Tax credits

HM TREASURY AND INLAND REVENUE – OCTOBER 2001

1. This paper describes:-

   a. the aims and principles behind the Government's tax credits;

   b. the key features of current tax credits and their success to date; and

   c. the "new tax credits" which represent the next stage of tax and benefit reform.

Aims and principles

2. The Government's 1997 manifesto promised " to examine the interaction of the tax and benefits systems so they can be streamlined and modernised, so as to fulfil our objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening community and family life"

3. Since 1997, in pursuit of that commitment, the Government has set out to:-

   a. tackle welfare dependency, by ensuring that people are better off in work compared to being on benefit;

   b. strengthen families by giving more support to all families with children, who had lost out in the previous twenty years; and

   c. reduce child poverty, by providing most help to those who need it most.

Achievements so far

4. Over the last Parliament, the Government introduced two tax credits for families with children:-

   a. the Working Families' Tax Credit (WFTC), which was introduced in October 1999, replacing Family Credit;

   b. the Children's Tax Credit (CTC), which was introduced in April 2001 replacing the Married Couples' Allowance.

5. These two targeted tax cuts now cost an additional £2.4bn compared to spending on Family Credit and the Married Couples' Allowance in 1996-97, although the net cost is much lower since up to £700 million has been directly saved from the estimated 160,000 increase in labour supply from tax credits and other measures, part of the £4bn saving on the costs of unemployment since 1996-7 from job creation and making work pay. In addition, separately from tax credits, £1.7bn extra per year is now being spent on universal child benefit and

related spending. These costs compare to an extra £33bn on health and education (more detail is provided in annex A).

Working Families' Tax Credit

6. The WFTC has succeeded in its aims, both making work pay for families with children and tackling child poverty. It is:-

a. claimed by around 1.3m families, almost 450,000 more than claimed Family Credit at its peak;

b. helping nearly 150,000 families with childcare costs through the childcare tax credit, three times more than the childcare disregard it replaced in Family Credit;

c. saving money which used to be spent on the bills of unemployment. Treasury estimates suggest that along with other labour market reforms, the WFTC has increased labour supply by around 160,000 individuals. On the assumption that these people go into work, this would produce an exchequer saving of an estimated £700m a year;

d. improving family incomes for the working poor, who have , on average, gained £35 a week from the WFTC, so that there is now a minimum income guarantee for families with a full-time earner of £225 per week, over £11,700 per year (around 45% of mean male earnings); and

e. a single earner family will pay no net tax until they earn £265 per week, £13,800 per year (around 55% of mean male earnings).

Children's tax credit

7. The Children's Tax Credit (CTC) was a response to the fact that families with children had lost out in the tax and benefits system over the previous twenty years and the old Married Couples Allowance was both anomalous in its operation and inadequate in the level of support it provided to families with children. The CTC:-

a. represents the first recognition of the costs of children in the tax system since the 1970s;

b. provides support for around 5 million families with children (85% of taxpaying families) of up to £520 a year, almost three times the level of support provided by the Married Couple's Allowance prior to its abolition and equivalent to nearly 3p off the basic rate of tax for a single-earner family on average earnings;

c. means that in 2001/2, the direct tax burden on a family on average earnings fell to 18%, its lowest level since 1972;

7. The final level of the award is then determined by summing the credits for which the family is eligible and then applying a single income taper across the employment tax credit and integrated child credit, withdrawing the employment tax credit first.

8. As noted above, it is the previous year's income that is used in the initial calculation. This is done because it is a known quantity and therefore provides a degree of certainty for the claimant. However, the new tax credits will include facilities for responding to changes that could affect families:-

a. families falling out of work and onto Income Support or Jobseeker's Allowance will get full integrated child credit;

b. the awards will also adjust to reflect changes in circumstances, such as the birth of a child; and

