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Chapter 13

Tax Credits

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Summary

Until fairly recently, paid employment and social security benefits have usually been seen as alternative sources of income. Wages were assumed to meet needs in work, with a small state contribution to the costs of children. Benefits replaced earnings for those periods when people were unable to support themselves through employment. But, as low-paid work has expanded, for some people wages alone may not be sufficient to provide a household with an adequate living standard, or an individual with sufficient financial incentive to take up paid work.

Thus employed people have been gradually brought into the social security system, at first through an in-work benefit for low-paid families with children, and now through a system of tax credits. This chapter:

- traces the development of in-work benefits and tax credits in the UK since the 1970s;
- outlines the policy goals and describes the main features of the tax credit system introduced in 2003;
- assesses tax credits against policy objectives;
- sets out the problems that have arisen in the administration of tax credits; and
- discusses the role of tax credits in welfare reform.

The start of in-work benefits in the UK: family income supplement

Beveridge's plan for social security set out a scheme with three main elements. These were: *national insurance benefits* (funded by contributions from workers, employers and the government; intended as a replacement for earnings loss); *national assistance benefits* (funded from general taxation, means-tested support for people with low incomes); and *family allowances* (funded from general taxation, paid at the same rate for all families, regardless of income level). Thus, with the partial exception of family allowances, the main function of social security benefits was clearly to replace lost earnings, not to pay benefits to working people.

This wage replacement system operated successfully in the 1950s and into the 1960s, a period characterised by full employment and stable families (see Chapter 8 here, Rowlingson). Poverty studies at the time suggested that working poverty had been largely eliminated. However, by the mid-1960s the 'rediscovery of poverty' challenged this benign view of welfare state success. In their influential study, Abel-Smith and Townsend (1965) found that poverty was much more widespread than had been thought, and also that it was increasingly a problem for working families, with one in five poor families with children being working families.

Thus by the early 1970s, the gaps and shortfalls of the Beveridge scheme were becoming much more visible and filling some of these gaps became an important part of the policy agenda. The new measures introduced for non-working people in the early to mid 1970s included non-contributory pensions, the extension of widow's benefits, and various benefits for disabled people. In relation to poor working families, various alternatives were being debated and considered. One option would have been for stronger measures of wage protection and regulation, including a national minimum wage. But this was not supported either by the governments of the time or by the trade unions, which were committed to free collective bargaining over wages (Brown, 1983; Millar *et al*, 1997). There was also a proposal was for a 'tax credit' scheme, set out by the government (Cmnd 4653, 1971) which would have replaced personal tax allowances (which exempt a portion of gross income from tax and so reduce payments to the tax system) with a refundable tax credit (which can reduce tax owed to below zero and so lead to a payment from the tax system). This would have meant that people with earnings below the tax threshold would have received additional cash support. This proposal almost reached the legislative stage before being rejected as too costly.

Thus, in the early1970s, neither wage regulation nor tax reform was seen as able to provide a solution to the problem of poverty among working families. That left the social security system, and the key measure here was the introduction of family income supplement in 1971. This new means-tested benefit was payable to families with dependent children, with an employed parent working at least 30 hours per week, and with wages below a certain level. It was originally introduced as a temporary measure, while the government considered the future of family support more generally (Deacon and Bradshaw, 1983). In the event, although child benefit was introduced in 1975 to replace family allowances and child tax allowances, family income supplement continued alongside these. Initially, as table 13.1 shows, this was a rather small and insignificant benefit, it did not cost very much and not many families received it. Take-up rates (the proportion of those eligible who actually received it) started at about 35 per cent in 1971 and had only reached about 50 percent by 1979 (Brown, 1983).

