

# **Tax credits: reforming financial support for families**

**The modernisation of Britain's  
Tax and Benefit System**

**Number Eleven**

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financial support for families

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# INTRODUCTION

**I.1** Over the past seven years the Government has reformed Britain's tax and benefit system to achieve three over-arching objectives:

- ensure adequate financial incentives to work;
- reduce child poverty and increase financial support for all families; and
- tackle poverty among the current generation of pensioners and support people in providing for their retirement.

**I.2** In the past, the tax and benefit system failed to address the challenges of rising worklessness, and poverty among families and pensioner households that emerged from the early 1980s. In the UK even during periods with relatively high employment, rates of household worklessness and child poverty were higher than in most other industrialised countries, and reached historically high levels in the mid-1990s. Further, while pensioners' incomes were improving on average, there was a large group of pensioners whose standard of living was falling behind the rest of society.

**I.3** To deliver the Government's aims of employment opportunity for all; giving every child the best start in life; and dignity in retirement for all pensioners, the need for fundamental reform of Britain's tax and benefit system was clear. This paper describes the reforms put in place since 1997 and the principles which underpin them, and sets out the evidence on their impact so far.

**I.4** Chapter two describes the trends of rising worklessness and child and pensioner poverty, and outlines the structure of the tax and benefit system prior to the reforms the Government has introduced and the inadequate work incentives that it contributed to, especially for families.

**I.5** Chapter three highlights the role of tax-benefit integration in providing effective incentives and targeted financial support for families and other groups. It outlines the key principles which underpin the Government's reforms of the tax and benefit system and the concept of net tax as the appropriate measure of a household's tax burden. Chapters four to six describe how the principles governing policy design have guided the Government's reforms and also assess the evidence on their impact.

**I.6** The Government's policies to modernise the tax and benefit system constitute the most fundamental programme of welfare reform since the 1940s. Nevertheless there remain important areas where further reform could contribute to the Government's aims. Chapter seven explains how future policies to reform Britain's welfare state will be guided by the principles for modernising the tax and benefit system.



# 2

## THE LABOUR MARKET AND POVERTY

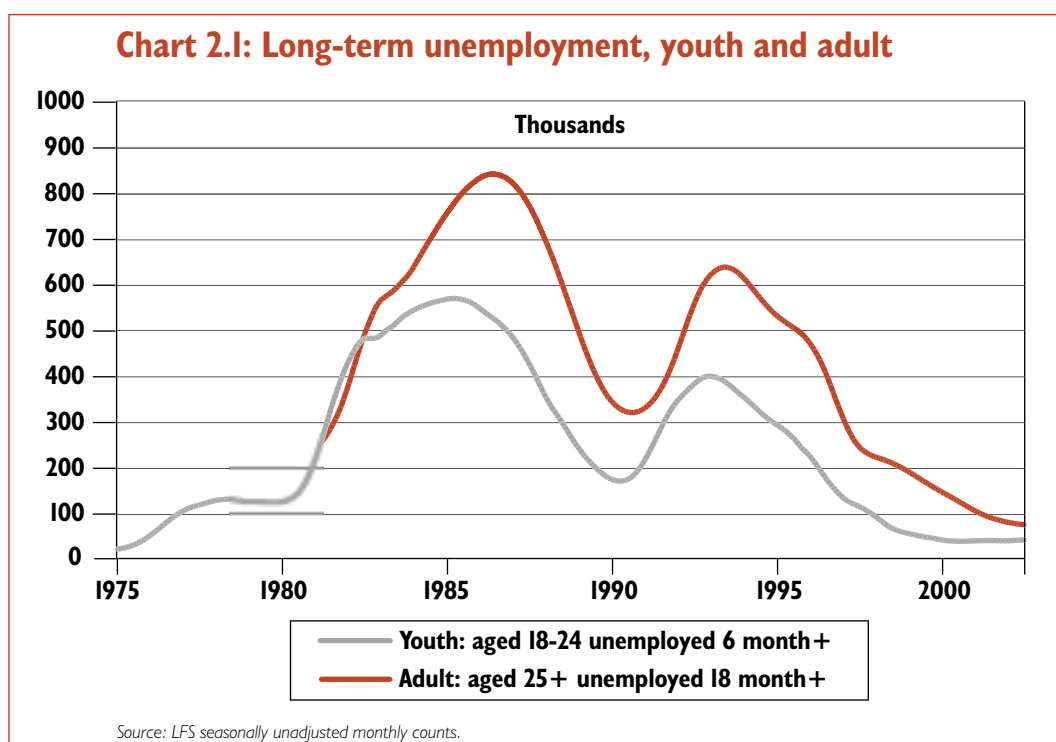
**2.1** The first part of this chapter sets out the background to the Government's welfare reform programme by describing key labour market trends in the 1980s and 1990s and their impact on the distribution of incomes for households with children. The increasingly unequal distribution of income among pensioners is also briefly outlined. The second section of the chapter discusses some of the weaknesses of the tax and benefit system which the Government inherited.

