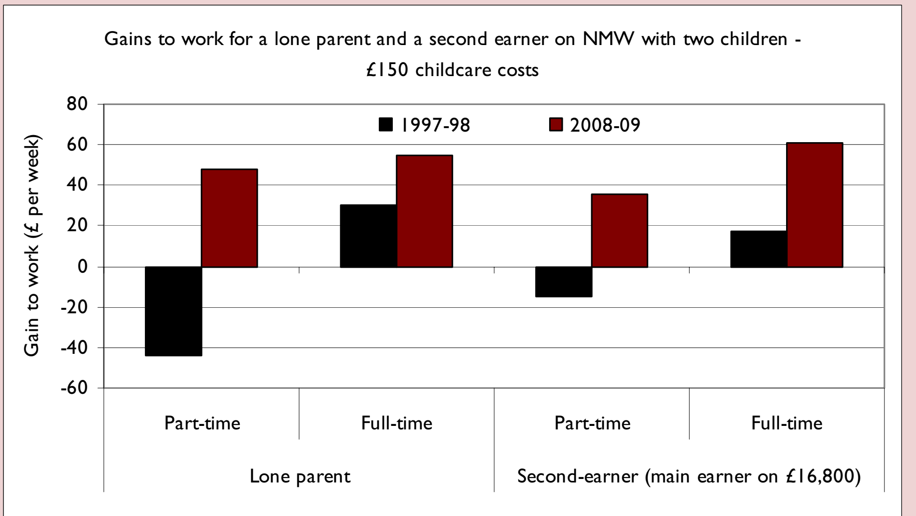
7.8 The Government recognises that costs can also vary between care provided to disabled and non-disabled children. However, most weekly costs for disabled children fall within the £175 and £300 thresholds and so there is not currently a case for separate thresholds for disabled children. The tax credit system already recognises the additional costs associated with bringing up disabled children through the disabled and severely disabled elements of the Child Tax Credit, worth up to £2,540 and £1,020 a year respectively, which are paid in addition to the child element.

7.9 Box 7.2 below, shows how the increased generosity of childcare support through tax credits, and linking the childcare element to work, have significantly improved choices for working families.

Box 7.2: Improved choices for working families

Tax credits, and particularly the childcare element, have significantly improved work incentives for second earners and lone parents. The chart below shows gains to work for a lone parent and a second earner whose partner is on half of male mean earnings (£16,800) under the 1997-98 and the 2008-09 tax and benefit systems. Gains to work are calculated as the difference between income (after childcare costs) if the individual is in work and income if the individual is out-of-work.

The chart illustrates gains to work for an individual working part-time (20 hours per week) or full-time (35 hours per week). In both cases, the individual is earning the National Minimum Wage (£5.52 per hour); has two children under 11; and childcare costs of £150 per week.



Note: Analysis in 2008-09 prices. Assumes £66 local authority rent.

This highlights the improvements in gains to work for both lone parents and second earners as a result of the tax and benefit reforms introduced since 1997. In particular, these reforms have improved gains to work for those who previously had the worst work incentives (lone parents and second earners on low pay working part-time). These increased gains to work are mainly due to increased generosity of childcare support under tax credits.

Through improving support for families with childcare costs, the childcare element of the Working Tax Credit has also helped parents achieve an improved work-life balance. These reforms therefore complement policies to give parents more choices about how to balance work and family life, including introducing enhanced maternity, paternity and adoption leave, and the right for parents to request flexible working.

ENTITLEMENT TO CHILDCARE SUPPORT IN THE CURRENT SYSTEM

7.10 As the childcare element is part of the Working Tax Credit, an eligible family will make one claim for tax credits, and receive a single weekly or monthly payment that includes their support from the childcare element, as well as from the other elements of the Child and Working Tax Credits that they are eligible to receive. Box 7.3 below explains in more detail the information used to calculate the maximum amounts of support families are entitled to receive from the childcare element.

Box 7.3: Entitlement to support from the childcare element

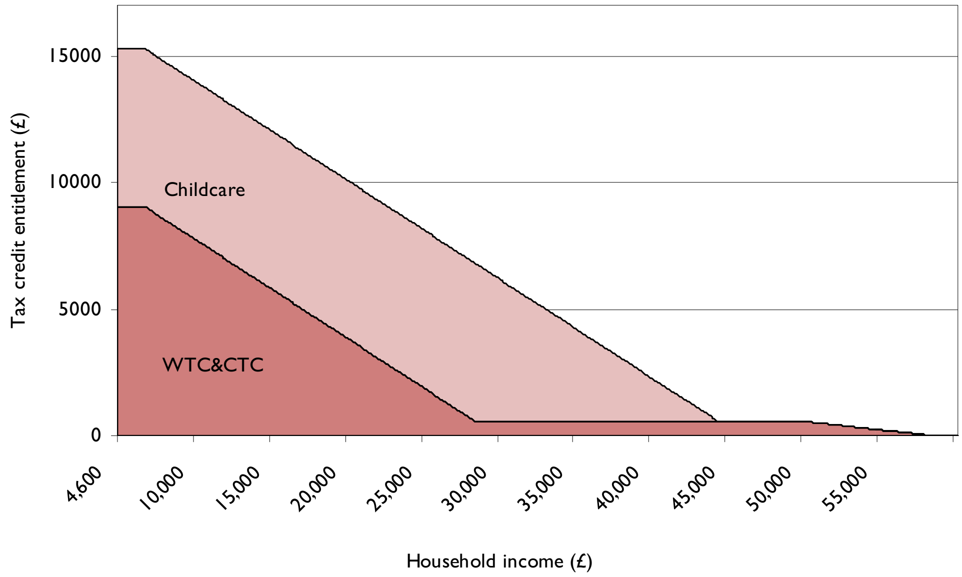
Families are required to estimate their annual childcare costs at the start of the year. They then receive payments based on their **average weekly costs**. This can be straightforward for families to calculate when their childcare costs are relatively stable across the year, however, it can be more difficult for families with more complex circumstances.

Families are entitled to receive up to 80 per cent of their maximum allowable childcare costs (£175 per week for families who pay childcare costs for one child; and £300 per week for families who pay childcare costs for two or more children). Depending on the precise level of household income, the amount of support a family receives will vary (this is explained in more detail below).

7.11 The amount of support that a family receives from the childcare element is added to all the other elements that apply to that family to calculate their "maximum tax credits". The Working Tax Credit consists of a basic element that all recipients receive and additional support that is available to those working over 30 hours a week, the disabled, and those aged 50 plus. In addition, families with children are also entitled to support through the different elements of the Child Tax Credit.

