7. Tax credits: fixed or beyond repair?

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Summary

- Since April 2003, the child and working tax credits have been extensively criticised, chiefly for the difficulties some families experience when HM Revenue and Customs (HMRC) recovers overpayments.
- In the 2005 Pre-Budget Report, the government announced substantial changes to the administration and operation of tax credits. These should reduce the scale of, and problems caused by, overpayments, but at the cost of making some families wait longer to receive money to which they are entitled and increasing families' compliance costs.
- It is still too early to tell whether the changes go far enough to avoid the need for further significant reform. But it is hard to see what more the government could do to reduce the problems caused by tax credit overpayments without abandoning some of the key principles behind the system.
- One key government aim was to provide greater income security for families leaving welfare for work. But IT problems have continually delayed the extension of tax credits to families on out-of-work benefits.
- The government has succeeded in creating a more responsive system of support for low-income families with children. But this has created the problem of overpayments, underlining the key trade-off between responsiveness of awards and certainty over their level.

7.1 Introduction

Since their introduction in April 2003, the child and working tax credits have been extensively criticised, chiefly for the difficulties some families experience when HMRC[2] recovers overpayments (see Box 7.2 later).

The government announced in May 2005 that it would improve the administration of tax credits and change some of the rules affecting overpayments. The December 2005 Pre-Budget Report (PBR) announced a more substantial set of changes to the rules and administration of tax credits, with the explicit aim of markedly reducing the problems caused by overpayments.

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[1] The author is grateful to Stuart Adam, Donald Hirsch, Matthew Wakefield and the editors for conversations about the issues and for comments on earlier drafts.

[2] Tax credits were operated by the Inland Revenue when they were introduced, but the Inland Revenue has since merged with HM Customs and Excise to become HM Revenue and Customs; this chapter uses 'HMRC' to refer to both the Inland Revenue and HM Revenue and Customs.

This chapter describes the background to the changes announced in PBR 2005, assesses the likelihood of their success and discusses whether these changes will mean that pressure to move back to a system of tax credits with fixed awards will now go away.

Section 7.2 describes the child and working tax credits, and compares the way they operate with the way their predecessor, the working families' tax credit (WFTC), operated. It also describes the administrative and operational changes made to tax credits during 2005. Section 7.3 discusses in more detail the background to the changes made in 2005, and analyses the impact of the changes to tax credits announced in the December 2005 Pre-Budget Report. Section 7.4 assesses whether the child and working tax credits can be said to have met their key goals, and asks whether the current system looks like a final resting point in the turbulent history of this policy. Section 7.5 concludes.

7.2 How do tax credits work?

The child and working tax credits

The introduction of the current tax credit system in April 2003 represented the largest change to the personal tax and benefit system made by the current government. It brought together three ways that the tax and benefit system had directed financial support to families with children, with the aim that the new child tax credit would ultimately deliver the majority of child-contingent financial transfers to families. In addition, the working tax credit was created to provide extra help for people in work and on a low income whether or not they have children. For those without children (and without a disability), this was something that had not been available before April 2003. Box 7.1 gives more detail. Tax credits illustrate the government's frustration with both the income tax and the benefits system as ways of targeting financial support: the income tax system does not allow sufficiently accurate targeting, and traditional means-tested benefits are seen as unacceptably complicated and stigmatising, and inappropriate for a programme that covers the vast majority of families with children.

As of December 2005, 5 million families with children were receiving the child tax credit and 600,000 families with children were receiving the equivalent level of support through out-of-work benefits. Of these 5 million families with children, 1.5 million were also receiving the working tax credit, and 356,000 of these 1.5 million families were receiving help towards their childcare costs. In addition, 320,000 families without children were receiving the working tax credit.[3] Around 7.4 million families receive child benefit, so around 1.8 million families with children are receiving child benefit but not the child tax credit nor extra help for their children through out-of-work benefits, either because they have not claimed these programmes or because they are too rich to be eligible.[4]

In 2004–05, HMRC paid out £15.8 billion in tax credits, and estimated entitlement to tax credits was £13.8 billion (the difference largely represents overpayments). The majority

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[3] HMRC, *Child and Working Tax Credits Statistics, December 2005*, 2005, http://www.hmrc.gov.uk/stats/personal-tax-credits/dec05_quarterly_dec05.pdf.

[4] HMRC, *Child Benefit Statistics, Quarterly Statistics, August 2005*, http://www.hmrc.gov.uk/stats/child_benefit/cb_aug05qrtly_nov05.pdf.

(73%) of entitlement to tax credits exceeds families' liabilities to income tax.[5] In addition, the Department for Work and Pensions (DWP) paid £3.4 billion in child additions to out-of-work benefits in 2004–05.[6]

Box 7.1. Recent tax credit changes

What was new in April 2003?

The **child tax credit** provides income-related support to the main carer. Around 90% of families with dependent children should be entitled to it or to receive child additions in out-of-work benefits. All families entitled to the child tax credit receive some or all of the family element, currently £545 a year. Poorer families (roughly the poorer half of families with children in the UK) will also receive some or all of the per-child element, currently £1,690 a year per child.