### Unemployment and worklessness

**2.2** After a period of comparative stability from the 1950s to the mid 1970s, the following twenty years saw unprecedented fluctuations in the UK's labour market. Dramatic swings in the macroeconomy pushed the unemployment rate up to post war highs of 11.9 per cent in the early 1980s and 10.5 per cent in the early 1990s, before the labour market started to recover. By the mid 1990s the unemployment rate had fallen back to around 8 per cent on the International Labour Organisation (ILO) measure with the employment rate rising to around 72 per cent. On the claimant count measure unemployment had fallen back from its peak in the early 1990s to around two million.

**2.3** However these headline figures masked a set of structural changes in the labour market which were producing far more unequal outcomes for working-age households. Although by the mid 1990s unemployment had started to fall in aggregate, it had become much more concentrated, with some people experiencing much longer periods unemployed.

**2.4** By 1997 the average worker's probability of becoming unemployed was almost as low as it had been thirty years earlier but the average spell of unemployment had increased approximately three-fold over the same period<sup>1</sup>. Chart 2.1 shows the number of adults and young workers in long-term unemployment.



<sup>1</sup> *The State of Working Britain*, Dickens, Gregg and Wadsworth, 1999.

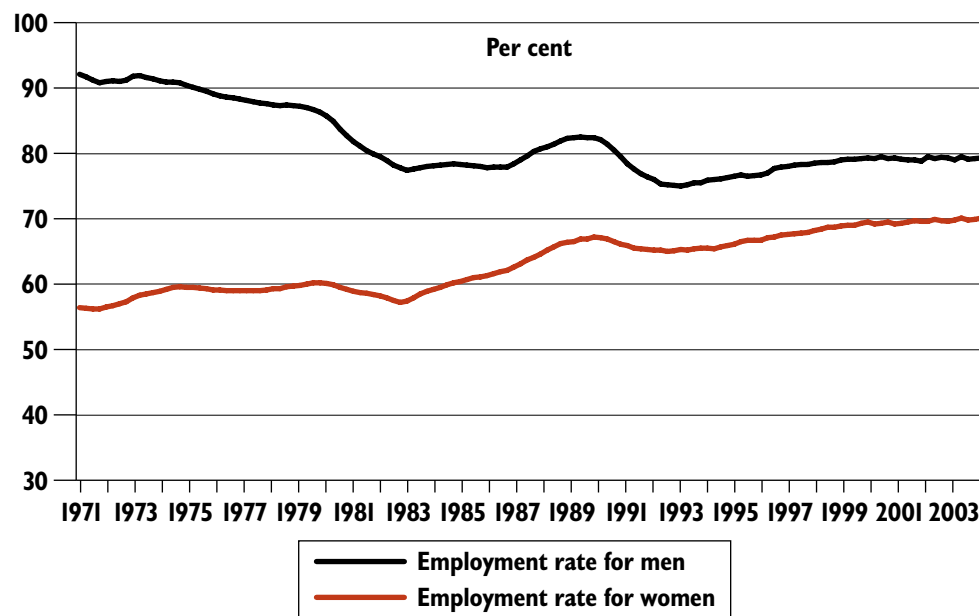
**2.5** But the more profound change was a sharp rise in economic inactivity. Increasing numbers of men were leaving the labour market altogether and there were more lone parent families, who often faced some of the highest barriers to work. As discussed in the next section, the existing tax and benefit system had not been designed to provide the right support and incentives for these groups, and as a result they were left to depend on benefits related to economic inactivity, such as incapacity benefits<sup>2</sup> and Income Support. The other key labour market trends were:

