BUDGET 98

The Modernisation of Britain's Tax and Benefit System

Number Three

The Working Families Tax Credit and work incentives

CONTENTS

INTRODUCTION AND SUMMARY

1.01 The Working Families Tax Credit (WFTC) is central to the programme of tax and benefit reform the Chancellor of the Exchequer announced in the Budget. It accompanies radical changes to the national insurance system and a £1¼ billion package of child support.

1.02 The introduction of the WFTC is one of Martin Taylor's recommendations in his report on Work Incentives, published on Budget Day.

1.03 The WFTC will be introduced from October 1999, replacing Family Credit. It will provide approaching £1½ billion more in-work support than Family Credit and will benefit around 400,000 more families with children .

1.04 The WFTC will make work pay for families, tackling the main obstacles to work: the unemployment trap, the poverty trap and lack of affordable childcare:

- the WFTC will guarantee working families a minimum income, above and beyond the level of the minimum wage. It will encourage people to move from unemployment into work. A family on £200 a week (the average entry wage for someone moving from unemployment into full time work) with two young children will be more than £23 a week better off as a result of the Budget;

- it will reduce the tax burden on families, raising the effective point at which they begin to pay income tax to the highest level since the 1960s;

- 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;

- the WFTC will be of particular benefit to women. It poses no threat to the principle of independent taxation, nor will it result in a compulsory transfer of resources from women to men. Couples will have the right to choose to whom the credit is paid, the man or the woman;

- women will benefit from the new childcare tax credit within the WFTC which will replace the failing childcare disregard in Family Credit (FC), increasing substantially the support available for childcare. Recipients of the WFTC will be entitled to help with 70 per cent of their childcare costs, subject to an overall ceiling for their childcare costs of £100 a week for one child and £150 a week for two or more children;

- the WFTC's withdrawal rate will be much lower than that of FC, improving work incentives and resulting in lower marginal tax and benefit withdrawal rates for 500,000 families currently in receipt of Family Credit. Under FC, $^{3}/_{4}$ million families face marginal rates of over 70 per cent. Under the WFTC this number will fall by two thirds to around $^{1}/_{4}$ million;

- the WFTC represents an important step towards greater integration of the tax and benefit system. It will reduce the wasteful overlap between the tax and social security systems. Almost 500,000 families pay income tax to the Inland Revenue while receiving FC from the DSS: the net effect of WFTC will be to take 97 per cent of them out of tax.

2 THE WFTC AND TAX BENEFIT REFORM

2.01 Last November, the Chancellor of the Exchequer committed the Government to a coordinated strategy of tax and benefit reform. This strategy will encompass a rolling programme of reform which is likely to continue to the end of this Parliament and beyond. The proposals which the Chancellor has announced in his Budget have been informed by Martin Taylor's report* on work incentives and represent a defining and important step on the road to reform. They will improve work incentives and help to make work pay. They will eliminate the tax burden on working families at the lower end of the earnings distribution, heralding a new beginning in the battle against poverty and welfare dependency.

2.02 The Chancellor has announced five key proposals in the Budget:

- a new tax credit paid to working families with children: the Working Families Tax Credit;
- a new childcare tax credit within the WFTC to help working families with the cost of childcare;
- a new tax credit to help sick and disabled people into work: The Disabled Person's Tax Credit;
- the biggest reform of national insurance contributions since 1975, which will encourage job creation at the lower end of the labour market, remove distortions and reduce administrative burdens on employers. The NIC burden on the lower paid will be reduced both for employees and employers, reducing the combined charge by £3.20 a week at earnings of £64 a week;
- a £1¼ billion package to increase support for children, raising child benefit for the oldest child by £2.50 a week from April 1999 and the child premia for the under 11s within the income-related benefits by £2.50 a week from November 1998.

---

*The Modernisation of Britain's Tax and Benefit System (No. 2) "Work Incentives: A Report by Martin Taylor".

2.03 In addition, he has reaffirmed his commitment to introduce a 10 pence starting rate of income tax as soon as it is right for the economy.

The Labour Market Challenge

2.04 The first paper in this series (The Modernisation of Britain's Tax and Benefits System (No.1) "Employment Opportunity in a Changing Labour Market") set out the labour market background to reform.