The **working tax credit** provides in-work support to around 1.8 million families (single people or couples) with or without children working 16 or more hours a week but with a low income, and also provides support for formal childcare costs for families where all the adults are in work.

What was abolished?

The **children's tax credit** reduced the income tax bills of around 5 million income-tax-paying families with children. It was subsumed within the family element of the child tax credit in April 2003.

The **working families' tax credit** (WFTC) provided support to low-paid families with dependent children working 16 or more hours a week. It was subsumed within the working tax credit and the per-child elements of the child tax credit in April 2003.

Child allowances and the family premium in income support (IS) or income-related jobseeker's allowance (JSA) provided extra money to families with dependent children claiming IS or income-related JSA. These are due to be abolished in Autumn 2006, to be replaced by the child tax credit.

Child additions to some National Insurance benefits provide extra money to families with dependent children receiving the retirement pension, incapacity benefit, severe disablement allowance, bereavement benefits or invalid care allowance. These additions were abolished for new claimants from April 2003.

Source: M. Brewer, *The New Tax Credits*, IFS Briefing Note no. 35, 2003, http://www.ifs.org.uk/bns/bn35.pdf.

How do tax credits now operate?

Below, we describe the key features of the operation of the child and working tax credits, by outlining a year in the life of a tax credit claim. We then compare this with the system of fixed awards operated under WFTC.

[5] HMRC, *Department of Inland Revenue 2004-05 Accounts*, HC 446, 2005, http://www.hmrc.gov.uk/about/ir-report2005.pdf.

[6] DWP, *Benefit Expenditure Tables, Table 5*, 2005, http://www.dwp.gov.uk/asd/asd4/Table5.xls.

- When a new claim for tax credits is made, a family's initial award is usually based on the previous tax year's income.
- During the year, claimants are required to report to HMRC some changes of circumstances (such as a partner joining or leaving the household, or a significant fall in the amount spent on formal childcare) and are encouraged to report others (changes in the number of dependent children; changes in family income; changes in weekly hours if they go below 16, become 16 or more, go below 30, or become 30 or more hours a week; a significant rise in the amount spent on formal childcare).
- If a change in circumstances justifies a higher award, then the monthly payment to the family is increased for the rest of the year, and HMRC makes a one-off payment to cover the underpayment (see Box 7.2) in the year to date.
- If a change in circumstances justifies a lower award, then an overpayment has arisen (see Box 7.2). The monthly payment to the family is then reduced or stopped for the rest of the year, so that the total amount of tax credits paid in the tax year is equal to the total entitlement for the tax year. To reduce the number of families who experience overpayments through rises in income, the first £2,500 of any increase in income is disregarded.
- At the start of the next tax year, claimants are required to verify their circumstances during the just-completed year, usually based on information from their P60s (a form that all employers give to their employees, detailing gross and net pay in the previous tax year). This verification may reveal that claimants received too little or too much in the previous tax year, in which case future awards are adjusted as described in Box 7.2.
- The newly confirmed income figures for the previous tax year are used to calculate the tax credit award for the (new) current tax year.

WFTC – the main programme that the child and working tax credits replaced – operated very differently. Unlike the current tax credit system, awards of WFTC were based on past circumstances: when applying, claimants had to provide evidence that they were in work and of their recent (7 weeks to 3 months) earnings and childcare costs (people who applied as they

Box 7.2. What are overpayments and underpayments?

The most significant problem with tax credits seems to be that they generate overpayments and underpayments. An **overpayment** arises when a family has been paid more tax credits than it was actually entitled to; as a result, future awards of tax credits are reduced, within limits, until the overpayment has been recovered (if the family is no longer entitled to tax credits, it will have to pay the money back to HMRC). Many overpayments arise when a family's income rises and the family does not tell HMRC sufficiently quickly to enable an immediate adjustment in its award.

Underpayments, on the other hand, occur when families have not been paid enough tax credits; as a result, HMRC owes them money. An underpayment is often caused by a family experiencing a fall in income and not reporting it quickly enough to HMRC to enable an immediate adjustment in its award.

started a job could have their awards based on their employer's best estimate of their likely earnings). Once awards had been calculated, they were fixed for 6 months, regardless of any changes in the circumstances of the family that had applied for them. Employers verified that claimants would be working at least 16 hours a week. Any changes in circumstances, of course, would be reflected in the next award, if the family re-applied after 6 months. Because awards were based on verified information, rather than a family's own estimates, there was no need to re-assess awards in the future. However, as we explain in Section 7.4, the government felt that WFTC was onerous for claimants and was not sufficiently responsive: families might have to wait 6 months to receive extra help through tax credits if their circumstances changed in a way that raised their entitlement to tax credits. WFTC also suffered from less-than-full take-up, particularly amongst couples with children.

7.3 What went wrong, and what has been done?

What went wrong with tax credits?

Tax credits have experienced difficulties ever since computer problems caused substantial delays to payments to many families in the first few months of 2003–04. Since then, several reports (see Box 7.3) have identified significant problems due to:

- delays and errors in payments, mainly but not exclusively affecting the first year of tax credits (2003–04);
- overpayments (see Box 7.2) resulting in high repayments, penalties and hardship among people on very low incomes.