Table 13.1 Family Income Supplement, 1971 to 1979

Year	Numbers in receipt	Costs (£m) Cash	Costs (£m) in 2008/9 real terms
1971/72	71,000	4	39
1972/73	106,000	10	95
1974/75	67,000	12	89
1976/77	97,000	18	93
1978/79	88,000	24	101

Source: Millar et al (1997, table1); DWP (2008) *Benefit Expenditure Tables*, Table 3a: nominal terms and Table 4a: real terms, 2008/09 prices, http://www.dwp.gov.uk/asd/asd4/medium_term.asp

The 1986 *Social Security Act* was an important piece of legislation in this story and one that really established wage supplementation through means-tested benefits as a legitimate, and integral, function of the social security system. Income support was introduced to replace supplementary benefit, and family credit was introduced to replace family income supplement. Common means tests were established for both, and for housing benefit, so that benefits in and out of work were more closely aligned. Family Credit was very much intended to act as a work incentive, as the key objectives show:

> ‘to provide extra support to these families in accordance with their needs; to ensure that as far as possible they are better off in work; and to see that they can achieve improvements in family income by greater effort without losing all benefit’ (DHSS, 1985, p29).

The structure and eligibility conditions for family credit were much the same as for family income supplement, although it was a more generous system. It was available for families with children, with earnings below a certain level according to family size, and there was a weekly hours threshold (a minimum of 24 hours per week). Eligibility was assessed with reference to family income over a 5-week (or 2 month) period, and once awarded the amount paid was fixed for the next six months. It was paid to the main carer, as either by an order book (cashable at post offices) or directly into back accounts. This was not what the government originally proposed, which was that it should be paid through the wage packet, and therefore to the wage earner rather than to the main carer. This transfer from ‘wallet to purse’ was strongly resisted, by women’s groups (including Conservative women) and by employers, who were not very willing to take on the responsibility of administering this.

Various rule changes increased the scope of the benefit over the next ten years, including a reduction in the qualifying hours threshold from 24 to 16 in April 1992, and the introduction of disregards for maintenance and childcare costs. Family credit receipt started relatively slowly but then started to rise rapidly, as table 13.2 shows. The number of recipients more than doubled between 1989 and 1996, from almost 300,000 to almost 700,000. Family credit was available to lone parents on the same basis as it was to couples, and many employed lone parents were (and are) in low-paid work, and so lone parents made up a significant proportion of those in receipt. Take-up also improved, with DSS estimating take-up rates in the mid 1990s of about 70 per cent by caseload and 82 per cent by expenditure (DSS, 1996). Research on non-take-up concluded that many of these non-claiming families were probably only eligible for short periods and for relatively small amounts of money (McKay and Marsh, 1995). The Conservative government regarded family credit as one of its great successes, and introduced a similar in-work benefit (the disability working allowance) for disabled people in 1992. It also piloted a similar 'Earnings Top-Up' for single people and couples without dependent children (Finlayson et al, 2000).

Table 13.2 Family Credit, 1988 to 1996

Year	Total numbers in receipt	Couples	Lone parents	Costs (£m) cash	Costs (£m) in 2008/9 real terms
1988/89	285,000	177,000	108,000	394	754
1989/90	299,000	180,000	119,000	425	759
1991/92	350,000	213,000	136,000	626	977
1993/94	520,000	293,000	228,000	1208	1779
1995/96	693,000	388,000	305,000	1740	2449

Source: Millar et al (1997); DWP, *Benefit Expenditure Tables*, Tables 3 and 3a : nominal terms and Table 4 and 4a: real terms, 2008/09 prices, http://www.dwp.gov.uk/asd/asd4/medium_term.asp

'Making work pay': Working Families Tax Credit

By the time the Labour government won the 1997 election the principle of supplementing wages through the social security system was thus well established. In the welfare reform Green Paper, *New ambitions for our country: a new contract for welfare* (Cm 3805, 1998, p1) the government argued that 'paid work is the surest route out of poverty' but that 'people face a series of barriers to paid work, including financial disincentives'. This started the development of a series of reforms to employment services and benefits (see chapters 11, Wright and 15 Stafford here). Measures to improve financial incentives to work included the introduction (for the first time in the UK) of a National Minimum Wage, reductions in tax and national insurance contributions for low-paid workers, and the introduction of Working Families Tax Credit and Disabled Person's Tax Credit.