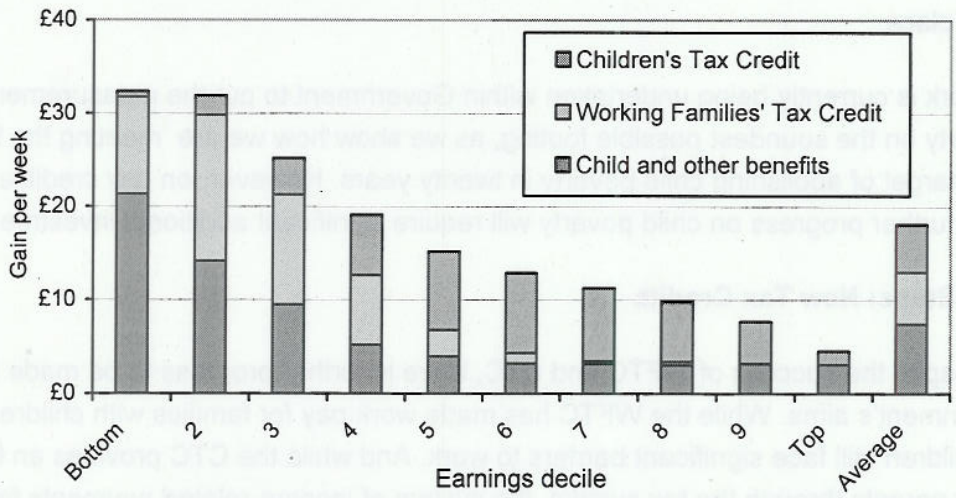
c. where income in the current year is "significantly" different to the previous year, their award will be recalculated on the basis of their current year income. (One of the key issues on which the consultation seeks views and which work is still continuing is what level of income change would trigger a change from previous year to current year income.)

d. combined with increases in Child Benefit, means that 5 million families eligible for CTC now stand to get up to £25.50 a week for the first child through CTC and Child Benefit compared to £11.05 from Child Benefit in 1997-98. In real terms a doubling of the level of support; and

e. will, from April 2002, be worth £20 a week to families in the first year of a child's life, ensuring most help for families when they need it most.

8. The chart below shows how the Government's reforms over the last Parliament have benefited all families with children. It shows how the CTC and WFTC have complemented each other to ensure that all families gained from reforms.

Gains from the Government's reforms over the previous Parliament



WFTC—An International Model

9. The WFTC was modelled on the US Earned Income Tax Credit, first introduced 30 years ago and significantly expanded under President Clinton. Now, following successful UK experience with tax credits, other European countries have followed our example:

The **French** "Premium for Work" is an in work tax credit for working people with and without children introduced in 2001.

The **Belgians** announced plans for an in-work tax credit in their 2000 budget. This is available to low income working people irrespective of whether they have children.

The **Dutch** are, in 2001, introducing a new employment tax credit in 2001 payable to all working people, with the greatest benefit felt by those near the minimum wage.

Putting Families First

10. Tax credits have also proved to be a key component in supporting families and tackling child poverty. As a result of all the reforms over the last Parliament, 1.2 million children have been lifted out of relative poverty compared to what would have happened with no policy action.

11. The Government has set itself a PSA target to reduce the number of children in poverty by at least a quarter by 2004. From a figure of 4.2 million children in households below 60% median income in 1998-99, this requires a reduction of just over 1 million. This target is defined by reference to what has actually happened in the economy, and given earnings growth over time, meeting it requires further measures above and beyond those already in place.

12. Work is currently being undertaken within Government to put the measurement of child poverty on the soundest possible footing, as we show how we are meeting the Prime Minister's target of abolishing child poverty in twenty years. However, on any credible definition, further progress on child poverty will require significant additional investment.

The Next Steps: New Tax Credits

13. Despite the success of WFTC and CTC, there is further progress to be made to meet the Government's aims. While the WFTC has made work pay for families with children, those without children still face significant barriers to work. And while the CTC provides an income stream for parents through the tax system, the system of income-related payments for children needs further modernisation to meet the Government's aims.

14. So the 2001 manifesto committed the Government to introduce new tax credits[1] (NTCs) from 2003. The new system will:

a. <u>separate the support for adults in a family from support for the children</u>, so as to provide a clearer focus on:-

   i. making work pay for those in low-income households, including those without children, through the <u>employment tax credit</u>; and

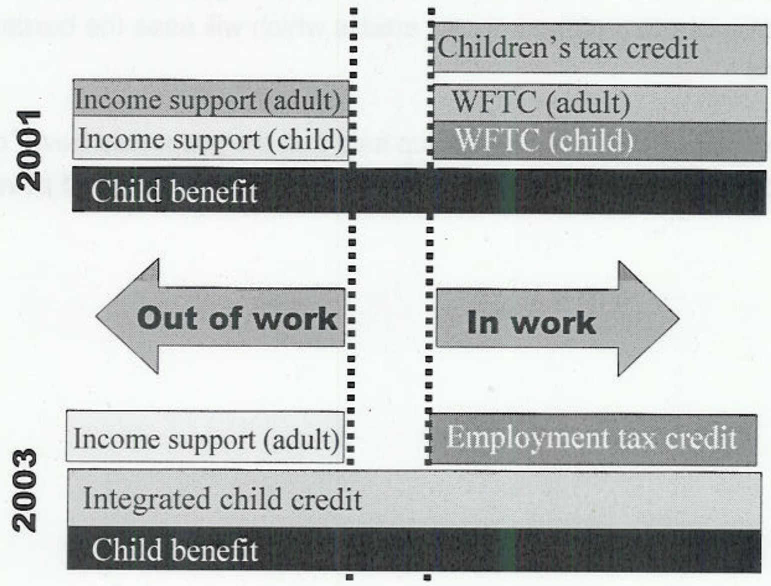
   ii. providing financial support for families with children and tackling child poverty, through the <u>integrated child credit</u> and Child Benefit;