2.05 There is increasing polarisation between working and non-working families – about 3.5 million households with at least one adult member of working age have no one in work – or 18 per cent, compared to 9 per cent in 1979. Non-working women are increasingly partnered with workless men, whereas women with working partners, especially in families with young children, have experienced rapidly rising employment rates. The priority must therefore be to help those without work into work.

2.06 Five million adults and 2.7 million children live in workless households, which account for a growing proportion of those in poverty. The proportion of children living in families without a full-time employee has risen from 16 per cent in 1970 to 33 per cent in 1995. The Government believes that the best way to tackle poverty is to get people into jobs. It is therefore important to improve skills and employability. But it is also necessary to address many of the features of the tax and benefit system that fail to reward work and allow people to climb the earnings ladder:

- the unemployment trap which can result in in-work incomes being little higher than those available out of work;
- the failure of in-work support to recognise in-work costs associated with childcare;
- the poverty trap which arises when people in work cannot improve their income by working longer hours or for higher pay. At present ¾ million working families face marginal tax and benefit withdrawal rates of over 70 per cent.

2.07 The Government regards the WFTC as integral to the strategy for overcoming these obstacles.

Introducing the WFTC

2.08 The WFTC will be assessed and administered by the Inland Revenue. It will be introduced from October 1999, replacing FC, and will be payable through the wage packet from April 2000. When it is fully on stream, it will provide around £5 billion of help to about 1½ million working families, equivalent to £70 per family per week. The WFTC will give approaching £1½ billion more in-work support than FC, and will benefit around 400,000 more families.

2.09 The WFTC is designed to make work pay for families, guaranteeing them a minimum income, above and beyond the level of the minimum wage. Its clear link with employment should demonstrate the rewards of work over welfare and help ensure that people move off welfare into work. As a tax credit rather than a welfare benefit, it should reduce the stigma associated with claiming in-work support, and encourage higher take-up. FC has only ever been taken up by around 70 per cent of those in work who are entitled to it. With the WFTC, the onus will be on the Government to seek to ensure that as many families as are entitled receive the credit.

2.10 The WFTC represents an important step towards greater integration of the tax and benefit systems. It will reduce the wasteful overlap between the tax and social security systems: at present, almost 500,000 families pay income tax to the Inland Revenue while receiving FC from the DSS.

2.11 The design of the WFTC has been informed by the period of consultation, since the pre-Budget Statement in November of last year. It has also been informed by international experience. The Earned Income Tax Credit (EITC) in the United States and the Working Income Supplement (WIS) in Canada have provided important lessons: for example, the Chancellor has been concerned to avoid the delays in payment, and unresponsiveness to changes in circumstances, inherent in these models. The WFTC has been designed to reflect British circumstances, building on the successful elements of FC.

The WFTC and women

2.12 The labour market has changed significantly over the last decade with the result that women are likely to benefit in particular from the WFTC. Whereas the majority of FC recipients in 1988 conformed to the "traditional" family model with the father working and the mother staying at home, this is no longer the case. Around half of FC recipients are lone parents; a further 10 per cent are couples where the mother is the main earner. Women in particular will benefit from the childcare tax credit.

2.13 The WFTC will be payable through the wage packet. For around half the caseload, the main wage-earner will be the mother. For the other half, where the main earner is the father, there will be no compulsory transfer of resources from women to men. Couples will have the right to elect to whom the credit is paid, the man or the woman.

2.14 The WFTC will be assessed and paid over a six month period, on the basis of an initial assessment of household income. In this respect, it will be similar to FC which it replaces. It therefore poses no threat to the principle of independent taxation. As the Chancellor has made clear, the Government has no intention of reverting to the system which existed before 1990 whereby women were treated effectively as their husband's chattels for tax purposes.

The WFTC and employers

2.15 The WFTC will be payable through the wage packet from April 2000. This mechanism is important in order to reinforce the link between receipt of the credit and rewards of work. However, the Government is determined to minimise burdens on employers. It is important here to look at the effect of the Budget as a whole: the national insurance contribution reform in particular is likely to ease administrative burdens in the medium term.