Box 7.3. Key reports on tax credits

Reports detailing problems with tax credits have been produced both by non-governmental organisations that represent claimants and their advisers and by official bodies. The most significant include:

Child Poverty Action Group, *Tax Credits – One Year On*, 2004

Citizens Advice, *Money with Your Name on It*, 2005

One Parent Families, *The New Tax Credits System*, 2005

Parliamentary Ombudsman, *Tax Credits – Putting Things Right*, 2005

House of Commons Public Accounts Committee, *Inland Revenue: Tax Credits and Deleted Tax Cases*, Fifth Report of Session 2005–06, HC 412 (incorporating HC 269-i, Session 2004–05)

In addition, the Comptroller General had to qualify his audit opinion on the 2003–04 and 2004–05 Trust Statements in respect of tax credits; broadly, this means that he cannot be sure that 'revenue and expenditure [on tax credits] have been applied to the purposes intended by Parliament and conform to the authorities which govern them' (page 67 of Inland Revenue 2004–05 Accounts[a]).

[a] HMRC, *Department of Inland Revenue 2004-05 Accounts*, HC 446, 2005, http://www.hmrc.gov.uk/about/ir-report2005.pdf.

In 2003–04, out of 5.7 million tax credit awards, 1.9 million (33%) were overpaid and 700,000 (13%) underpaid. The total value of overpayments was £1.9 billion and of underpayments was £0.5 billion; in the same period, total entitlement to tax credits was £12.1 billion, and £13.5 billion was paid out. The mean overpayment was £1,028, but there were a few awards with very large overpayments: half the total value of overpayments was due to the 15% of overpaid awards where the overpayment exceeded £2,000. Although rises in income between 2001–02 and 2003–04 were one cause of overpayments, 47% of the value of overpayments was paid to families whose gross pre-tax income in 2003–04 was under £20,000.[7]

A recent survey (which pre-dated the 2005 PBR) of the key reports that had investigated problems with tax credits concluded that the delivery of tax credit entitlements was flawed, because of delays and errors in payments and because the number and size of overpayments arising were resulting in high levels of repayments, penalties and consequent hardship amongst people on low incomes.[8] Furthermore, it found that both of these problems had been exacerbated by a general lack of comprehension amongst claimants about the system and by poor communication between claimants and Revenue staff.

The review attributed some of these problems to teething problems, but others are a direct result of the way that HMRC chose to administer tax credits, and others still are due to the rules and regulations that determine how entitlements are calculated and how overpayments are recovered.

Changes to tax credits in 2005

Presumably responding to public concern, the government announced in May 2005 that it would improve six areas of tax credit administration.[9] Compared with those that followed, these changes were relatively small, designed to reduce the number of overpayments that arise and to reduce the inconvenience they cause to families when they do arise.

In PBR 2005, much more significant changes were announced, designed both to reduce substantially the amount of overpayments generated and to reduce the financial impact on families of reporting changes in circumstances; see Box 7.4 for details.

The government estimates that the package of measures will reduce the value of overpayments by about a third from its 2003–04 value of £1.9 billion. In net terms, this package is broadly cost-neutral in the medium term: HMRC estimates that it will cost the government £100 million in 2006–07, raise £200 million in 2007–08 and £50 million in

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[7] See table 3 of HMRC, *Child and Working Tax Credits Statistics, Finalised Awards 2003-04, Supplement on Payments in 2003-04*, 2005, http://www.hmrc.gov.uk/stats/personal-tax-credits/cwtc-payments-0304.pdf.

[8] See D. Hirsch, 'What's wrong with tax credits?', presentation given at Institute for Fiscal Studies, 15 September 2005, http://www.ifs.org.uk/events.php?event_id=80.

[9] These were to review information provided to claimants, to test methods of reminding claimants of the importance of providing up-to-date information in-year on changes in their income and circumstances, to improve the quality of service on the helpline, to identify and resolve IT system problems and processing errors more quickly, to develop innovative ways of working with the voluntary sector to target more active support on vulnerable families, and to suspend recovery of overpayments in cases of hardship where the recovery of an overpayment is disputed. See HC Deb (session 2005–06), 26 May 2005, Column 22WS, http://www.parliament.the-stationery-office.co.uk/pa/cm200506/cmhansrd/cm050526/wmsindx/50526-x.htm.

Box 7.4. Changes to tax credits announced in 2005 Pre-Budget Report[a]

1. From April 2006, the annual income disregard will increase from £2,500 to £25,000. This means that income in the current tax year will have to be at least £25,000 higher than income in the previous tax year before entitlement to tax credits in the current tax year is affected.

2. From November 2006, tax credit payments for low- to middle-income families will be reduced by a maximum of 25% where an overpayment has been generated (at present, overpayments can mean that tax credit awards are stopped altogether while the overpayment is being collected).