It was the Treasury in particular that was driving these measures through, and the tax credits story can be traced through a series of Treasury papers called *The Modernisation of Britain's Tax and Benefit System* (HM Treasury 1997, 1998a, 1998b, 1999, 2000, 2002, 2005, 2008). The second of these, the report on 'work incentives' by Martin Taylor, is a key document in this story (HM Treasury, 1998a). Martin Taylor, Chief Executive of Barclays, was asked to chair a task force set up in May 1997 (immediately after the election) with a remit to 'examine the interaction of the tax and benefits systems so that 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' (HMT, 1998a, p 5)[1]. Taylor starts by rejecting a full-scale integration of the tax and benefits systems on the grounds that they have different objectives, do not cover the same people, and have different units of assessment (individual for taxes, family for benefits). He argues that in-work wage supplements are necessary because there are 'a large number of people whose labour is not sufficiently well rewarded to allow them to support their families in an acceptable way. It seems to me far better that these people should be working, and receiving in-work benefits to top up their net pay, than that they should be idle' (p 8) and he argues for a tax credit, as opposed to a benefit because:

> A tax credit will associate the payment in the recipient's mind with the fact of working, a potentially valuable psychological change. I believe that a payment through the tax system, associated with the recipients work, is likely to prove more acceptable to society at large. And the establishment of a tax credit system is likely to come in useful in future as a broader delivery mechanism, eventually allowing closer integration between the benefits system and conventional income tax' (*op cit*, p8).

These points were repeated in the next Treasury paper (HMT, 1998b), which set out the details of the new tax credits:

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[1] The report covered national insurance contributions and benefits for the partners of unemployed claimants as well as tax credits, but we focus on the latter here.

> ‘As a tax credit rather than a welfare benefit, it will reduce the stigma associated with claiming in-work support, and encourage higher take-up. Its clear link with employment should demonstrate the rewards of work over welfare and help ensure that people move off welfare into work’ (*op cit*, p3).

The key rationale for a tax credit, as opposed to a benefit, is thus that taxes are positively associated with paid work while benefits are negatively associated with dependency. This, it is argued, makes tax credits more acceptable to recipients and to the public in general. The language here is also notable, it clearly reflects the influence of the USA, where ‘welfare’ is a negative term associated with dependency and failure (Deacon, 2000; Hirsch, 2000, see also Chapter 11 here, Wright). Indeed, there has been much policy sharing and policy transfer across countries in respect of tax credit provisions, with the USA experience, and values, an important element in this. Box 13.1 outlines the system in the USA and gives some further examples of tax credits in other countries.

Box 13.1 Tax Credits in the USA, Australia and Canada

The USA

The 'Earned Income Tax Credit' (EITC) has been in operation in the US as a federal scheme since the mid 1970s, but it is only in the past ten years or so that it has come to play a central role as part of the drive to 'end welfare' and get people into paid work. It is now a very large programme costing about $34 billion in 2003 and received by about 19 million families. The EITC is mainly targeted at families with children although it also available, at lower levels of payment, to childless and to single people. It is a refundable credit, which initially rises as earnings rise, then is paid at a maximum rate over a wide range of income, and finally is reduced as earnings increase until it reaches zero. Most families opt to receive their EITC annually, as a lump sum at the end of the year, rather than as an ongoing payment. Holt (2006) provides an overview of thirty years of the EITC and concludes that it is ‘has become a robust and largely successful component of American labor and antipoverty policy’ (page 1).