7.12 Above a certain threshold of household income, the maximum tax credit amount a family can receive is reduced at a steady rate for each extra pound earned. In 2008-09, for families in receipt of the Child and Working Tax Credits, once income exceeds £6,420, for each extra £1 earned, tax credit entitlement reduces by 39 pence. This is illustrated in more detail in Chart 7.1, which shows the amount of tax credits a dual earning couple with two children, and £150 per week childcare costs, would receive at each income level. The childcare element of the award does not start tapering away until the point where the family only receives the family element of the Child Tax Credit.

Chart 7.1: Dual earner couple with two children and £150 per week childcare costs



Source: HMRC analysis based on years 2008-2009

7.13 The precise amount of support a particular family receives from the childcare element therefore depends on their household income, as well as childcare costs incurred and the number of children using childcare. The rules for reporting and calculating changes in childcare costs were designed to respond promptly to customers' changing circumstances, while not requiring them to report every small and/or temporary fluctuation in their childcare costs. They mean that:

- if childcare costs decrease, the change does not have to be reported unless it reduces the customer's average childcare costs by £10 per week; and
- any changes for less than four consecutive weeks (and the first four weeks of any longer change) are ignored.

LEARNING FROM THE EXPERIENCE OF TAX CREDITS TO DATE

7.14 As set out earlier in this chapter, the generosity of this system has led to unprecedented numbers of families benefiting from childcare support. Box 7.4 captures some of the experiences of customers receiving the childcare element.

Box 7.4: Customer experience of the childcare element

Research with focus groups shows that most customers recognise the key role that the childcare element plays in providing a regular source of income to pay for childcare costs and, that for many customers, being able to afford childcare had fundamentally changed their employment prospects.

While customers were generally aware of the importance of the childcare element some were not aware of its precise monetary value in relation to the other tax credit elements. Evidence is mixed on the importance customers attach to transparency.

Customers were generally aware of the need to use registered childcare and found providing HM Revenue and Customs (HMRC) with the provider's registration number unproblematic. However, understanding about why providers had to be registered or who the registering bodies are varied between customers.

HMRC's 2004-05 random enquiry programme, which measured error and fraud in the tax credit system, showed that a significant number of families made errors when reporting childcare costs. Evidence suggests that some customers are not aware of the importance of keeping the childcare claim up-to-date, and also that customers find it difficult to understand the averaging rules when calculating costs.

The customer experience

7.15 From research undertaken to date, the Government is aware that some customers seem to find that the amount of childcare support they are entitled to receive:

- can be difficult to calculate correctly when their childcare costs vary through the year;
- can appear changeable in amount, as it depends on their precise income and use of childcare, both of which can fluctuate, though the £25,000 income disregard now limits the impact of income fluctuations; and
- can be difficult to identify as they get one tax credit award that includes all the support they receive from all the tax credit elements that they are eligible which does not identify the separate contribution of the childcare element.

The provider experience

7.16 Childcare providers are indirectly receiving over £1.5 billion a year through the support given for the childcare element of the Working Tax Credit each year. However, some have expressed concerns about customers falling behind with their payments, allegedly because there has been a delay in their tax credit payments, or abusing the system by enrolling their child with a registered provider, claiming the childcare element and then withdrawing their child without informing HMRC. However, there are many reasons why customers might legitimately move their child to a different childcare setting, and compliance procedures are in place to prevent abuse.

Improving the delivery of the childcare element

7.17 As with the rest of the tax credit system, the Government is keen to explore options to improve delivery of the childcare element. The remainder of this chapter sets out these issues in more detail, identifies options for addressing them, and seeks views on these options. Taking forward reforms to address the issues set out above, also creates an opportunity to look again at whether the Government has struck the right balance in making childcare payments to customers rather than to providers. This chapter therefore also assesses the advantages and disadvantages of the current approach.

7.18 This chapter discusses a broad range of policy proposals on which the Government is keen to seek views, in order to inform longer-term policy development. Implementing most of the options and approaches set out in this chapter would require additional IT support. If the Government were to adopt any of these options, it is envisaged that any new IT support for the childcare element would run alongside the current main tax credits computer and would receive customer data directly from it, thus mitigating the need for customers to report information to HMRC more than once.

MAKING CHILDCARE SUPPORT EASIER TO CALCULATE

7.19 The amount of childcare support customers are eligible to receive depends on both household income and eligible childcare costs, and some customers find it difficult to estimate these. This section therefore sets out options that address each of these issues in turn.

Simplifying the way childcare costs are calculated

Current calculation is difficult for customers with complex circumstances

7.20 The current system of calculating childcare support, based on average weekly childcare costs throughout the year, works well if childcare costs are relatively constant. However, often family circumstances are much more complex so that childcare costs vary across the year, making it more difficult for families to estimate their annual childcare costs. For example, different children may use different childcare providers, or the family may need different amounts of care at different times. As a result, significant numbers of customers are getting the calculation wrong.

7.21 An alternative approach would be for the customer to inform HMRC of actual costs, after they have been incurred, perhaps on a monthly basis. This approach would mitigate the need for a complicated calculation and increase responsiveness as the customer would be getting support for costs actually incurred. The approach is set out in more detail in Box 7.5.

Box 7.5: Simplifying the childcare cost calculation

The Smith family have two children in childcare. Their childcare costs £3.50 per child per hour. During the school terms they use registered childcare between 8 and 9am and 3 and 6pm each weekday. That equates to 40 hours across the week, and costs a total of £140 per week. However, there are 13 weeks during the year that the children are not at school. In nine of those weeks, the total childcare used per week will increase to 80 hours (£280 per week), and in the remaining four weeks, no childcare is required.

Under the current system, the Smiths are required to estimate their annual childcare costs at the start of the year. They then receive payments based on their **average weekly costs** of £154. The childcare element provides support for childcare costs incurred up to 80 per cent of a threshold of either £175 for one child or £300 for two or more children per week. Because the Smiths have two children they are entitled to benefit from the threshold of £300 per week. In this example, the maximum allowable childcare costs are therefore £123, or 80 per cent of the average cost of £154.

Provided there were no changes to household income or childcare usage, they would continue to receive the same amount of tax credits each week. This means they would receive payments during the weeks when they use no childcare, however, they would have to consider the weeks during the school holidays where their costs rise significantly and budget accordingly.