3. From April 2007, when claimants report a fall in expected income during the year, their tax credit payments will no longer include a one-off payment for the underpayment generated earlier in the year; instead, any underpayment will only be refunded after their award has been finalised at the end of the tax year. The government argues that many overpayments are caused by families overestimating the fall in their income, so this change reduces the number of overpayments that accrue to families whose income falls, but at the cost (to society) of increasing the number of underpayments.

4. In Summer 2006, the deadline for providing information to finalise and renew tax credit awards will be brought forward by one month (from the end of September to the end of August) to shorten the period during which provisional payments may be made using out-of-date information.

5. In early 2007, towards the end of the tax year, HMRC will contact key groups of claimants to obtain more up-to-date income information on which to base the next year's payments while the finalisation process is completed.

6. From 2008–09, the income figure used in setting provisional payments will be uprated by average earnings until up-to-date information is provided.

7. From November 2006, families will have to report a wider set of changes in circumstances that reduce entitlement to HMRC within three months. From April 2007, the time allowed to report such changes will be reduced to one month.

[a] Brief details were given in the Pre-Budget Report documents. Full details can be found in HC Deb (session 2005–06), 5 Dec 2005, Column 55WS, http://www.parliament.the-stationery-office.co.uk/pa/cm200506/cmhansrd/cm051205/indexes/dx051205.htm.

2008–09, and cost £50 million in 2009–10 and £150 million in 2010–11.[10] However, the long-run costs are not clear, because different parts of the package have different effects and because some of the reforms will have sizeable effects on cash flow in the short run but should have little or no impact in the long run. In particular:

[10] Estimates for 2006–07 to 2008–09 from 2005 PBR; estimates for later years from personal communication from HMRC to author.

- The first change increases entitlements to tax credits for families whose current-year income is more than £2,500 higher than their previous year's income, and so costs the government money.
- The second change allows families to repay overpayments over a longer period. This will cost the government money only in the short run (because the changes affect only the timing of payments).
- The rest of the reforms reduce the amount of money that HMRC pays out to families only to have to collect it back because the families were not entitled to it (in other words, the money was overpaid). The changes therefore save the government money in the short run (by affecting the timing of payments), but they will also save money in the long run if HMRC would otherwise have had to write off overpayments.

HMRC says that it holds no information that separately identifies the effect of the PBR package on HMRC's costs of administering tax credits.[11] Having fewer overpayments to collect should release resources that HMRC can use elsewhere, but implementing these changes will require extra resources, certainly in the short term and maybe in the long term.

What was the justification for the PBR 2005 package?

The package of changes announced in the 2005 Pre-Budget Report was designed explicitly to reduce the problems caused by overpayments.

As has been stressed by the government, overpayments are not an unexpected phenomenon: government documents about tax credits released before April 2003 said explicitly that there would be families who would be overpaid.[12]

Overpayments are built in to the design of the child and working tax credits because these tax credits operate on an annual cumulative system. In this sense, they operate in a similar manner to income tax and, as we described earlier, in quite a different way from how WFTC operated.[13] The fact that the current system of tax credits operates on an annual, cumulative basis has several implications:

Awards depend on income over the whole tax year, not just recent income

- Entitlement to tax credits is supposed to depend on income received in the current tax year, and this means that rises in income in (say) March 2006 reduce a family's entitlement to tax credits received in (say) April 2005, thereby leading to an overpayment.[14]

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[11] Personal communication from HMRC to author.

[12] See chapter 4 of HM Treasury, *The Child and Working Tax Credits*, The Modernisation of Britain's Tax and Benefit System Number Ten, 2002, http://www.hm-treasury.gov.uk/mediastore/otherfiles/new_tax_credits.pdf.

[13] The old children's tax credit operated on an annual cumulative system because it was a full part of the income tax system. However, because it operated through the PAYE system, and because it was relatively small in value and had a shallow taper affecting few relatively well-off families, concerns about overpayments never arose. By contrast, the current tax credits operate separately from PAYE, can be worth several thousands of pounds a year, and have a steep taper affecting millions of families.

[14] Income tax works in exactly the same way, for people under PAYE. A comparable situation to a tax credit overpayment would be when individuals move from being basic-rate to higher-rate taxpayers: someone who had weekly earnings of £692.30 for the first 48 weeks of 2005–06, and then of £942.40 for the last 4 weeks of the year,

All tax credit awards are provisional, and have to be checked after the end of the tax year

- Because tax credits operate outside the PAYE system, there is no way that tax credit awards can depend upon current income. The government's solution to this was to make initial tax credit awards 'provisional', by basing them on a proxy for current-year income. Awards only become 'final' when families confirm to HMRC (usually between July and September) what their income was over the preceding tax year. Two kinds of proxy for current income are used. The default is to use income in the previous tax year as a best estimate of income in the current year, but families who suspect that their current income is different from their income in the previous tax year are allowed to have their tax credit awards based on their own estimate of their current income.
- Any discrepancy between the original proxy for current-year income and actual income can therefore lead to overpayments or underpayments. In particular, overpayments arise when:
  - A family's current-year income is higher than the previous year's income. To reduce the extent to which this phenomenon would generate overpayments, the first £2,500 of a rise in income do not affect entitlements to tax credits.[15]
  - Families who suspect their income is lower than in the previous year underestimate their current income.[16]
  - There are delays in recalculating awards at the start of a tax year. Families currently have 6 months at the start of a tax year to confirm to HMRC their income in the previous tax year; this figure is then used to determine tax credit awards for the current year. Until this happens, families' tax credits are based on income information that is 2 years out of date, frequently leading to an overpayment.
- None of these situations would arise if tax credits were an integral part of the tax system that could be operated through PAYE by employers, such as the former additional personal allowance and children's tax credit.