- a significant gender shift in the labour market with rising employment among mothers with a working partner;
- falling employment rates for lone parents and couple mothers without a working partner;
- low employment rates among disabled people and some ethnic minority groups; and
- wages for the lowest paid workers falling further behind average wages.

### Changing employment patterns

**2.6** Over the past thirty years there has been a substantial gender shift in the labour market. The employment rate for working-age men has fallen from 92 per cent in 1971 to 80 per cent today while the employment rate for women has increased from 56 per cent to 70 per cent over the same period.

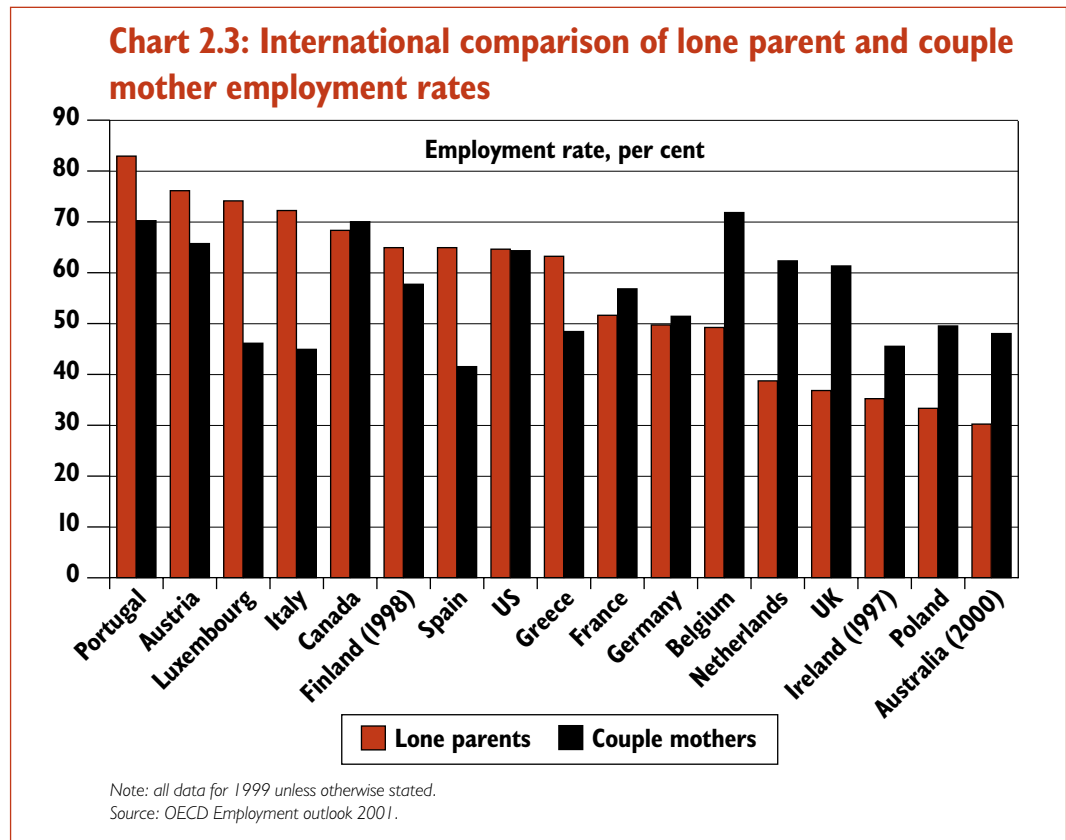
**Chart 2.2: Employment rates for working-age men and women**



Source: Office for National Statistics.