If payments were based on **actual costs incurred**, the Smiths (or their chosen childcare provider) would inform HMRC on a monthly basis of the childcare costs they had actually incurred. In each month, they would receive a set proportion of the costs incurred in that month, with the amount of support received varying, depending on household income. In this proposed approach, however, since payment would be made in arrears the amount received in any particular week or month would not always match the costs being incurred in that week or month.

7.22 Although basing payments on actual costs incurred would reduce complexity for customers, it would require payments to customers to be made in arrears. Such a model could create cash flow difficulties for some parents, particularly those whose childcare providers charged in advance.

7.23 In any case, details of these costs would have to be provided either by the customer or by the childcare provider. Either way, a significant new burden would be placed either on customers or on the provider to regularly report costs to HMRC. This would also generate a significant increase in numbers of calls to HMRC. Under a system where customers provide costs, they would maintain the same control as under the current system. Requiring the provider to report costs would be much simpler for the customer, at the expense of taking control away from the parent, and creating new burdens for childcare providers. This would be particularly complicated where customers use more than one provider, for example, during school terms and school holidays, or for different children.

7.24 Under a system based on actual costs, customers could still incur an overpayment if their use of childcare differed from the details provided to HMRC. They could also arise if the customer overestimates an income fall or, in the renewal window, if the customer does not accurately report an income rise in good time, or underestimates an income rise. Requiring providers to supply details of costs incurred could also present challenges around how and from whom an overpayment resulting from inaccurate reporting of childcare costs incurred is collected if they were to provide HMRC with the wrong information.

Question 7.1: The Government seeks views on whether basing childcare support on actual costs incurred, and therefore paid in arrears, would simplify the system for customers, or create problems for customers and/or providers in managing their cash flow. If such a system were adopted, the Government would also welcome views on whether customers or providers should have responsibility for informing HMRC about childcare costs incurred.

Simplifying the way income relates to childcare support

7.25 The fact that the precise amount of support a particular family receives from the childcare element depends on total household income, with support being tapered away once income reaches a set threshold, means that the childcare element:

- offers the greatest amount of support to those who need it most (those on the lowest incomes, or with the highest childcare costs); and
- ensures that, as well as helping to lift the barriers to work, it protects incentives to progress in work by tapering away support gradually.

7.26 However, as described in Chapter 6, some customers find it difficult to estimate their annual income, especially when this changes during the year. The increase in the income disregard to £25,000 has largely eliminated overpayments as a result of income rises in-year. However, if customers do not report an income increase, or they underestimate it, they can still incur an overpayment during the renewal window, when the award is based on the latest income figure supplied.

Income banding

7.27 One way of simplifying the calculation of income would be to move from a system based on exact income estimates to a system, similar to that in New Zealand, where childcare support is calculated by putting the customer's income into a 'band of entitlement'. This would mean that customers with broadly similar incomes would effectively have the same entitlement to childcare support. Box 7.6 sets out the New Zealand model of childcare support in more detail.

7.28 The 'income bands model' set out here would not work in the same way as the model set out in Chapter 6. Entitlement to support through the childcare element would depend on the band the family's income fell within, and their entitlement to support would not be recalculated on a different basis at the end of the year.

Box 7.6: The New Zealand system of childcare support

In New Zealand, entitlement to childcare subsidy is calculated by assigning the customer's income to one of three income bands. They are then entitled to a set rate of support per hour, which varies according to how many children they have. The subsidy is paid direct to the childcare provider, with parents topping up any fees outstanding. The following table shows the latest childcare subsidy rates.

	Weekly household income (gross)	Per child, per hour, subsidy
1 child	< NZ$1,200	NZ $3.40
	< NZ$1,300	NZ $2.36
	< NZ $1,400	NZ $1.31
2 children	< NZ $1,380	NZ $3.40
	< NZ $1,490	NZ $2.36
	< NZ $1,600	NZ $1.31
3 children	< NZ $1,540	NZ $3.40
	< NZ $1,670	NZ $2.36
	< NZ $1,800	NZ $1.31

While paying support in three bands is a much simpler system for customers to understand it has inevitable cliff edges, so that the amount of support customers receive can fall significantly following a small rise in income. It is also tapered away separately to the main tax credits system, meaning that some individuals can face high Marginal Deduction Rates.

Increased transparency for customers

7.29 A system of this kind could increase the transparency of childcare support by making it clearer to customers what they would be entitled to receive at different income levels. If the Government introduced such a system of income bands, it would retain the current approach of linking receipt of childcare support to eligibility for the Working Tax Credit and of paying customers a set percentage of their eligible costs, rather than paying a set rate of subsidy as in New Zealand. Doing this would help to keep the costs of childcare down and also ensure that customers living in areas where childcare costs are highest get the greatest support.

7.30 In the current system, all customers are entitled to receive up to 80 per cent of their eligible childcare costs, with support tapered away according to household income. In an income bands model the percentage of support offered would depend on the customer's income level, with customers on higher incomes receiving a lower percentage of their eligible childcare costs. This would wholly or partly replicate the effects of the current taper rate, with customers moving between income bands as their income increased and decreased. An illustrative model is set out in detail in Box 7.7.

Box 7.7: An illustrative model of an income bands system

An income bands system could be based on any number of income bands. The table below sets out how an income bands model could be designed. The advantage of setting wider and fewer income bands is one of transparency for the customer. An income bands model could provide broadly the same, or better levels of support than the current system.

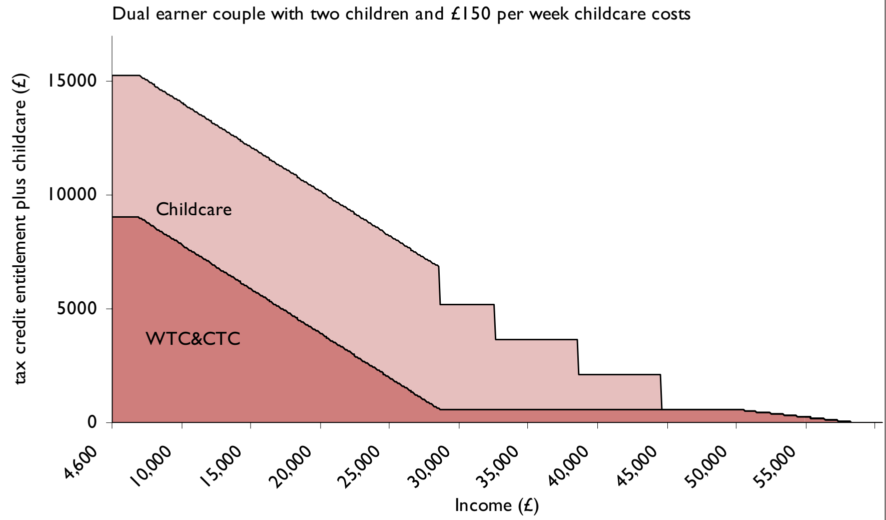
Number of children	Household income	Support with childcare costs
1 Child	< £22,000	80 per cent
	< £26,000	60 per cent
	< £30,000	40 per cent
	< £40,000	20 per cent
2+ Children	< £28,000	80 per cent
	< £32,000	60 per cent
	< £38,000	40 per cent
	< £44,000	20 per cent
Disabled Child	< £36,000	80 per cent
	< £40,000	60 per cent
	< £46,000	40 per cent
	< £50,000	20 per cent