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would pay £126.77 in income tax (18.3% of gross earnings) a week for the first 48 weeks and £181.89 a week (19.3% of gross earnings) in the last 4 weeks. Someone with the same annual income (£37,000) spread equally across the year (£711.53 a week) would pay £131.01 (18.4% of gross earnings) in income tax each week. In effect, the individual who has a pay rise at the end of the year that makes them a higher-rate taxpayer has paid 'too little' income tax earlier in the year, and has to make up for it in the last 4 weeks.

[15] This measure was relatively expensive: the government estimates that, had there not been a £2,500 disregard in 2003–04, entitlements to tax credits would have been £800 million lower, with the average fall in entitlement of around £10 a week affecting 1.5 million families. See HC Deb 2005–06, 4 Jul 2005, Column 98W, question 8584, http://www.publications.parliament.uk/pa/cm200506/cmhansrd/cm050704/text/50704w27.htm#50704w27.html_sbhd1

[16] Australia's tax credit system is similar to the UK's, except that initial tax credit awards are always based on families' estimates of their current-year income. When designing tax credits, UK government officials said that they had learnt from the experience of the first year of tax credits in Australia, where a substantial number of families significantly underestimated their income and were therefore overpaid significant amounts of tax credits. The Revenue's reaction to this was to reject the use of estimated income as a proxy and instead base the majority of tax credit awards on the previous year's income. As in the UK, tax credit overpayments were extremely unpopular in Australia, and the government made several changes designed to reduce the incidence of overpayments, mainly by making families wait until they had verified their incomes after the end of the year before they could be paid all of the credits to which they were entitled. See P. Whiteford, M. Mendelson and J. Millar, *Timing It Right? Tax Credits and How to Respond to Income Changes*, Joseph Rowntree Foundation, York, 2003, http://www.jrf.org.uk/bookshop/eBooks/1859351107.pdf.

Accurately calculating entitlement to tax credits relies upon families telling HMRC promptly about changes in circumstances that affect tax credit awards

- There is no mechanism that allows tax credit awards to react automatically to many of the changes in circumstances that currently affect entitlement to tax credits (such as changes in the presence of a partner, the number of dependent children, spending on formal childcare, or whether parents work more or less than 16 or 30 hours a week). Entitlements to tax credits change on the day these changes occur, yet awards cannot be adjusted until families tell HMRC, and HMRC recalculates entitlement; overpayments often arise during the intervening period.

Will the PBR 2005 package fix the problems?

The most tangible impact of the changes announced in PBR 2005 will be to reduce the value of overpayments by a third (according to the government), reducing the number of families experiencing overpayments and the problems brought about by their recovery.[17] This should be welcomed by tax credit recipients, particularly those who would otherwise have received an unwanted overpayment.

On the other hand, some elements of the package mean that some families will have to wait longer to receive tax credit payments to which they are genuinely entitled.[18] Furthermore, several elements of the package require families to report more changes in circumstances to HMRC, and to report them more quickly, increasing the cost to families (measured in time and effort) of claiming and complying with tax credits.[19] And the government may be hoping that, by reducing the number and value of overpayments, HMRC might be able to write off fewer of them in the future; if true, this would mean lower tax credit awards for some families in the future.

It is not possible to assess now whether the changes announced in PBR 2005 will go far enough to make overpayments a tolerable part of the tax credit system. However, it is not clear what further administrative or operational changes the government could have announced to reduce the problem of overpayments whilst remaining true to the concept of an annual, cumulative tax credit system. A superficially appealing policy is to write off (i.e. allow claimants to keep) all overpayments. But this would cost substantial sums of money, and, once claimants knew that overpayments would not be recovered, they would face a very strong incentive to play the system, further increasing the cost.

[17] It is not known how many fewer families will experience overpayments, but 1.9 million awards in 2003–04 had an overpayment, and HMRC estimates that the value of overpayments in 2003–04 is a good guide to the value in future years were the PBR 2005 package not to be introduced (see HC Deb (session 2005–06), 5 Dec 2005, Column 55WS, http://www.parliament.the-stationery-office.co.uk/pa/cm200506/cmhansrd/cm051205/indexes/dx051205.htm).

[18] For example, families whose income falls year-on-year will have to wait until they confirm their income after the end of the tax year before receiving all the tax credits to which they are entitled, as will families whose earnings rise year-on-year by less than the average earnings index (after the change in April 2007).

[19] Alternatively, if families do not change the speed at which they report changes in circumstances, then some of the savings to HMRC that have been assumed may not materialise.