Australia

There are two main benefits for children delivered through the tax system in Australia: Family Tax Benefit Part A is a means-tested payment similar to the UK's Child Tax Credit. Family Tax Benefit Part B provides extra assistance to single-income families including lone parents, with higher rates for families with children under five years of age. Around 2.2 million families with 4.3 million children receive Family Tax Benefits, covering about 80 per cent of families. As in the UK, there is an assessment based on annual income with an end of year reconciliation. And, also as in the UK, the issue of overpayments have given cause for concern and various reforms form 2006 have sought to reduce these. See the Australian National Audit Office (2006).

Canada The Child Tax Credit is available to lower income families with children, paid monthly, on the basis of annual earnings but with no annual reconciliation. It is therefore very simple in design but set at a relatively low level. There is ongoing debate about the merits of setting up a wider tax credit system to support low-paid workers, see Battle and Mendelson (2005).

See Whiteford et al (2003) for a comparison of how Australia, Canada and the UK have designed their tax credits systems.

However, despite the presentation of these tax credits as something new and different, their structure was in fact very similar to that of family credit. As with Family Credit, Working Families Tax Credit was available only for families with children, it was paid to those with earnings below a certain level according to family size, and there was still a weekly hours threshold of 16 hours per week. Once awarded WFTC remained in payment for six months, regardless of changes in income or circumstances. All this mirrored the family credit rules, albeit more generously. Working Families Tax Credit also included a 'childcare tax credit' which covered up to 70 per cent of eligible costs for registered care, subject to a maximum limit. This was available to lone parents and couples if both parents were in paid work.

Table 13.3 shows the numbers in receipt of Working Families Tax Credit from 1999 to 2002 (it was replaced in 2003). In November 1999 there were about 966,000 families in receipt. Lone parents outnumbered couples (as they had done since about November 1998 for Family Credit) and the average payment was about £66 per week. The numbers in receipt rose steadily every year, reaching 1.3 million families in May 2002 with an average weekly payment of about £88. About 162,000 families were receiving help with childcare costs.

Table 13.3 Working Families Tax Credit, 1999 to 2002

Year	Number in receipt (000s)	Couples (000s)	Lone parents (000s)	Average weekly amount	Childcare tax credit (000s)
1999	9,66	468	498	£66	55
2000	1,061	513	548	£73	108
2001	1,259	617	642	£84	145
2002	1,340	634	706	£88	162

In May of each year, except 1999 November
Source: Inland Revenue (2002)

The Treasury was, perhaps not surprisingly, very upbeat in their assessment of Working Families Tax Credit (HMT, 2000, pp 9-10). It had, they argued, tackled the unemployment trap by ensuring that families were ‘generally’ better off in work and tackled the poverty trap by reducing by two-thirds the number of families with marginal tax rates of over 70 per cent. Alongside other measures it had also helped to increase the number of people seeking to enter work by about 160,000 and it had helped to increase family incomes, especially for the poorest families and so contributed to reduced levels of child poverty.

Independent research partly confirmed some of this, but also showed a more complex picture (Brewer and Gregg, 2001; Blundell and Walker, 2001; McLaughlin *et al*, 2001). The financial gains to work were indeed generally higher, but this applied primarily to full-time work and was much less the case for those receiving housing benefit (which is reduced as Working Families Tax Credit is received) and for those with high work costs including childcare costs (which were only partly met by the childcare care tax credit). Families in receipt of other means-tested benefits (again particularly housing benefit) still faced high marginal tax rates. The labour supply effect was estimated to be positive for lone parents and for the first earner in a couple. But the incentive for a second earner in a couple to take up work was much reduced[2].

Tax credits from 2003: Working Tax Credit and Child Tax Credit

The Working Families and Disabled Person's Tax Credits were replaced in 2003 by the 'next generation' of tax credits.

The Child Tax Credit is available to families with dependent children and consists of three elements: the family element which is the basic payment per family, the child element which is the amount per child, and a disabled child element for families caring for a disabled child. It has a wide coverage, with about nine in ten families eligible for the family element (see further discussion below).