7.31 In contrast to the current system's smooth taper, an income bands system would introduce some cliff edges at the stepping points between bands. That could create some disincentives to progress in work, which would be partly mitigated by the income disregard in the current year. There is an obvious trade-off here: fewer income bands would lead to a simpler system, but the stepped increases and decreases in support would be fairly significant. More income bands would reduce simplicity but the step increases and decreases could be less dramatic. Box 7.8 illustrates the effect that calculating entitlement to the childcare element on the basis of income bands might have on a family's overall entitlement at various income points.

Box 7.8: Withdrawal of childcare support under an illustrative model of an income bands system

For those in receipt of the Child and Working Tax Credits with income above £6,420, tax credits are currently withdrawn at a rate of 39 pence for every additional pound earned. Because the Child Tax Credit, Working Tax Credit and the childcare element of the Working Tax Credit are all part of the same system, the tax credit withdrawal rate does not exceed 39 per cent.

Paying childcare support alongside the Child and Working Tax Credits requires childcare support to be withdrawn separately to tax credits. The chart below shows the support a dual earner couple with two children, and £150 per week childcare costs, would receive at each income level if the illustrative income bands model outlined in Box 7.7 were implemented.



Source: HMRC analysis based on years 2008-2009

This chart illustrates that an income bands model can be designed to ensure that, as currently, the majority of families do not have their childcare support withdrawn at the same time as having the Child and Working Tax Credits withdrawn. However, an income bands model would change the way childcare support is withdrawn once the family is receiving only the family element of the Child Tax Credit, creating sharp steps beyond this point.

These steps would affect families in different ways. They would not affect families whose income increased but stayed within the same income band. In contrast, families who experienced an income increase that pushed them into a different band could see a decrease in support (though the £25,000 income disregard would protect families from this effect in-year). Similarly, families whose income fell but stayed within the same income band would not see any increase in support, whereas families whose income fall pushes them into a different income band could see a substantial increase in support.

It is difficult to determine what impact an income band system would have on the behaviour of families. It is clear, however, that an income band system, while simpler for customers, could distort decisions to progress in work and could produce 'rough justice' for families just either side of a step.

7.32 Support for childcare under an income bands model would effectively be paid separately from the rest of the tax credit system. However, to minimise the burdens on customers, and to maintain the links with work, income information gathered by HMRC to determine eligibility for the Working Tax Credit would be used to inform the customer and HMRC of the correct income band for entitlement to help with childcare costs.

Question 7.2: The Government seeks views on whether basing entitlement to childcare support on income bands, rather than a precise income level, would simplify the system for customers relative to the current system.

Question 7.3: The Government would also be interested in views about the appropriate balance between minimising the number of income bands to provide simplicity, and ensuring that customers do not face significant decreases in support (cliff edges) as their income increases.

Summary

Reducing customer error

7.33 Both the approaches outlined above should make it easier for customers to calculate and understand the childcare support they are eligible to receive, and so should reduce customer error. However, basing childcare support on actual costs would put new obligations on customers or childcare providers to supply information to HMRC and could create cash flow problems for customers or providers. Basing entitlement to childcare support on income bands would also reduce the extent to which support is tailored to the precise level of the customer's income, thus potentially reducing incentives to progress in work.

Increased transparency

7.34 Paying childcare support separately to the rest of tax credits, based on income bands, would also make the system more transparent for the customer. Under such a system the customer would be able to clearly see the level of support provided at a certain income, with variable entitlement based on factors that could include number of children and whether or not they had any disabled children. This would help make decisions about a return to work and/or progression in work easier.

7.35 By paying support based on a broader measure of customer income, income bands will also reduce the apparent changeability of payments (which has already been reduced by the increase in the income disregard to £25,000). However, this will not be fully eliminated and the following section discusses options to go further.

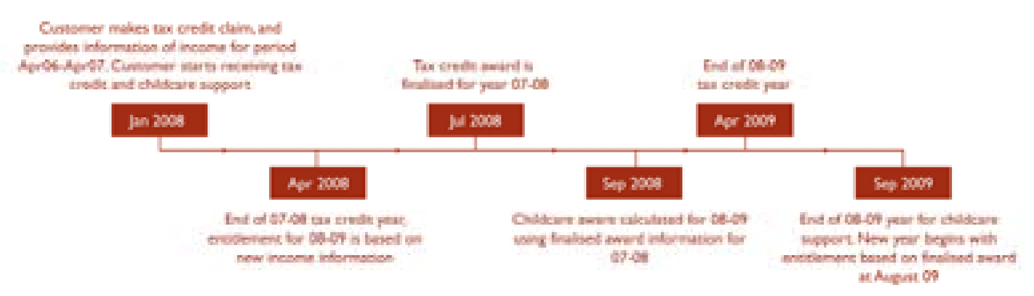
GIVING GREATER CERTAINTY TO CUSTOMERS OVER THEIR CHILDCARE SUPPORT

7.36 The current system of childcare support responds quickly to families' changing circumstances, including changes in income. This means recalculating entitlement whenever household income changes, and a small change in household income can alter the level of entitlement. While the effects of income rises have been largely mitigated by the increase in the income disregard to £25,000, this responsiveness to income can mean that the amount of childcare support customers receive can appear to be changeable when they experience an income fall; and families must tell HMRC about income changes to keep their awards up-to-date.

7.37 One approach to reduce this variability and so increase certainty would be to establish entitlement to the childcare element for the whole of the school year ahead (September to September), but base it on the income used to finalise the tax credit award for the tax year just ended. Box 7.9 sets out how this model might work.