**2.7** While women are now more likely to be in work, the rise in the employment rate of mothers has been much larger than for women without children, two-thirds of whom were already in work in the early 1970s. But the rise in employment among mothers was confined to those with a working partner. Employment rates of both lone parents and couple mothers with a workless partner decreased during the 1980s and early 1990s. Chart 2.3 shows that by the end of the 1990s the difference in the employment rates of lone parents and couple mothers was higher in the UK than in any other OECD country.

<sup>2</sup> Incapacity benefits include Incapacity Benefit, Income Support on the grounds of incapacity and Severe Disablement Allowance.



**Worklessness among lone parents** **2.8** By the mid 1990s around 20 per cent of the 7.2 million families with children in the UK were headed by a lone parent. Compared with other industrialised countries, lone parent employment in the UK was exceptionally low. Around 44 per cent of lone parents were working in the mid 1990s while in many other OECD countries the lone parent employment rate exceeded 60 per cent.

**2.9** The increase in the number of lone parents, together with their falling employment rate, led to a three-fold rise in the total number of lone parents receiving Income Support to over 1 million by 1995, as shown in Chart 2.4.

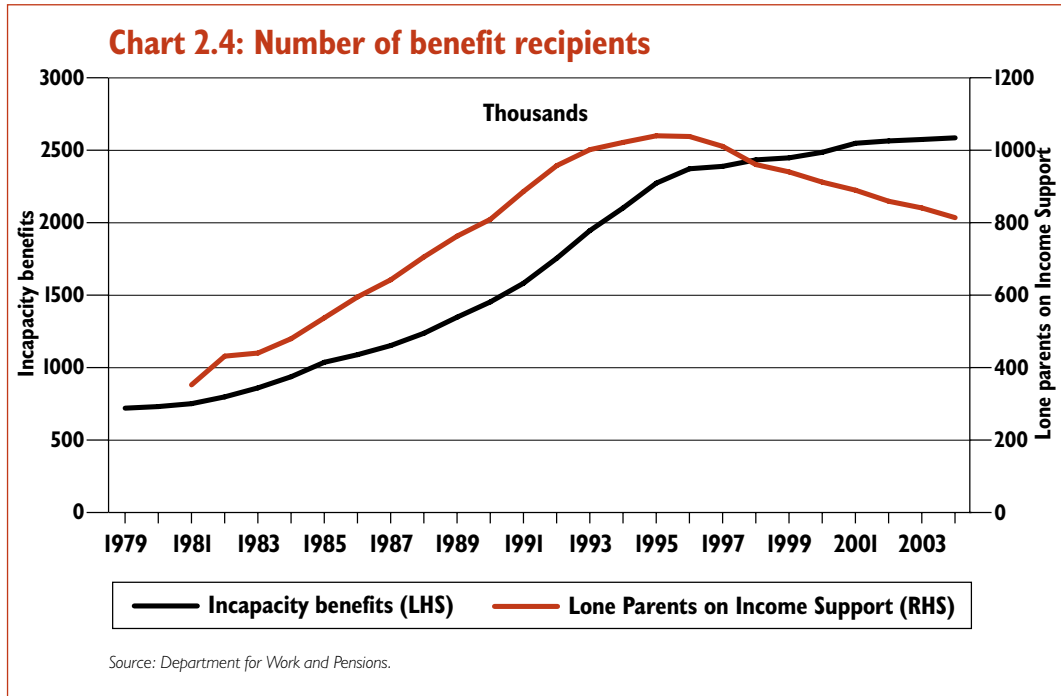
**2.10** As a result children in lone parent families were disproportionately likely to be in workless families and in poverty. Around 60 per cent of children in lone parent families were living in a workless household in the mid 1990s and a similar proportion were living in absolute low-income households<sup>3</sup>. By comparison, in the same period about 10 per cent of children in couple families were in workless households and just over one quarter were living in poverty.