Should overpayments remain a problem in the future, there are various broad directions that future policy could take, but all would require compromising some of the government's original aims for the tax credits system:[20]

- **Reduce the importance of tax credits in families' budgets**, thereby reducing the size of future overpayments. If this were to be done without creating losers, then it could be done by cutting the per-child element of the child tax credit and increasing child benefit rates, although this would be expensive and would run counter to the government's approach of tackling child poverty in an affordable manner by using income-related programmes such as tax credits.
- **Reduce the volatility of families' entitlements to tax credits**. Many of the cases of large overpayments are in families receiving help with childcare costs through the working tax credit. This could be because the rules around the childcare element are particularly complicated, but also because some families can receive very large amounts of tax credits through the childcare element. One way to reduce the scale of overpayments would be to find a different way of helping parents afford formal childcare, perhaps by replacing the childcare element of the working tax credit with some form of supplier subsidy. However, there are considerable (but different) drawbacks to supporting childcare through supplier subsidies, and such a change should be a medium- to long-run reform.
- **Return to a system of tax credits with fixed awards**, like those in WFTC. Such a system need not operate identically to WFTC, but the key features would be shared: awards would be based only on historical, verifiable, information, so there would be no need to verify circumstances at the end of the year and no way of generating overpayments. But such a system would also mean – just as occurred under WFTC – that families' awards would always be based on their past circumstances; under such a system, the level of tax credit payments would be much more certain, but much less responsive, than under the current tax credit system.[21]

It would, of course, be possible to combine elements of each of these options with elements of the current tax credit system. For example, tax credits could operate as fixed awards only for claimants whose circumstances improved over time; this could be operationalised by having tax credits operate as a fixed award for all, but allowing families to re-claim during the period of the fixed award if they felt their circumstances justified a higher award. Such a reform might balance families' need for certainty with the desire to achieve responsiveness.

However, returning to a system with fixed awards would have implications other than removing overpayments. Indeed, the advantages and disadvantages of moving back to fixed awards are obviously very similar to (but working in the opposite direction to) the advantages and disadvantages of replacing WFTC with the new system of tax credits that were

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[20] Such compromises over the operation of tax credits are not unheard of: the government has decided that, from April 2006, tax credits will not be paid by employers, but instead should be paid direct by HMRC into claimants' bank accounts, like social security benefits; this comes 6 years after the government said that paying tax credits through employers reinforced the message that work paid.

[21] If tax credits were fixed, then it would be possible to replace the family element of the child tax credit with a rise in the first-child element of child benefit. This would remove over 2 million families from the tax credit system, at the small cost of extending a child benefit payment to 700,000 very rich families with children.

considered by the government when it decided to scrap WFTC. We therefore examine in the next section the aims that the government had for the new system of tax credits when it first announced the reform.

7.4 Have the new tax credits met their goals?

The changes announced in PBR 2005 should substantially reduce the problems caused by overpayments. However, overpayments would never have occurred had the government stuck with WFTC, as described earlier.

So to understand why the government deliberately designed a system that allows overpayments, it is important to realise what the government did not like about WFTC and what it hoped to achieve with the new tax credit system.

At a detailed level, paragraphs 2.29–2.32 of HM Treasury (2002)[22] set out many of the advantages of the new tax credits as seen by the government. Some of these are more significant than others, and to appreciate fully why the government wanted to replace WFTC (and other programmes) with the current system, we need to focus on the key aims that the government had for tax credits that could not have been achieved without scrapping WFTC. There were four of these:

i. To design a system of support for low-income families with children that was more responsive than WFTC, particularly when families experienced changes in circumstances that would justify increased state support. WFTC was seen as unresponsive because awards were fixed for 6 months, which meant that families whose income fell (or childcare costs rose) had to wait up to 6 months (and an average of 3 months) before receiving extra help.

ii. To provide more income security when families left benefits to move into work than previously provided by WFTC. Families with children who moved into work had to claim a new set of benefits if they moved from out-of-work benefits into low-paid work (or vice versa), and any delays in processing claims would lead to temporary shortfalls in income. It is argued that these perceived difficulties deterred some lone parents from seeking work.

iii. To reduce non-take-up of WFTC, particularly amongst couple families (HMRC estimates that between £0.7 billion and £1.1 billion of WFTC payments were unclaimed in 2002–03[23]). Arguably, having three different income-related programmes for supporting families with children may have confused some families, who may therefore not have claimed all they were entitled to. There was also a perception that some non-take-up of WFTC could have been caused by families being unwilling to claim in-work support designed for a minority of families who are

[22] HM Treasury, *The Child and Working Tax Credits*, The Modernisation of Britain's Tax and Benefit System Number Ten, 2002, http://www.hm-treasury.gov.uk/mediastore/otherfiles/new_tax_credits.pdf.