Box 7.9 Basing entitlement to the childcare element on previous year's income

Under the current responsive system entitlement to childcare support is finalised at the end of the tax year using current year income. Moving to a school-year system based on the previous year's income would do more to provide certainty for customers around childcare support, but at the expense of its ability to respond to in-year reductions in a family's income. The following diagram illustrates how such a system would work for a customer who makes a new tax credit claim on 1 January 2008.



Because the customer has claimed during the 2007-08 year, entitlement is determined on the basis of their household income during 2006-07. The Child and Working Tax Credits are awarded up to 5 April 2008, while a separate but linked award for childcare support is made until the 31 August 2008, to align with the school year.

7.38 While this would give customers more certainty over the level of childcare support, this would be at the expense of being less responsive to income falls. As set out in Annex A, any steps to mitigate this would substantially increase the overall complexity of the system. Coupling this approach with the income bands proposal set out previously could potentially mitigate this effect for some customers as the bands would reduce the extent to which levels of support varied with changes in income.

7.39 Like the income bands model, this option would need to be delivered separately to the rest of tax credit system while continuing to be linked to the Working Tax Credit.

Question 7.4: The Government seeks views on the advantages and disadvantages of increasing certainty for customers over their entitlement to childcare support, by basing entitlement to childcare support on the school year and on the previous year's income.

INCREASED TRANSPARENCY OF CHILDCARE SUPPORT

Simplifying the claims process

7.40 As well as linking payment of the childcare element to the Working Tax Credit, and therefore reinforcing the links with work, establishing entitlement to childcare support as part of a single claim for tax credits has made it easier for families to claim, and not to overlook, their entitlement to childcare support. That may also explain the significant increase in the numbers of families receiving support for childcare costs since the introduction of tax credits. However, as customers receive a single weekly or monthly payment to cover their total tax credit award they can be unclear as to the amount of that payment that actually relates to their childcare support.

7.41 Evidence around whether or not customers prefer to receive one payment for all support or a separate payment for childcare support is mixed. However, by paying childcare support separately to the main tax credits award, some of the options set out earlier in this chapter could help increase transparency while preserving the advantages of the current system, namely eliminating the need for a separate application for childcare support. As explained previously, in any new system, income gathered by HMRC to determine eligibility for the Working Tax Credit would be used to inform the customer and HMRC of the correct income to determine entitlement to help with childcare costs.

METHOD OF PAYING CHILDCARE SUPPORT

7.42 In line with the National Childcare Strategy commitment to encourage parents to use safe, good quality childcare, the childcare element is only payable if the customer uses registered or approved childcare. Being registered or approved indicates that the provider has met certain minimum standards of safety and quality.

7.43 Under the current system the Government pays childcare support as a cash payment to parents as part of their overall tax credit award. The parent is responsible for using this money to purchase childcare from a registered or approved childcare provider. HMRC undertakes checks to ensure that the childcare element is being used for registered or approved childcare and follows up cases where that is in doubt.

7.44 This system has the advantages of putting money in the hands of the parents, therefore reducing stigma and emphasising their clear right to choose and change registered providers, and is therefore consistent with much of the financial support system. However, there is a risk that some customers may, perhaps unwittingly, be purchasing childcare from an unregistered provider, having removed their child from a registered provider after putting in their claim, thus incurring overpayments.

Payment to providers

7.45 It has been put to the Government that making payments directly to childcare providers could ensure that payments are only made to registered providers. The Government already has experience to draw on from paying childcare providers directly through the universal offer of 12 and half hours free early years education to three and four year olds, although the administrative processes would likely be different as this would be paid centrally rather than through local authorities.

7.46 Payment to providers could be implemented alongside any of the possible changes set out earlier in this chapter. Making a payment direct to a provider essentially entails moving away from providing any monetary support directly to parents and instead paying the providers for the childcare used by eligible tax credit customers. In practice this would involve providers registering with HMRC and providing details of customers and their individual costs, perhaps on a monthly basis, in arrears.

7.47 This approach could help customers to be sure that their chosen provider was registered with the Office for Standards in Education (Ofsted) (or equivalent in Scotland, Wales and Northern Ireland) as only registered childcare providers could register and claim from HMRC. However, it may reduce customers' financial control. Another option that would achieve the same objective would be to give parents a voucher that could be used to purchase formal childcare, or having payment by some form of credit system. Like the current system, the voucher could entitle customers at different income levels to receive a set proportion of their childcare costs.

7.48 Just under nine out of ten families are entitled to receive tax credits, which has helped reduce stigma relative to previous systems of support. Vouchers, on the other hand, could potentially be stigmatising, because as well as revealing that the family is claiming tax credits, they would also reveal the amount of support they receive, making it possible to infer their household income. They could also present a new risk of secondary markets in childcare vouchers emerging, and so the Government would want to be certain that it had robust anti-fraud measures in place if it were to pursue this option. In the longer term, the Government is interested in exploring the feasibility of eliminating this potential stigma, and the risk of fraud, by making payments electronically to the provider. Box 7.10 below sets out how such a system might work.

Box 7.10: A possible model for making electronic payments to providers

One way of delivering a reformed childcare element could be through a joint account that could be accessed by the provider and paid into by the customer and HMRC. This system would not have to involve a physical card but could simply be an account provided by a third party. It would require both the customer and HMRC to put sufficient money into the account to meet the childcare costs incurred. This would also require a form of registration for providers to enable them to withdraw money from the account.

Such a system would ensure payments were only made to registered providers. It would also ensure that the amount of Government support a particular customer receives would bee invisible to their childcare provider, since they would receive one payment from the joint account which combines the money contributed by HMRC and the customer. However, this would be complex to deliver and would require a large number of information flows that would involve active participation from providers and customers. The Government would also want to put robust defences in place to ensure the accounts were not vulnerable to attack from fraudsters.

Question 7.5: The Government seeks views on whether the current system, where payments are made to the customer, remains the right approach going forward.