2.16 Another important priority will be to ensure that the WFTC gets to recipients quickly and efficiently: uncertainty about in work support can be a big disincentive to returning to work. The design of the WFTC – whether paid through employers or direct from the Inland Revenue – will aim to deliver the tax credit to individuals reliably and on time.

2.17 In the months ahead, work will continue on the administrative arrangements for WFTC:

- efficient and effective delivery of the WFTC to those entitled to it will be a key objective;
- the Inland Revenue will be consulting employer organisations about the arrangements for paying WFTC through the pay packet. The aim will be to minimise extra work while ensuring successful delivery of the new credit. (A regulatory assessment will be published when detailed administrative arrangements have been settled.)

3 THE STRUCTURE OF THE WFTC

The structure of the WFTC

3.01 The proposed structure of the WFTC is set out in Table 1. In general, families on low incomes where the main earner works more than 16 hours will be entitled to a tax credit of £48.80 in respect of the adults (or adult) in the household, and a tax credit ranging from £14.85 to £25.40 a week, depending on age, in respect of each child.

3.02 The tax credit will begin to be withdrawn when the family's net income, before adding the WFTC, exceeds £90 a week. The withdrawal rate for each additional pound of net earnings will be 55 per cent. This means that a recipient in the 20 pence income tax band, who is paying national insurance contributions at 10 per cent and income tax at 20 per cent, will lose just 38.5p in tax credit for every additional pound they earn. The lower taper, compared to one of 70 per cent in Family Credit, combined with the more generous threshold and the retention of the additional credit of £10.80 where the main earner works for more than 30 hours a week, will encourage low earners to move from part-time to full time work, and onwards up the earnings ladder. The box (overleaf) illustrates how the WFTC will be calculated for various illustrative families.

Table 1: Structure of WFTC (£ per week; 1998-99 prices)

Basic tax credit (one payable per family)		48.80
Tax credits for each child aged	0-11	14.85
	11-16	20.45
	16-18	25.40
30 hours tax credit		10.80
Taper (Amount of credit withdrawn as % of every additional £1 of net income in excess of threshold)		55 per cent

The childcare tax credit

3.03 For many families, especially lone parents, the cost of childcare is a major obstacle to work. The previous Government attempted to address this problem by introducing a childcare disregard in Family Credit. But the disregard has been a failure: it has been taken up by just 32,000 families, just 20 per cent of the number originally expected. It has been of no help to the poorest families. Those earning below the withdrawal threshold (£79 a week) gain nothing from the disregard; only those earning over £139 a week can gain the maximum support.

3.04 The WFTC will therefore include a childcare tax credit designed to make support for childcare through the tax system more generous and more transparent.

3.05 The childcare tax credit will provide support over and above the basic adult, child and thirty hour credits. It will be worth 70 per cent of eligible childcare costs, subject to an overall limit on these costs of £100 a week for one child and £150 a week for two or more children. These limits have been carefully chosen to reflect the average cost of childcare, while also providing a 'shopping incentive' to find good value. The maximum childcare support will be £70 a week for a family with one child; £105 for a family with two or more children. (This compares to maximum support at present through Family Credit of £42 a week, rising to £70 a week in respect of two or more children from June.) Moreover, the maximum will be available to the lowest paid, unlike with Family Credit.

3.06 The definition of childcare for the purposes of the childcare tax credit, will be based on the rules for Family Credit. Eligible costs will include registered childcare, child care on school premises (eg out of school clubs) and at certain other places exempt from registration.

3.07 Any lone parent working 16 hours a week or more, and paying for child care will be eligible for the childcare tax credit. Couples will also be eligible where both partners are working 16 hours or more a week.

3.08 The childcare tax credit will be an integral part of the WFTC. It will be added to the basic and child credits, and withdrawn on the same basis. However, in practice, all families eligible for the WFTC in the absence of childcare costs will be entitled to a tax credit worth at least 70 per cent. of their eligible childcare costs. For example, a lone parent with two children under 11 and whose earnings are below around £320 a week, will be entitled to the maximum childcare credit of 70 per cent of the costs up to £150 per week.

3.09 The childcare help will go much further up the income distribution. For example, a couple earning £450 a week with two young children might receive as much as £45 a week. (See Example 4 below).