**Inactivity and disability-related benefits** **2.11** In addition to the rise in workless lone parents, since the late 1970s there has been a significant increase in the number of people in the UK who are economically inactive because of a health condition or disability. In 1979, around 700,000 people were claiming incapacity benefits. By the mid 1990s, inflows had increased to over 1 million a year and by 1997 the number of claimants had trebled to 2.6 million, as shown in Chart 2.4.

**2.12** Many claimants were effectively consigned to long-term benefit receipt – evidence shows that once a person has been on incapacity benefits for 12 months, the average duration of a claim is 8 years. Claimants became increasingly isolated and distanced from the labour market and the welfare system at that time largely treated them as passive benefit recipients and afforded them neither the advice nor access to employment programmes that were available to the unemployed.

<sup>3</sup> Defined as a household with income below 60 per cent of 1996-97 median household income.

**2.13** With the right employment and health-related support, long-term benefit receipt should not have been the inevitable outcome of the main conditions reported by incapacity benefits claimants: most new claimants, for example, have positive work aspirations – 90 per cent want and expect to work again.



**2.14** Rising worklessness among people with a health condition<sup>4</sup> explains much of the long-term decline in the employment rates of older workers. In 1973 nearly 90 per cent of men aged between 50 and the state pension age were in work but by 1995 this had fallen to below two-thirds. This in turn contributed to the fall in the mean age of effective retirement from 67 in 1950 to 63 in 1995, which had a substantial impact on the UK's capacity to respond to the challenges of longer life expectancy.

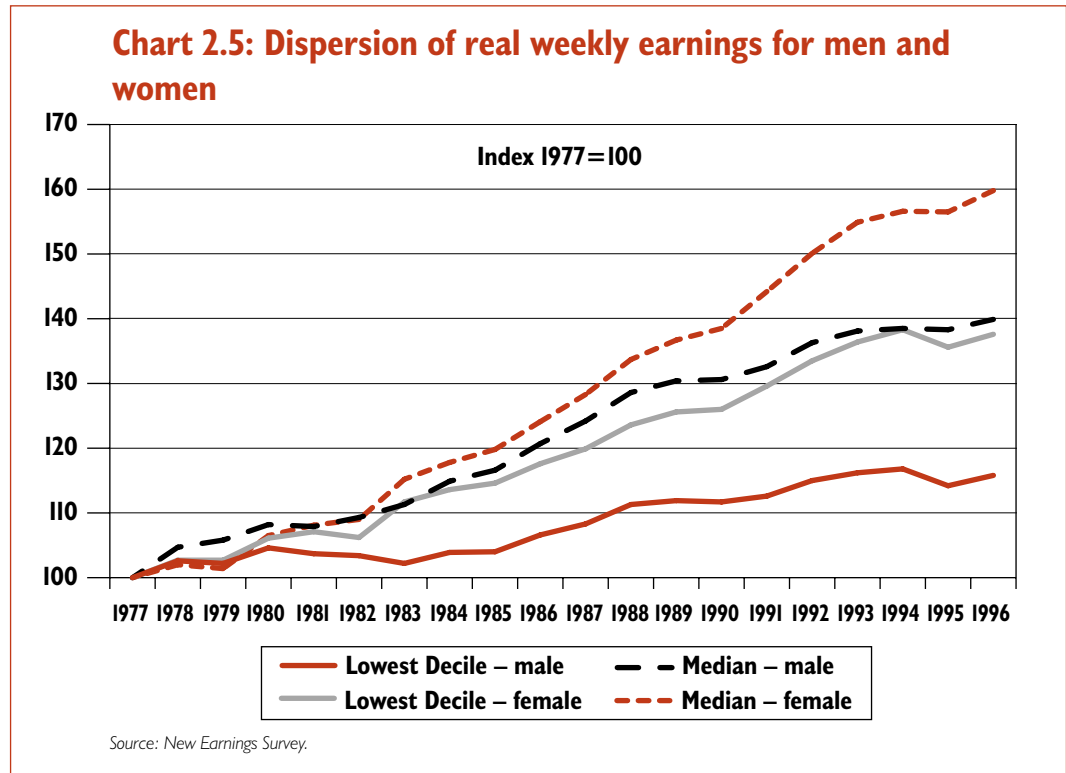
**Ethnic minorities 2.15** The labour market performance of ethnic minority groups also remained relatively weak. In 1992 the unemployment rate of Bangladeshi, Pakistani and Black Caribbean men was 15-20 percentage points higher than that of their White counterparts. Over the 1990s the scale of this disparity decreased but overall the employment position of ethnic minorities remained considerably worse than that of the White population<sup>5</sup>.