The Working Tax Credit is targeted on low-paid workers, including families with children or disabled people if they work at least 16 hours per week, and single people and couples without children if they are aged 25 and above and work for at least 30 hours per week. It includes a thirty hour element for those with children (i.e. an extra payment for hours of work of 30 and above) and elements for disabled workers and people aged over 50.

The Working Tax Credit also includes a childcare tax credit for lone parents and couples where both are employed for at least 16 hours per week. This pays up to 80 per cent up to a maximum of £175 for one child and £300 for two children or more (rates in 2008). It is only payable to families using registered childcare.

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[2] This disincentive to second earner also existed under family credit of course, although less strongly because the level of benefit was lower. This problem is inherent in a family-based means test - when the second earner enters work the amount of benefit received starts to reduce. This is one of the arguments used in favour of a more individualised system of benefits (Millar, 2005).

Aims: supporting work, reducing poverty and modernising systems

Tax credits are a key element in the government's reform programme aimed at increasing employment participation rates and reducing poverty. The key aims were set out by HM Treasury (2002, p. 3) as follows:

– supporting families with children, recognising the responsibilities that come with parenthood;
– tackling child poverty, by offering the greatest help to those most in need, such as low-income families;
– helping to make sure that work pays more than welfare and that people have incentives to move up the earnings ladder.

In addition, the tax credits were presented by the Treasury as an opportunity to 'modernise' delivery, and in particular to create a simpler and more effective form of means-testing, with administration rationalised into one government department, the Inland Revenue (now HR Customs and Revenue), and assessment based on a simpler annual income test. The tax credits were designed to be simpler to administer and understand but also well targeted to people's needs: "the income tax system provides a light touch and non-stigmatising way of measuring income' (HM Treasury, 2002, para 2.10) which will 'provide continuity of support for those who are not experiencing significant changes in circumstances or income, with the ability to adjust quickly for those who are facing major changes' (op cit, para 4.1)

In order to seek to assess whether tax credits are meeting these aims, we start with an overview of the numbers in receipt since 2003.

Receipt of tax credits

Table 13.4 shows the numbers in receipt of tax credits since 2003. Overall the number of recipients has remained similar at about six million individuals or families. The six million includes about 1.4 million unemployed families (again the number has remained much the same over time) who are receiving the equivalent of Child Tax Credit while claiming an out-of-work benefit such as Income Support or Jobseekers Allowance. The number of working people receiving support has also remained steady at about 4.6 million. This represents about one in eight of the UK’s working-age population.

In 2003 there were about 121,000 working people without children receiving tax credits, rising to 376,000 by 2008. This is a sharp rise, but nevertheless these are a small minority and the bulk (over four million) of those in work receiving tax credits are families with children. These families can be divided into three main groups: those getting both Child Tax Credit and Working Tax Credit (about 1.7 million families), those getting Child Tax Credit only but receiving more than just the basic family element (about 671,000) and those receiving only the family element or less (about 1.9 million).

Table 13.4 Working Tax Credit and Child Tax Credit, provisional awards, 2003 to 2008

	Total	Out of work	In work	In work (thousands)			
				No children- WTC only	With children WTC and CTC	With children CTC more than family element	With children CTC family element or less
2003	5.5m	1.4m	4.1m	121	1,465	647	1,851
2004	6.0m	1.4m	4.5m	235	1,589	704	2,013
2005	6.0m	1.4m	4.6m	282	1,531	711	2,115
2006	6.0m	1.4m	4.6m	319	1,565	684	2,033
2007	6.0m	1.4m	4.6m	343	1,645	665	1,966
2008	6.0m	1.4m	4.6m	376	1,715	671	1,898

April each year, except July 2003
Source: HM Revenue and Customs (2008a) Table 1.1.