Calculating entitlement to the WFTC

Example 1: lone parent with one child under 11, working part time and earning £90 a week. Her aggregate income will consist of:

Earnings		£90.00
less national insurance		2.60
Net income (1)		£87.40
WFTC (2)		63.65
of which basic tax credit	*48.80*	
child tax credit (0-11)	*14.85*	
Child Benefit (3)		13.95
Total Income (1+2+3)		**£165.00**

Example 2: a one earner couple earning £220 a week, with two children aged under 11.

Earnings		£220.00
less national insurance		15.60
and gross income tax		25.91
Net income (1)		£178.49
WFTC (2)		40.63
of which basic tax credit	*48.80*	
2 child tax credits	*29.70*	
30 hour tax credit	*10.80*	
less 55% of excess of (1) over withdrawal threshold of £90	*48.67*	
Child benefit (3)		23.25
Total Income (1+2+3)		**£242.37**
Memo item: net income tax		**–14.72**

Example 3: two earners couple with the father earning £200 a week and the mother £100 a week, with two children under 11. Eligible childcare costs of £60 a week.

Earnings (father)		£200.00
less national insurance		13.60
and gross income tax		21.31
Earnings (mother)		£100.00
less national insurance		3.60
and gross income tax		3.86
Net family income (1)		£257.63
WFTC (2)	*39.10*	
of which basic tax credit	*48.80*	
2 child tax credits	*29.70*	
30 hour tax credit	*10.80*	
Childcare tax credit (70% of £60)	*42.00*	
less 55% of excess of (1) over withdrawal threshold of £90	*92.20*	
Child benefit (3)		23.25
Total Income (1+2+3)		**£319.98**
Memo item: net income tax		**–13.93**

Example 4: two earner couple, with the father earning £250 a week and the mother £200 a week. Two children under 11. Eligible childcare costs of £150 a week.

Earnings (father)		£250.00
less national insurance		18.60
and gross income tax		32.81
Earnings (mother)		£200.00
less national insurance		13.60
and gross income tax		24.97
Net family income (1)		£360.02
WFTC (2)		45.79
of which basic tax credit	*48.80*	
2 child tax credits (0-11)	*29.70*	
30 hour tax credit	*10.80*	
Childcare tax credit (70% of £150)	*105*	
less 55% of excess of (1) over withdrawal threshold of £90	*148.51*	
Child benefit (3)		23.25
Total Income (1+2+3)		**£429.06**
Memo item: net income tax		**11.99**

4 WFTC AND WORK INCENTIVES

Making work pay

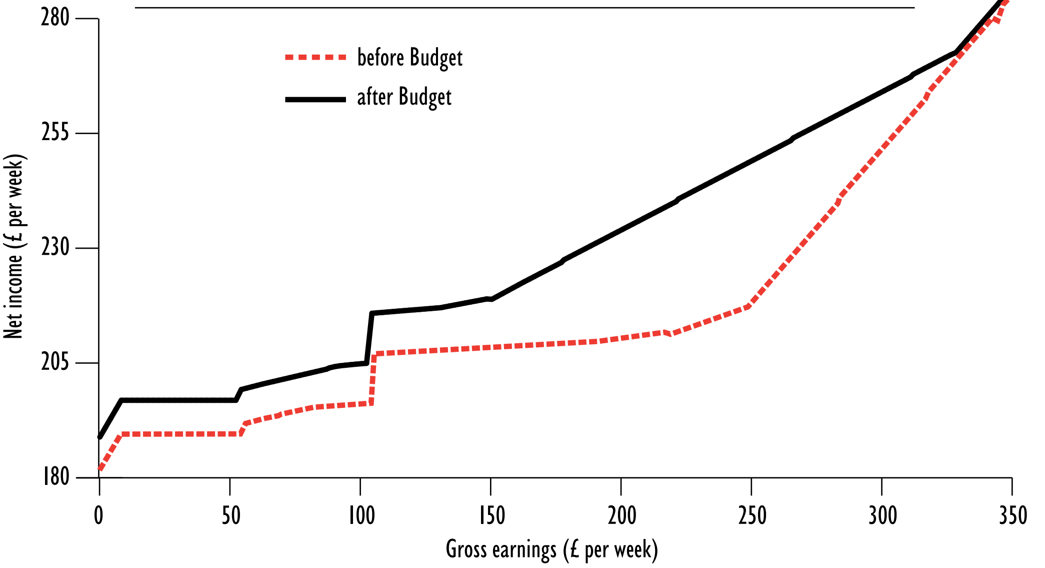
4.01 The WFTC will improve work incentives for families by making work pay.