CONCLUSION

7.49 This chapter has identified a number of options to improve delivery of the childcare element by addressing some of the areas of concern that have emerged from the experience of the tax credit system to date. The following table summarises the key options and trade-offs involved in taking these forward:

Option	Advantages	Issues to consider
Basing childcare support on actual costs incurred	Makes it easier for customers to calculate the amount of childcare support they are entitled to receive.	Customers or providers would be required to provide more information to HMRC more frequently. Increased frequency of calls to HMRC's contact centres.
Income Bands	Makes it easier for customers to calculate the amount of childcare support they are entitled to receive. Separating childcare support from the main tax credit system, will increase transparency around the amount of childcare support customers receive.	Depending on the width of income bands could create some disincentives to progress in work.
Aligning with school year and basing entitlement on previous year income	Makes it easier for customers to calculate the amount of childcare support they are entitled to receive, and provides customers with more certainty over the childcare support they are entitled to receive. Separating childcare support from the main tax credit system will increase transparency over the amount of childcare support customers receive.	Loss of responsiveness to income falls. Potential disjoint between the basis for the main tax credit award and for childcare support.
Making payments directly to the provider	Ensures childcare support is only spent on registered childcare providers. Gives customer more security in knowing that childcare is registered and approved.	Takes financial control for childcare support away from the parent. Potential for stigma.
Making payments to customers through a voucher or credit system.	Ensures childcare support is only spent on registered and approved childcare providers.	Potential for stigma by making support visible to providers. Could create risk of fraud through a secondary market.

Question 7.6: The Government is interested in identifying all options to simplify the delivery of childcare support through the tax credit system. In particular, it is interested in views on the options identified in this chapter.

8 How to respond

8.1 The Government invites responses to the issues raised in this discussion paper. The Government would welcome responses by 5 September 2008.

8.2 Please ensure that your responses to this paper reach us by the closing date. We cannot guarantee to consider your response if it arrives after that date.

Responses should be sent to:

Tax credit discussion responses

Work Incentives and Poverty Analysis Team

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Email: tax.credits@hm-treasury.gsi.gov.uk

8.3 This paper is available on the Treasury's public website at www.hm-treasury.gov.uk. For hard copies, please use the contact details above.

8.4 When responding, please state whether you are responding on behalf of an individual or representing the views of an organisation. If responding on behalf of an organisation, please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

Confidentiality

8.5 Information provided in response to this discussion, including personal information, may be published or disclosed in accordance with the access to information regime. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act (DPA) and the Environmental Information Regulations 2004. If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality will be maintained in all circumstances.

8.6 In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded for the purpose of publishing responses unless an explicit request for confidentiality is made in the body of the response.

8.7 Subject to the previous two paragraphs, if you wish part (but not all) of your response to remain confidential, please supply two versions, one with the confidential information deleted, and another confidential version for use by HM Treasury.

8.8 Any FOIA queries should be directed at:

Correspondence and Enquiry Unit
Freedom of Information Section
HM Treasury
1 Horse Guards Road
London, SW1A 2HQ
Telephone: +44 (0)20 7270 4558
Fax: +44 (0)20 7270 4681
Email: public.enquiries@hm-treasury.x.gsi.gov.uk

Code of practice for written consultation

8.9 This process is being conducted in accordance with the consultation criteria in the Cabinet Office Code of Practice, which sets down the following criteria:

- Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy;
- Be clear about who may be affected, what questions are being asked, and the timescale for responses;
- Ensure that your consultation is clear, concise and widely accessible;
- Give feedback regarding the responses received and how the consultation process influenced the policy;
- Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator; and
- Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

A full version of the code can be found at: www.cabinetoffice.gov.uk/regulation/consultation/code/index.asp

8.10 If you feel that the consultation does not satisfy these criteria, or if you have any complaints about the process, please contact:

Luke McInerney
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ
Telephone: 020 7270 4517
Email: luke.mcinerney@hm-treasury.gov.uk

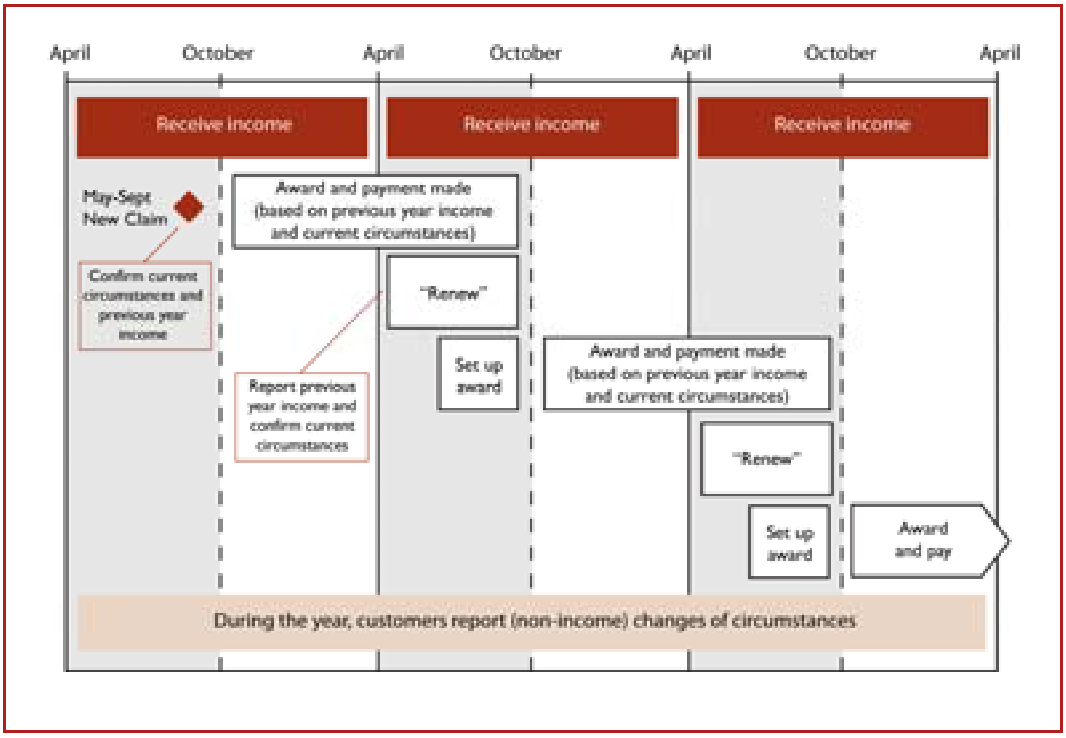
A HOW WOULD A FIXED SYSTEM OF TAX CREDITS WORK?

A.1 This annex describes how a fixed annual system of tax credits would work, illustrating in more detail why it would have the outcomes described in Chapter 2. A fixed annual system would mean that entitlement would be established, and tax credit awards calculated, on the basis of (known) income in the previous year; and awards would remain fixed for the whole year, whatever happened to family income. In the current system, the £25,000 income disregard provides this certainty for customers experiencing income rises, but a fixed system would also disregard all reductions in income.