Table 13.5 looks in more detail at the families with children, in order to compare couples and lone parents, using the most recent data for 2008. There are a number of points to note here. Couples make up about 73 percent of working families in receipt of tax credits and lone parents about 27 percent. This is not dissimilar to the overall population proportion (lone parents make up about 25 per cent of all families with children)[3]. However lone parents and couples receive different types of support from tax credits. The majority (75 per cent) of couples are receiving Child Tax Credit only and just five per cent receive the maximum amount of Working Tax Credit. By contrast the majority (81 per cent) of lone parents are receiving both Child Tax Credit and Working Tax Credit. This of course reflects the lower earnings of lone parents – mainly lone mothers – and the fact that many of them work in part-time jobs. They

[3] See also Brewer and Shaw (2006) for a discussion of the estimates of the numbers of lone parents receiving tax credits.

are also sole earners (among couples about half of tax credit recipients are sole earners). In addition, almost half a million families are receiving help with childcare costs (a substantial increase since 2002, see table 13.2. above), but lone parents are more likely to receive this support than are couples (about 25 per cent compared with about five per cent).

Table 13.5 Tax credits: in-work families with children, provisional awards, 2008

	Total	Couples	Lone parents
Tax credits	%	%	%
CTC and WTC: maximum	12	5	29
CTC and WTC: tapered	28	20	52
CTC only: more than family element	16	18	9
CTC only: family element	41	53	9
CTC only: less than family element	3	4	0.1
	(100%)	(100%)	(100%)
Number of families (000s)	4,284.4	3,146.6	1,137.8
Number of children (000s)	7,435.1	5,693.2	1,741.9
Child care element (000s)	448.8	161.7	287.1

Source: HM Revenue and Customs (2008a), tables 2.1, 3.2, 4.3, 4.4, 5.1 and 5.2

Poverty and work incentives

Tax credits are an increasing significant part of government expenditure. In 2006/7 about £20 billion was paid to tax credit recipients, including about £5.7 billion to families not in work and receiving tax credits for children and about £14.7 billion to working people (HM Revenue and Customs, 2008d). The average payment for family with two children receiving just the family element of Child Tax Credit was about £600 per year, rising to over £7000 for those receiving both Child Tax Credit and Working Tax Credit (HM Revenue and Customs, 2008a). Tax credits have increased the financial returns from work, especially for lone parents. In 1999 a one-child family with one adult working part time would have had an income in work of about £136 per week, by 2008 this had risen to £226 per week (TUC, 2008).

Overall employment rates have been rising and poverty rates falling in recent years (see various Chapters here including 4, 8, 9 and 10). However estimating the direct impact of tax credits on employment rates and poverty is complex because of the range of other factors and policies involved. Brewer and Browne (2006) summarise evidence from five studies looking at Working Families Tax Credit (i.e. before the 2003 changes) and conclude that Working Families Tax Credit increased the proportion of lone mothers who work (probably by about five percentage points) but had little overall effect on couples with children. HM Treasury (2008) concludes that Working Tax Credit has increased employment among childless people.

The child poverty rate for children in working families is much lower than that of non-working families and much of the fall in child poverty rates since 2001 has been attributed to the impact of tax credits. Hirsch (2006, p42) concludes that initially 'rising employment was the biggest factor behind falls in child poverty, more recently it appears that jobs played a smaller role, and rises in tax credits a relatively large one'. However he also concludes that the current levels of tax credits will not be sufficient to meet the government's targets for eliminating child poverty, although increasing spending on Child Tax Credit by £4.2 billion would meet the 2010 target of reducing child poverty by half. Furthermore receipt of tax credits does not guarantee avoiding poverty. Barnes et al (2008), analysing data from the 2005 Families with Children Survey, show that among those receiving tax credits, about 29 per cent of couples with one earner are in poverty (defined as income below 60 per cent of the median), as are eight per cent of two-earner couples and 13 per cent of lone parents. To avoid poverty one earner couples at the minimum wage and receiving tax credits would have to work considerably more hours per week than lone parents (House Of Commons Work and Pensions Select Committee, 2008). Tax credits are more effective for lone parents than for one-earner couples because the poverty line is lower for lone parents but the level of tax credit is the same.