15. The diagram below shows how the reforms will change the structure of support. Financial help for families with children that is currently provided through Income Support/Jobseekers' Allowance, Working Families' Tax Credit and the Children's Tax Credit

[1] The new tax credits do not include the Pension Credit which is being developed separately by the Department for Work and Pensions, with the aim of supporting pensioners on low and modest incomes. NTCs are principally focused on people of working age and/or those with children.

will be brought together to form the new integrated child credit. This will be complemented by a separate employment tax credit for low income working people.

How the new tax credits restructure support for families



16. The new tax credit for children, the integrated child credit, will, for the first time, create a seamless system of income-related support for families with children. It has a number of advantages:-

a. promoting work, through a portable and secure income bridge spanning welfare and work;

b. providing all children's support to the main carer (usually the mother), in line with Child Benefit;

c. providing a simple instrument which can help meet the Government's aims on child poverty;

d. ensuring a common framework for assessment and payment, so that all families are part of the same system; and

e. rationalising administration by making one department, the Inland Revenue, responsible for administering all aspects of the Government's support for children.

Initial reactions to the new tax credits

17. While there still remain a number of issues on which the Government is consulting, the principle of the new tax credits, particularly the integrated child credit, has been widely welcomed. For example:-

a. the Social Security Select Committee welcome the opportunities the introduction of the new tax credits gives to tackle child poverty, improve work incentives and make the system simpler;

b. the Institute of Directors welcomed key changes to the design and administration of the new tax credits which will ease the burdens on business; and

c. the Child Poverty Action Group said that the proposals have “considerable potential to contribute to the objectives of abolishing child poverty”.

Government spending on public services and tax credits

The table below shows spending on three key public services compared to expenditure on current tax credits. The current (full-year) cost of the WFTC and CTC are just over £7.8 billion, compared to £5.4 billion spent on Family Credit and Married Couples Allowance in 1996-97.

Selected spending totals for 1996-97 to 2003-04
(£bn, 2001-02 prices)

	1996-97	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**Change 96 to 04**
Health	44.1	44.9	46.1	49.0	53.4	56.7	59.7	62.9	**18.8**
Education	39.2	39.2	39.3	40.6	45.2	47.7	50.3	53.0	**13.9**
Law, Order & Protective Services	17.6	17.8	17.8	19.1	20.2	22.5	22.5	22.2	**4.7**
Fam. Credit & Marr. Couples Allow.	5.4						-	-	
WFTC & CTC	-					7.8	7.8	7.8	**2.4**
of which									
- WFTC						*5.3*	*5.3*	*5.3*	
- CTC (full year cost)						*2.5*	*2.5*	*2.5*	
Child Benefit and other spending on children*	12.1					13.8	13.8	13.8	**1.7**

* Excluding Family Credit

Further detail on the new tax credits

1. The Inland Revenue consultation document, "New Tax Credits: Supporting families, making work pay and tackling poverty" was published in July 2001 and sought views on some of the key structural and technical issues. The consultation period ends on 12 October, with legislation due to be introduced before the end of the year. The principal characteristics of the new credits are discussed below.

2. The integrated child credit can be claimed either by a lone parent or a couple with one or more children. It is available irrespective of the work status of the adult(s) in the household, thereby creating a secure "income bridge" as families move off welfare and into work.

3. The new credit will consist of a "family element" with additional credits paid for each child in the family. It will be paid in respect of children under 16 and young people 16-19 in full time education. The main carer will receive the integrated child credit either weekly or four-weekly as they choose.

4. The employment tax credit can be claimed by both employees and self-employed people. To be eligible for the employment tax credit, the minimum number of hours' work required in a week are:-

   a. 16 hours for a lone parent, one partner in a couple with children or a disabled worker; and

   b. 30 hours for an individual or couple without dependent children. Eligibility for those without children or a disability will also be limited to people aged 25 or over.

5. As a tax credit to improve the gains to work, the employment tax credit will be paid to employees through the wage packet. It will also include support for childcare through a childcare tax credit component.

6. The calculation of the award will initially depend on two main factors:-

   a. the current composition of the family (e.g. the number of children or adults and the presence of disability); and

   b. the income of the adults in the household for previous tax year