A.2 Designing a fixed system of tax credits would involve two key considerations: whether, and how, to deal with the consequences of income falls, and how to respond to non-financial changes (for example, numbers of children or hours of work). These are dealt with in turn in this annex.

RESPONDING TO CHANGES IN INCOME

A.3 In a fixed system, entitlement to tax credits can only be calculated once a family's annual income is known with certainty. For most employed customers, this is in May when they receive their annual P60 setting out their earnings over the previous tax year. Applications could therefore be made for a fixed system of tax credits from May, using earnings data for the previous tax year. However, payments for that award period would not start until the following autumn, to enable the information given by customers to be processed and verified by HM Revenue and Customs (HMRC). This gap between the period over which income is measured, and the payment year when tax credits are paid out, is necessary to avoid having a renewal window, during which payments would be based on out-of-date or unconfirmed information with the potential for overpayments to be generated. A possible new claim and renewal cycle is set out below.



Delays responding to income falls

A.4 Whereas under the current system families experiencing a fall in income can see their tax credit award adjusted almost immediately, a fixed system would not allow awards to respond to income and other life changes as they happened. In particular, under a fixed system of the sort described in the diagram above, awards 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. To understand why, it is useful to compare a fixed system of tax credits with the existing system, using an illustrative example. This takes the case of Catherine who, at the start of the tax year in April 2010, is in a job paying £18,000 a year and is receiving tax credits. In October 2010 she moves into a new job paying £12,000 a year. Table A.1 illustrates how her tax credit award responds to her falling income in the current system of tax credits, and in a fixed system of tax credits.

Table A.1: an illustration of the effects of falling income under a fixed annual system

	Tax credit payment under current system	Tax credit payment under fixed income system, with a staggered payment year
October 2010	Under the current system, payments are based on the income in the current year, and adjust as soon as the customer reports an income fall. Following her income fall in October 2010, Catherine's annual income for the 2010-11 tax year decreased to £15,000, and her payments increase.	No change, as this year payments are based on income in the 2009-10 tax year which was unchanged by Catherine's fall in income in October 2010.
April 2011	New payment year begins, with payments based on income in the 2011-12 tax year, when Catherine's annual income fell to £12,000. Her payments therefore increase again.	Again no change, as payments are fixed until the start of the new payment year in October 2011.
October 2011	No change, as Catherine's tax credit payments have already fully adjusted.	New payment year begins, with payments based on income in the 2010-11 tax year. In this year Catherine's income fell to £15,000 and her payments therefore increase.
October 2012	No change, as Catherine's tax credit payments have already fully adjusted.	New payment year begins, with entitlement based on income earned in the 2011-12 tax year when Catherine's income fell again to £12,000. Her payments therefore increase again to adjust fully to her income fall.

Delays responding to income falls

A.5 These time lags in responding to income changes mean that under a fixed system the money provided does not reflect the income and circumstances of people such as Catherine at the time when they would most need this additional support. Chapter 3 showed that under the current system there are significant numbers of families benefiting from increased tax credit awards as a result of an income fall. All these families would therefore lose out from a fixed system.

A.6 If the Government wanted to mitigate the consequences of these long response lags, it would, of course, be possible to establish a separate 'hardship mechanism' or safety net that provided some form of increased support, such as a one-off monthly payment for families with large falls in income. However, to create a fair and effective safety net, hardship payments would have to be set according to a family's income and circumstances, which would add another level of complexity and administrative burden to the system. Providing additional support for those who experienced a large income fall, or were in hardship, would essentially mean replicating the current system of tax credits to sit alongside the fixed system.

RESPONDING TO OTHER CHANGES IN CIRCUMSTANCES

Changes in non-financial circumstances

A.7 In addition to income, entitlement to tax credits also depends on the numbers of hours worked, the numbers and ages of any children, the amount of any eligible childcare costs and whether the customer or any of their children have a disability. As well as basing tax credit entitlement on previous years' income, a fixed system could also reduce the responsiveness of the tax credit system to changes in non-financial circumstances.

A.8 A key difference between income and these non-financial circumstances is that such circumstances can be more accurately observed by the customer in-year. As a result, there are more choices about how to respond to changes in non-financial circumstances. These range from the least flexible (fully fixed, as for income), to the most flexible (essentially the current system which responds flexibly and quickly to such changes).

A.9 In a similar way to income, it would be possible to fix a family's circumstances (for example, the number of children) at the start of a year and pay their award on that basis. This was the basic model for the Working Families' Tax Credit and Family Credit. However, this would mean that families' tax credit awards would not be adjusted when circumstances changed, and increased support would await the next award. It would also be difficult to establish a fair point to fix customer circumstances, either a single point in time or apportioning costs across the year.

One-way bets

A.10 An alternative approach would be to operate a system of one-way bets whereby awards would be adjusted immediately following a change that increases entitlement (for example, the birth of a new child), but would not adjust until the end of the relevant award period if a change occurs that reduces entitlement (for example, a child leaving home). If the current amounts were maintained for each element of tax credits, a system of one-way bets would be significantly more expensive than the current system of tax credits, costing up to £500 million more if combined with a fixed income approach. This is because customers would continue to be paid a higher amount even after they had ceased to be in the circumstances that entitled them to the award in the first place. Like lags in responding to income changes, this would also reduce effective targeting of tax credits.

Run-ons **A.11** A more limited alternative would be to operate a system of run-ons. Like one-way bets awards would be adjusted immediately following a change that increases entitlement. However, following a change that reduces entitlement, the customers' tax credit award would continue for a set period as though the change had not occurred. As the run-on of entitlement would not be as long as under a system of one-way bets, this option is likely to be less expensive than a system of one-way bets though more expensive than the current system.

A.12 At the other end of the spectrum, awards could be responsive to changes in circumstances, as in the current system. This would be less expensive than the proposal for one-way bets or run-ons and would also mean awards would reflect current non-financial circumstances. However, it would still mean an appreciable level of overpayments as failure to report changes in non-financial circumstances promptly remains a significant cause of overpayments.

NON ANNUAL SYSTEMS OF ENTITLEMENT

A.13 The discussion above explained that a fixed annual system of tax credits would be less responsive to customers' needs, and potentially significantly more expensive, than the current system. One way of mitigating these downsides could be to shorten the period for which the awards runs, for example to three or six months. This would mean that customers waited for less time before their next award reflected a change in their circumstances, however it would be more difficult to determine and check the income on which the award is based.