Tax credits have thus contributed to rising employment and falling poverty. But at the same time there has been significant criticism of both the design and delivery of tax credits and some concern that failures in administration have undermined the capacity to meet policy objectives.

Modernising design and delivery

As Millar (2008, p26) points out there are several features of the administration that are new to the UK, including:

- The use of the tax system to assess and make payments.
- An income test based on an annual assessment of entitlement.
- A simple definition of gross income, not taking into account capital assets.
- Limited responsiveness to changes in income and other circumstances during the period of the award.
- The separate tax credits for children and adults.
- An integrated system of support for all children, regardless of the employment status of their parents (not yet fully achieved in practice).
- The inclusion of childless and single people.

Delivering such a system had proved very challenging for the government, and especially for HM Customs and Revenue, the department in charge of assessment and payment. As noted above, one of the aims for tax credits was to achieve a light-touch means-test that would balance security of support with responsiveness to changes in income and circumstances. This was to be achieved by not seeking to fine tune the credits to reflect changes as they happen (as is the case for Income Support, for example). The assessment for tax credits is initially made on the basis of gross family income in the previous tax year. This forms the basis for the provisional award for the following 12 months. During the period of that award recipients are required to report certain changes in circumstances (such as splitting up with a partner) and awards are re-calculated during the year. However it is not required that all changes have to be reported and so there may be a difference between the provisional award (based on income in the previous tax year) and the finalised award (based on income in the current tax year). This is dealt with by means of an end of year reconciliation. At that point any underpayments are covered by a lump-sum payment at the end of the year and any overpayments are recovered either by adjusting subsequent tax credit awards or by adjusting the main tax codes if tax credits are no longer due.

Under and overpayments are thus an inherent element of the design of tax credits. But the government were clearly taken by surprise by the extent of these. Over the first few years overpayments affected about 1.9 million awards per year, costing about £1.5 billion to 1.8 billion annually. Underpayments affected about 0.8 million awards, at about £0.5 billion annually (Millar, 2008). Families receiving both Child Tax Credit and Working Tax Credit were the most likely to have under or overpayments, and these are the lowest income families, most likely to have volatile income and circumstances and most likely to rely upon tax credits for a substantial part of their incomes. The repayment of overpayments has been a source of significant concern and hardship for families, as has the lack of transparency and poor communication. Qualitative research with lone-parent families receiving tax credits has shown how important these are to family income in work but has also highlighted the problems caused by delays, incorrect payments, changes to awards and by a general lack of information and clarity about awards (Millar, 2008; Ridge and Millar, 2008). Box 13.2 summarises some of the key points of criticism of the administration of tax credits.

Box 13.2 The administration of tax credits – issues and problems

Godwin and Lawson (2008) identify the following issues in the delivery of tax credits:

- Under and overpayments - the scale of these, the impact on families, and the difficulties in recovering overpayments, leading to the write-off of significant debts

- Fraud and Error – estimated at about £1.04 to £1.30 billion in 2004/5, fraud has included organised fraud on the online claiming system, and there are high levels of customer error due to lack of understanding of the system.

- Take-up – The latest figures for 2005/6 (HMRC, 2008b) show 82 per cent take up of Child Tax Credit and 61 per cent take up of Working Tax Credit. About 1.1 million people estimated to be eligible non-claimants of Working Tax Credit, with about £2.2 billion unclaimed.

- Compliance costs to employers – this was higher under Working Families Tax Credit which was paid through the pay packet, which is not the case for Child and Working Tax Credits. Godwin and Lawson suggest that the main cost to employers is in providing information to assist people with claims.

- Compliance costs to claimants – the lengthy claim form, the obligations to report some changes, problems with estimating income and childcare costs, difficulties in accessing helpline services, delays and errors.

Various reports have criticised the administration of tax credits including: National Audit Office, 2005; Parliamentary and Health Service Ombudsman, 2005; House of Commons Treasury Committee, 2006; House of Commons Committee of Public Accounts, 2007.