**Wage inequality and the skill premium 2.16** A further dimension to the increasingly unequal outcomes in the labour market was rising wage inequality. From the mid 1970s growth in real wages for men at the bottom of the wage distribution<sup>6</sup> was well below earnings growth at the median. Low paid women saw significantly faster growth in their real wages but from a much lower base. These trends are illustrated in Chart 2.5.

<sup>4</sup> *Inactivity among prime age men in the UK*, Faggio and Nickell, 2005.

<sup>5</sup> *Ethnic minorities and the labour market*, Prime Minister's Strategy Unit, 2003, [www.number-10.gov.uk/su](http://www.number-10.gov.uk/su).

<sup>6</sup> Between 1977 and 1996 annual average growth in real wages at the 10th percentile of the wage distribution was 0.8 per cent for men compared with real earnings growth at the median of 1.8 per cent.



**2.17** The level of wages paid to people moving into work also grew more slowly than wages in aggregate, increasing the costs of unemployment in terms of lower expected future wages. Among men, a spell of unemployment was found to reduce wages by about 6 per cent on re-entry to the labour market compared with people moving directly between jobs<sup>7</sup>. More generally, there is evidence that between the early 1980s and mid 1990s spells of unemployment among men were leading to larger reductions in subsequent hourly earnings<sup>8</sup>.

**2.18** There is also evidence that unemployment has scarring effects through increasing worklessness in later life<sup>9</sup>. With the costs of a period of unemployment rising, macroeconomic stability attains even greater importance. Its role in providing a foundation for welfare reform is set out in Box 2.1 at the end of this chapter.

**2.19** The causes of the fall in economic activity among men and rising wage inequality are complex but part of the explanation is the decline in the demand for low-skilled workers. In the early 1980s 4.3 per cent of low-skilled prime age men were economically inactive compared with 1.9 per cent of those who were not low-skilled<sup>10</sup>. Twenty years later the inactivity rates in these groups had risen to 18.1 per cent and 3.9 per cent respectively.

**2.20** Over the same period the wage premium attracted by individuals with higher qualifications rose despite a dramatic increase in the proportion of the working-age population with these qualifications. The relative decline in demand for unskilled labour is attributable to two important trends which continue to shape the global economy. First, advances in technology which favour high-skill workers – either because they replace routine manual operations or because they increase the productivity of individuals with high skills. Second, increased trade with countries which have abundant labour supply, creating a comparative advantage in producing low-skill intensive goods.

<sup>7</sup> *Is unemployment really scarring? Effects of unemployment experiences on wages*, Arulampalam, Economic Journal, 2001.

<sup>8</sup> *A Picture of Job Insecurity Facing British Men*, Nickell, Jones and Quintini, Economic Journal, 2002.