A.14 Awards could be based on income in a snapshot period, for example the last six weeks, or based on income in the previous six months. However the income tracking research referred to in Chapter 4 demonstrated that using short snapshots could lead to families seeing arbitrarily high or low awards that do not reflect their position over the year as a whole. This is exacerbated by the fact that tax credit awards take into account other sources of income, such as savings income, that do not readily fall into shorter periods.

A.15 In addition, anecdotal evidence suggests that using a snapshot under the Working Families' Tax Credit created incentives for people to lower their income during the assessment period (for example, by not undertaking overtime) thus boosting their entitlement. The resulting awards were based on an unrepresentative, but legitimate, income assessment. This would be difficult to determine, and therefore potentially very costly for the Exchequer with the extra money being (by definition) poorly targeted on the families in greatest need.

A.16 Shorter award periods could also increase the administrative burden of the system, as customers would need to submit more than one claim per year. Basing awards on a snapshot would also require customers to report their income from their payslips covering the relevant weeks or months. This would be more cumbersome for the self-employed, who may have to produce accounts for short periods.

SUMMARY

A.17 This annex has described why a system of fixed annual award would be less responsive to changes in income and, potentially, other non-financial circumstances. If the same tax credits elements were maintained, the Exchequer cost of such a system could be up to £500 million higher than that of a responsive system while being less effectively targeted. This means that those families most reliant on support would benefit least. One way of mitigating these downsides could be to shorten the period for which the awards runs, for example to three or six months. This would mean that customers waited for less time before their next award reflected a change in their circumstances, however it would be more difficult to determine and check the income on which the award is based. Given these trade-offs, the Government has decided that 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.

B INFORMATION ABOUT IN-YEAR INCOME FALLS

B.1 Chapter 3 explained that tax credit payments can adjust quickly, to provide more support to households experiencing income falls. The experience of the tax credits system to date, has reinforced the importance of this flexibility. Table B.1 below shows that in 2006-07 720,000 households experienced income falls which increased their entitlement to tax credits. The table allows this group to be analysed, both by the size of the income fall experienced, and the level of the household income after the income fall.

Income falls

B.2 The table shows that in 2006-07, around 230,000 families experienced an income fall of less than £1,000. However, a substantial number of families saw much larger income drops; in particular, around 410,000 families with incomes below £25,000 had income falls of £1,000 or more, including 100,000 families with incomes below £15,000 who had experienced falls of £5,000 or more.

Table B.1: Families ('000s) experiencing falls in household income (2006-07)

Fall in household income	Range of household income (after income all)									
	Up to £5,220	£5,220 - £10,000	£10,000 - £15,000	£15,000 - £20,000	£20,000 - £25,000	£25,000 - £30,000	£30,000 - £40,000	£40,000 - £50,000	Over £50,000	All
Under £1,000	9	82	56	39	23	9	3	1	6	228
£1,000 - £2,000	11	33	26	20	13	5	2	1	4	116
£2,000 - £3,000	10	20	16	13	9	3	1	2	3	78
£3,000 - £5,000	16	23	20	17	11	4	2	4	4	101
£5,000 or Over	30	35	37	32	19	8	10	19	8	197
TOTAL	77	193	155	122	74	29	18	26	25	720

Source: HMRC analysis.

Increased support from tax credits

B.3 Table B.2 below illustrates how the current flexible system of tax credits responds to these income falls. This shows that, of the 720,000 families experiencing an income fall in 2006-07, nearly 500,000 families saw their tax credit award increase by up to £1,000 as a result of the income fall. This included around 100,000 families with incomes below £20,000 who saw an increase between £500 and £1,000. There were also a significant number of families who saw a more substantial increase in entitlement, including 155,000 families with incomes of less than £15,000 who gained £1,000 or more, and among these around 45,000 families who gained £3,000 or more.

Table B.2: Families ('000s) benefiting from increased tax credit entitlement following an income fall (2006-07)

Increase in tax credit entitlement	Range of household income (after income fall)									
	Up to £5,220	£5,220 - £10,000	£10,000 - £15,000	£15,000 - £20,000	£20,000 - £25,000	£25,000 - £30,000	£30,000 - £40,000	£40,000 - £50,000	Over £50,000	All
Under £1,000	43	130	96	77	52	22	15	25	25	485
£1,000 - £2,000	16	32	28	26	15	5	2	1	0	126
£2,000 - £3,000	8	14	16	11	4	1	1	0	0	56
£3,000 - £5,000	6	12	12	6	2	1	0	0	0	40
£5,000 or Over	4	5	3	1	0	0	0	0	0	14
TOTAL	77	193	155	122	74	29	18	26	25	720

Source: HMRC analysis.

C LIST OF QUESTIONS

Question 6.1: The Government would be interested in views on the benefits, in a UK context, of introducing a system of income bands.

Question 6.2: The Government would therefore welcome views on whether further run-ons of entitlement should be introduced, including for customers whose hours fall below 30 hours a week.

Question 6.3: The Government is therefore seeking views on whether, in the longer-term, further reforms should be introduced, building on those introduced to date, to help customers build up end-year top-up payments by, following the Australian example, giving customers more choices about how they receive their awards. An example of such choice could be to allow customers to choose to defer some or all of the family element until the end of the year.

Question 6.4: The Government is therefore interested in views on whether the advantages of giving customers more choice are outweighed by the risk of increased complexity in the system.

Question 7.1: The Government seeks views on whether basing childcare support on actual costs incurred, and therefore paid in arrears, would simplify the system for customers, or create problems for customers and/or providers in managing their cash flow. If such a system were adopted, the Government would also welcome views on whether customers or providers should have responsibility for informing HMRC about childcare costs incurred.

Question 7.2: The Government seeks views on whether basing entitlement to childcare support on income bands, rather than a precise income level, would simplify the system for customers, relative to the current system.

Question 7.3: The Government would also be interested in views about the appropriate balance between minimising the number of income bands to provide simplicity, and ensuring that customers do not face significant decreases in support (cliff edges) as their income increases.

Question 7.4: The Government seeks views on the advantages and disadvantages of increasing certainty for customers over their entitlement to childcare support, by basing entitlement to childcare support on the school year and on the previous year's income.

Question 7.5: The Government seeks views on whether the current system, where payments are made to the customer, remains the right approach going forward.

Question 7.6: The Government is interested in identifying all options to simplify the delivery of childcare support through the tax credit system. In particular, it is interested in views on the options identified in this chapter.

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