A series of reforms to the system brought in from 2005 onwards were intended to improve the administration of tax credits and specifically to reduce over and under payments (Brewer, 2006). The measures included a very large increase in the level of disregarded earnings from £2,500 to £25,000. This means that if income rises by up to £25,000 in one year, the tax credit award for that year will not be adjusted. This provides a significant cushion against overpayments occurring due to income rises. Other measures included changes to the reporting requirements and to the way awards are adjusted in the year. These changes have lead to a fall in overpayments of about £0.7 billion, such that in 2006/7 overpayments stand at about £1.0 billion, affecting about one million awards. Underpayments are still at about £0.5 billion, affecting about 0.8 million people (HM Revenue and Customs, 2008c).

Various wider reforms have been suggested (Brewer, 2006; House of Commons Treasury Committee, 2006; Smithies, 2007) including a return to a fixed period of award, with no requirement to respond to changes in income or circumstances during that time (as in the old family income supplement and family credit systems). HM Treasury (2008) argues against this on the grounds of the need for flexibility and effective targeting, and instead proposes further reforms to the administration, including more disregards, lump-sum payments, use of banded income measures, and changes to the delivery of childcare support.

Tax credits and welfare reform

Tax credits are central to the Labour government's welfare reform agenda. Adler (2004) argues that tax credits and the New Deal programmes together represent a 'new and distinctive' approach to social security policy, addressing the new social risks of insecurity in employment and family structure. Tax credits provide income support to people in potentially adverse labour market situations, including low pay, self-employment, part-time work, and temporary or irregular work. They are also intended to enable families with just one earner, especially lone-parent families, to sustain employment. Tax credits can therefore be seen as part of a shift towards a "social investment" welfare state, which promotes self-support through employment, and includes policies intended to improve skills for employment, to invest in children, and to enable people to build up assets (Dobrowolsky and Jenson, 2005). Grover and Stewart (2002) interpret these policy developments in a different way, arguing that tax credits and other measures to 'make work pay' are about ensuring that unemployed people are driven into low-paid jobs while the costs of labour to employers are kept low.

The importance of tax credits shows how the UK 'social security' has become increasingly focused on wage supplementation rather than on wage replacement, which was the rationale for the system of social insurance designed by Beveridge in the 1940s. Tax credits are also a break with Beveridge in another sense, in that they take the UK even further down the means-testing road and away from universal or categorical ways of targeting support. Compared with any previous measures, tax credits cover more groups of the population and extend higher up the income scale. The attempt to do this by means of a 'light touch and non-stigmatising' means test has proved to be very difficult to achieve in practice and arguably the changes since 2003 have pushed the system further back into the more traditional form of means-tested support. Balancing simplicity and responsiveness, while still targeting effectively, is an elusive goal.

Overview

Support for low-paid workers dates back over 30 years in the UK, but has become increasingly important in recent years.

Tax credits are now a key part of the UK income transfer system, providing financial support to six million people, including 4.6 million working families with children.

They are innovative in design, extensive in coverage and generous in level compared with the UK's traditional means-tested social security support. There has been significant criticism of the design and delivery of tax credits, in particular the extent of over and under payments and how these have been dealt with.

Tax credits have contributed to rising employment and falling poverty, providing a substantial boost to the incomes of many low-paid people. They are central to the government's welfare reform agenda.

Questions for discussion

1. Why have tax credits become such an important part of government policy?
2. Have the government found the right balance between simplicity, targeting and responsiveness in the design of the Child Tax and Working Tax Credits?
3. How could the administration of tax credits be improved?

Website Resources

HM Treasury Work and Welfare	http://www.hm-treasury.gov.uk/documents/taxation_work_and_welfare/work_and_welfare/tax_workwel_index.cfm
HM Revenue and Customs – Tax Credit statistics	http://www.hmrc.gov.uk/stats/personal-tax-credits/cwtc-quarterly-stats.htm

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