<sup>9</sup> *Persistent poverty and Lifetime Inequality: The Evidence*, CASE report no. 5/HM Treasury Occasional Paper no. 10

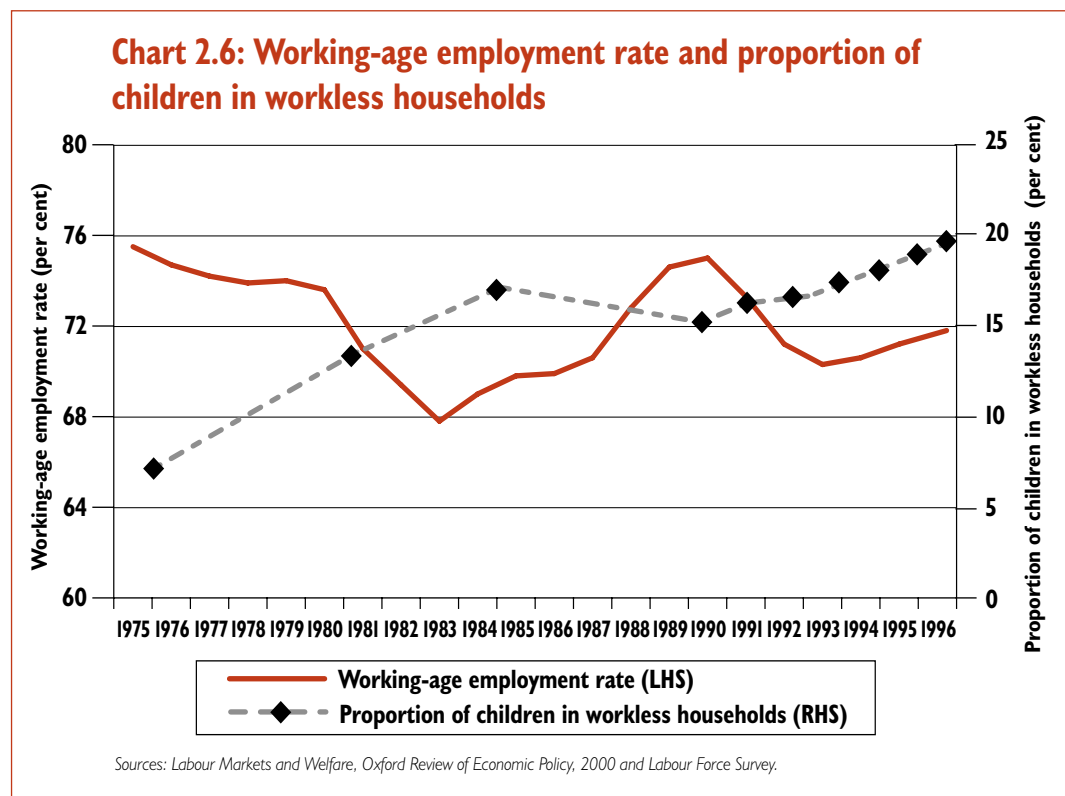
<sup>10</sup> *The Labour Market under new Labour, The State of working Britain*, Dickens, Gregg and Wadsworth, 2003.

**2.21** The changing world economy presents the Government with the challenge of ensuring that the economic benefits of trade are shared widely across society. This requires that everyone has the opportunity to acquire and update their skills, improving their employability. In the longer term, investment in skills, particularly at the lower end of the skills distribution, can help to reduce income inequality and poverty, in particular by reducing vulnerability to structural change in the economy. Further, the tax and benefit system should ensure that work is financially rewarding, especially for those who in the past would have been adversely affected by the changing structure of the economy.