[23] Source: Table 2 of Inland Revenue, *Working Families' Tax Credit Estimates of Take-Up Rates in 2002–03*, 2005, http://www.hmrc.gov.uk/stats/wftc/wftc-takeup-2002-03.pdf.

relatively poor, and there was a hope that a system of tax credits to which the majority of families were entitled would be much less stigmatising.

iv. To reduce compliance costs incurred by low-income families with children claiming income-related benefits. These families had to fill in long and detailed claim forms twice a year if they were claiming WFTC continuously, and more frequently if they were moving in and out of work.

The government has met the first of these aims, but at a considerable cost to claimants. So far, it has failed to achieve the second, and it is not yet possible to assess the final two. We explain our reasoning below:

- **A more responsive system: achieved, at the cost of introducing uncertainty and over-payments.** The government has succeeded in making tax credits more responsive than WFTC: families do not need to wait 6 months for their awards to rise, as they might have had to do under WFTC. However, this responsiveness has only come about through designing the annual, cumulative system, so the price paid for more responsiveness has been the problem of overpayments and the attendant lack of certainty. Although some families felt that WFTC was too unresponsive, it is by no means clear that those families prefer the current system of tax credits to WFTC.

- **Greater income security: failed.** The government has still not abolished child allowances in out-of-work benefits, as originally set out in the plans for tax credits and as presaged in the original name of the child tax credit, an 'integrated child credit'. The current plan is to abolish them in Autumn 2006, but this date has been postponed continually since April 2003 because of uncertainties over whether the IT system operating tax credits will be able to cope. This delay means that families moving off benefits and into work still face income insecurity when they cease to get child-related support through out-of-work benefits while they wait for HMRC to process their claim for tax credits.

- **Reducing non-take-up: too soon to judge.** Although we know how many families are receiving tax credits, reliable data on take-up rates (i.e. the proportion of those eligible to claim who are receiving tax credits) do not yet exist. Advisory groups cite cases where families who have experienced substantial problems with overpayments since 2003 are now preferring to stop claiming tax credits rather than risk further problems; it is not yet clear, though, whether these high-profile examples are indicative of a widespread phenomenon. Furthermore, it is too early to judge whether tax credits have addressed the problem of non-take-up: take-up rates of a new programme will always take a few years to reach their steady long-term level.

- **Reducing claimants' compliance costs: no data to judge, but HMRC's administration costs have risen.** Some tax credit recipients – chiefly better-off families or families with stable circumstances – only need to interact with HMRC once a year to receive tax credits. Although robust and quantified evidence does not yet exist, compliance costs for these families will probably be lower than they would have been had the families been claiming WFTC. However, better-off families would probably not have been eligible for WFTC, and would instead have been claiming the children's tax credit, which had a much simpler claim process than the current set of tax credits. On the other hand, it is likely that families who have to report changes in circumstances, appeal against overpayments or chase up missing or incorrect payments are facing much higher compliance costs than they would have done had they been claiming WFTC. Furthermore, the changes in PBR 2005 will probably increase claimants' compliance costs by requiring faster notification of changes in circumstances and quicker end-of-year reconciliations and renewals, although they will probably reduce compliance costs by reducing the number of families affected by overpayments. The much-vaunted flexibility and responsiveness of tax credits have only come about by making families report changes in circumstances as they happen to HMRC, much as families receiving means-tested benefits have to report changes each week to DWP. Data are available on HMRC's costs of administering tax credits: in both 2003–04 and 2004–05, these stood at just over 3 pence per pound paid out, higher than the costs of administering WFTC and nearly three times the cost of administering child benefit.[24]

In Table 7.1, we list the other advantages of tax credits as seen by the government, indicate whether the government's ambitions have been met, and show which could have been achieved with the pre-2003 system. As the table shows, our assessment is that tax credits have not achieved all of the government's ambitions for them, and some of those that have been achieved could have been achieved without scrapping WFTC.

Furthermore, as we argued earlier, of the significant ambitions that the government had for tax credits that did require WFTC to be scrapped, only one can be said to have been met so far: that of providing a more responsive system for low-income families with children. But the PBR 2005 changes arguably show that the government has altered its views on the right balance between responsiveness and certainty. After the changes announced in PBR 2005 are fully implemented, tax credits will be a lot less responsive to changes in income, and more responsive to other changes in circumstances that affect entitlements (hours of work, number of children, childcare costs), for the following reasons:

- For the vast majority of families whose income rises, tax credit awards will operate as if they were a system of fixed awards, because the amount of tax credits received in the current tax year will be determined by income in the previous year (through reform 1 in Box 7.4).
- For families whose income falls, tax credit awards will operate a little bit more like a system of fixed awards, and a little bit less like an annual, cumulative system. This is because families whose income falls will now need to wait until the following tax year before they can receive all of the tax credits to which they are entitled in the current year (through reform 3 in Box 7.4).
- Families who experience changes in other circumstances will have to report them more quickly to HMRC.

[24] Page 104, table 1 of HMRC, *HM Revenue & Customs Annual Report 2004-05 and Autumn Performance Report 2005*, Cm. 6691, 2005, http://www.hmrc.gov.uk/about/hmrc-report2005.pdf.