4.02 The WFTC's structure reflects the priority the Government attaches to getting those who are out of work into work. The WFTC unambiguously improves the return from work. Moreover, by targeting the greatest increase in support on those earning in the range of £100 to £300 a week, the WFTC will support the sort of jobs those moving from unemployment and inactivity are most likely to take. The reforms to national insurance paid by employees and employers will reinforce this effect.

4.03 The WFTC's structure is also designed to make full-time work more attractive for those already in work, making it easier to move up the earnings ladder. The childcare tax credit, in particular, will help lone parents and two parent families to increase the hours they work.

4.04 Chart 1 illustrates entitlement to the WFTC for a two-earner family with two young children, and compares it to how much they are currently entitled to under FC. Table 2 sets out how much such a family will gain from the Budget.

Chart 1: Effect on net income after taxes and benefits of a one-earner couple with two children*



*Assuming a typical rent and council tax; earnings of £3.50 an hour; and no other income or capital

4.05 The WFTC will:

- **support the family:** every family working at least 16 hours and earning less than £90 a week, will receive at least £77.60 extra a week from the Government in the form of the tax credit and child benefit;

- **provide an income guarantee:** every family which works sixteen hours at a rate of £3 an hour will be guaranteed take home pay of at least £125 a week. Where the family has two children and the earner works full time at a rate of £4 an hour it will be guaranteed take home pay of at least £218 a week;

- **make entry level jobs more attractive and increase in work support** for the vast majority of families currently on Family Credit;

- **reduce the net tax burden on working families:** no family with a wage packet of less than £220 a week will have net income tax to pay – the highest effective starting point for income tax in thirty years. All but 3 per cent of the 500,000 Family Credit recipients, who currently pay income tax, will be effectively taken out of tax.

Table 2: Increase in income after tax and benefits for a one-earner couple with two children under 11[1].

(£ per week)

Weekly earnings (£ per week)	Increase in income (£ per week)
0	7.50
100	8.85
130	9.25
160	12.75
200	23.30
250	31.50
300	13.10
400	1.95

[1] *Assuming a typical rent and council tax; earnings of £3.50 an hour, and no other income or capital.*

4.06 The WFTC will improve the rewards from work. By targeting families with children on low to moderate earnings it will especially help those for whom the unemployment trap is particularly severe. The increase in the reward from working will be substantial. For example, a one-earner couple earning £130 a week (the average entry wage for someone moving from unemployment into work) with two children under 11 will gain £9.25 a week as a result of the Budget. A similar family on £200 a week (the average entry wage for a full-time job) will gain more than £23 a week.

Table 3: Average increase in income from working full time for families in the unemployment trap[1].

(£ per week)		
	Employed	**Non-employed**
Increase in income in full time work		
Families with children	7.20	12.50
All benefit units	4.00	6.20

[1] *Figures are for those with replacement ratios of over 70 per cent. Those for the employed are for families where the head works 30 hours or more and exclude the self-employed. Those for the non-employed are for families where the head of the household is currently unemployed or inactive and assume the head works full-time with hourly wages in line with those currently obtained by those leaving unemployment for work. The figures do not include the effects of the childcare credit.*

Effect on marginal rates (and the 'poverty trap')

4.07 The poverty trap arises when the combination of tax and the withdrawal of benefit gives rise to penal marginal "tax" rates. It can discourage work and damage the incentive to rise up the earnings ladder.

4.08 The WFTC will ease the poverty trap by reducing marginal rates for over $1/2$ million families, currently in receipt of FC. This will encourage people either to work longer or to get better paid jobs. It will also encourage partners of WFTC recipients to become second earners. The reduction in marginal rates arises because of:

- the lower taper of 55 per cent compared to the 70 per cent available in Family Credit;
- changes in the interaction with Housing Benefit which will end the anomaly whereby the 30 hour premium in Family Credit could give rise to marginal rates of over 100 per cent for a small number of families with FC entitlement of less than £10.80 a week;
- the increase in the withdrawal threshold;
- the increase in the child credits;
- the WFTC will float around 50,000 families off Housing Benefit, greatly reducing the number facing penal rates from the combination of more than one benefit taper.

4.09 Table 4 shows the effect on marginal rates if the WFTC were in place today. The number facing marginal rates of over 70 per cent is reduced from 3/4 million to about 1/4 million.

Table 4: Effect of Budget on Marginal "Tax" Rates[1]

	Before	After
100%+	5,000	0
90%+	130,000	20,000
80%+	300,000	200,000
70%+	740,000	260,000
60%+	760,000	1,010,000

[1] *Figures are for families in the UK in receipt of income-related benefits or the WFTC where at lease one partner works 16 hours or more. They are based on 1997-98 caseloads and take up rates.*

4.10 Reducing marginal rates for the lowest paid inevitably means that marginal rates will have to rise higher up the income distribution. Those brought into entitlement and on the WFTC taper will face higher marginal rates than at present. This is, of course, inevitable if the worst excesses of the poverty trap are to be removed. But some have therefore questioned the extent to which the WFTC will improve work incentives. In particular, it has been argued that some second earners will choose to reduce their hours in order to increase entitlement. However, this fails to take into account that:

- at a time when one in five households are not working, the **highest priority must be to get one member of workless families into work.** It is the 'work poor' rather than the 'work rich', which need the greatest help in the modern labour market. As mentioned above, the WFTC targets those moving from unemployment into work. Its lower taper will also encourage partners of low earners to get a job;

- in any case, the **childcare credit will benefit second earners,** as well as lone parents, making it easier to return to employment, and once there reducing the cost of working longer hours. Two earner households will only be eligible for the credit if they both work more than sixteen hours a week. For many second earners working only a few hours, this will provide a strong incentive to work more ;

- only a **minority of families** floated on to the WFTC will be two-earner couples;

- those **facing higher marginal rates** – as a result of being brought into WFTC entitlement – will be better off than they are now: in some cases, significantly so. It is difficult to argue that those earning around £300 a week are entrapped in poverty.

4.11 Academic research supports the conclusion that the WFTC will improve work incentives.

4.12 Modelling labour supply responses to tax and benefit changes is notoriously difficult. It is necessary to overcome a series of problems, including the estimation of potential “entry wages” for those out of work, work related costs and stigma and awareness effects. In addition, it is necessary to take into account the possibility of involuntary unemployment, and the interaction between family members. All too often, studies focus on one group of people and assume the employment status of their partners remains constant: however, the polarisation of working and workless households suggests this assumption can lack plausibility. The ideal study would cover a panel of individuals over a long period of time, covering the period before and after a major policy change. The use of a control group of individuals who are unaffected by the policy change and can be used as a benchmark against which to draw comparisons, greatly increases the accuracy of the results, making it possible to net out time variations, such as the state of the labour market. But control groups are impossible to define where the policy is a tax or benefit change affecting everyone. Simple cross section studies are therefore the least powerful tool for measuring work incentives, because they fail to capture the dynamics of adjustment to policy changes. Improvements in the quality and availability of labour market data have offered new opportunities to explore the question of work incentives, and recent studies using ‘before and after’ techniques are producing interesting and relatively robust results.

4.13 Subject to these caveats, it is possible to draw some tentative conclusions from academic studies of work incentives in the USA and UK:

- in-work credits, such as the EITC and Family Credit, have the potential to raise substantially labour market participation for poorer families, particularly lone parents, both in respect of part time and full time work;

- a fall in marginal deduction rates can help more people move up the earnings ladder. But the withdrawal of in work support as income rises can also reduce modestly the hours worked of those already employed.

Further copies of this document are available from:
The Public Enquiry Unit
Room 89/2
HM Treasury
Parliament Street
London SW1P 3AG

Tel: 0171 270 4558

http://www.hm–treasury.gov.uk

RF57372

Printed by Royle Financial Print