Table 7.1. The government's other aims for the new tax credits system

What did government consider wrong with 2002 system?	Government's aim for tax credits	The outcome
Pre-tax-credits system left too many families in poverty	Greater generosity	Poverty reduced, but tax credit problems in 2003–04 meant some families temporarily fell into poverty while their claims were being processed. Did not require WFTC to be scrapped to reduce poverty.
WFTC and means-tested benefits used different income definitions from income tax	Simpler administration as definition of income aligned with income tax	Succeeded in bringing definition of income closer to that used in income tax. Unclear whether this simplifies administration. Did not require WFTC to be scrapped to achieve closer definitions.
Measuring income over a short period (as WFTC did) was unfair, and allowed families to 'play the system'	A fairer system because awards are based on annual income	Succeeded in creating system where awards are based on annual income, but annual, cumulative system leads to overpayments.
WFTC penalised second earners	Better incentives for dual-earner couples by assessing awards on gross, not net, income	Aim was realised, but other tax credit changes since April 2003 have reduced pay-off to having second adult in work.[a] Did not require WFTC to be scrapped to achieve better incentives.
WFTC penalised savers by reducing awards when savings exceeded £3,000	Better incentives to save	Succeeded. There are no capital limits, and there is a generous disregard for unearned income. Did not require WFTC to be scrapped to achieve this.
Evidence suggests that mothers more likely than fathers to spend money in ways that benefit children, yet different programmes paid child-contingent support to different members of family	Support for children paid to main carer	Succeeded, but did not require WFTC to be scrapped to achieve this.
Payment through the wage packet underlined the pro-work message of tax credits, yet employers found WFTC onerous to operate	Support through the wage packet that was simpler for employers	Failed. HMRC will no longer pay tax credits through the wage packet from April 2006 because employers found it too onerous even after changes in 2003.
Some low-income families (students, and those with low incomes but large savings) could claim neither in-work nor out-of-work benefits	Support extended to groups previously denied income-related support	Succeeded in extending support to around 100,000 families previously denied income-related support (over and above those newly entitled to income-related support because tax credits more generous than their predecessors).

[a] See M. Brewer and A. Shephard, *Has Labour Made Work Pay?*, 2004 http://www.ifs.org.uk/publications.php?publication_id=3155, and M. Brewer and A. Shephard, *Employment and the Labour Market*, IFS Election Briefing Note no. 5, 2005, http://www.ifs.org.uk/bns/05ebn5.pdf.

Source: Government's aims taken from paragraphs 2.29–2.32 of HM Treasury, *The Child and Working Tax Credits*, The Modernisation of Britain's Tax and Benefit System Number Ten, 2002, http://www.hm-treasury.gov.uk/mediastore/otherfiles/new_tax_credits.pdf.

The version of tax credits that will exist after all the PBR 2005 changes are implemented will look even less like something that is part of the tax system: for many families, the amount of tax credits received in a given year will not depend upon income in that year. Instead, the new version of tax credits will feel more like a means-tested benefit – because changes in family circumstances will have to be reported very quickly – and more like an in-work benefit such as WFTC – because awards will be fixed with regard to income rises.

So if the key advantage of tax credits so far has been increased responsiveness of awards to changes in circumstances, and if the scale of responsiveness of tax credits has been reduced, to some extent, by the changes announced in PBR 2005, then maybe it wouldn't cause too much pain to go back to something like WFTC.

7.5 Conclusion

Does the fact that the government has made considerable changes to the administration and operation of tax credits show that it failed to anticipate correctly the impact of an annual, cumulative system of tax credits?

That there is a trade-off between responsiveness and certainty of awards should not have come as a surprise to the government: many organisations, including IFS, pointed out this trade-off when the government announced that it wished to create an integrated child credit.[25] That overpayments were generated also should not have been a surprise: when it first announced how the new system of tax credits might work, HMRC openly acknowledged that the annual, cumulative system it wanted to introduce would lead to families being overpaid.

Presumably, then, what was unanticipated by the government, apart from the considerable difficulties with the IT system that processes tax credit awards, was either the volume of overpayments or the difficulties that low-income families have in understanding, complying with and budgeting around an annual, cumulative system of tax credits rather than one based on fixed awards.[26] In the government's defence, though, because the design of the new system of tax credits was innovative, compared both with past taxes and benefits in the UK and with those currently operating in other countries, there was limited evidence to draw upon when evaluating various options for the new system of tax credits. A positive thing that can be said, then, is that the next reform of tax credits will be able to be based on much more evidence than the current one. Given this improvement in the available evidence base, it would not be surprising for further reforms to occur sooner rather than later.

[25] After details of how the new system of tax credits might work were announced, IFS researchers concluded that the '[government's] aim of targeting the [child and working tax] credits effectively means that [it] has compromised on simplicity and predictability for families whose composition or income changes significantly during a year. Many families will find themselves in this position. The need for claimants to monitor annual income, average hours of work and, if appropriate, childcare costs will lead to a less certain and more complicated system for some families'; see M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, IFS Commentary no. 86, London, 2001.

[26] It is not possible to say for certain whether the government underestimated the extent of overpayments, because it forecast only the number of families who would experience an overpayment through a rise in income, and this is only one cause of overpayments.