## Worklessness and poverty

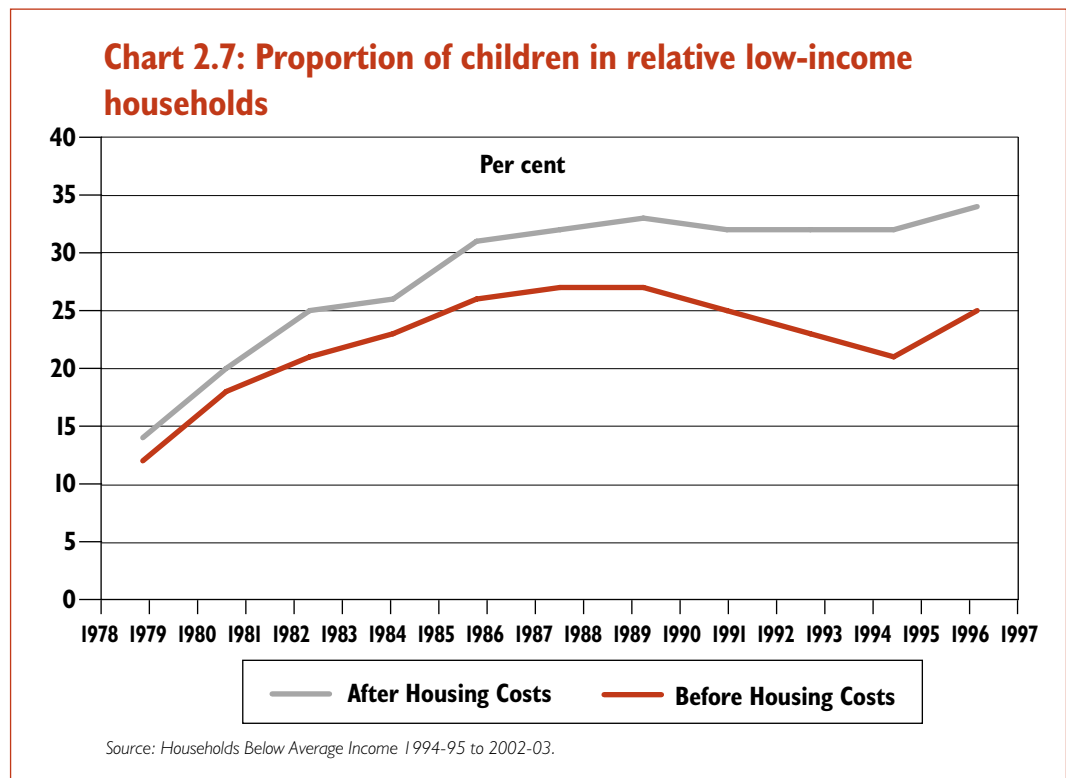
**2.22** The falling employment rate of low-skilled men, the increased number of lone parent households and lower employment among mothers with unemployed partners contributed to an increasingly polarised distribution of work across households. The proportion of couple households with a single earner reduced sharply, with corresponding increases in workless households and households in which all adults were in work. By the mid 1990s just under 19 per cent of working-age households had no adult in work.

**2.23** Although other industrialised countries had similarly high proportions of households with no adult in work, the UK was exceptional in the concentration of worklessness on families with children. In 1996 over 30 per cent of workless households in the UK contained children, compared with 14 per cent in France, 11 per cent in Germany and 18 per cent in Spain<sup>11</sup>. Even though the employment rate in 1996 was not far below its level of twenty years earlier, over that period the proportion of children living in workless households had increased nearly three-fold.



<sup>11</sup> *The State of Working Britain*, Dickens, Gregg and Wadsworth, 1999.

**Child poverty 2.24** Rising worklessness and wage inequality both contributed to the sharp increase in the proportion of children living in households with relative low income<sup>12</sup>. From the early 1980s to 1996-97, the proportion of children in relative low-income households (those with equivalised<sup>13</sup> incomes below 60 per cent of the contemporary median) rose from 12 per cent to 25 per cent measured on a before housing costs basis and from 14 per cent to 34 per cent on an after housing costs basis<sup>14</sup>. The UK had the highest proportion of children in low-income households in the EU in 1998<sup>15</sup>. Chart 2.7 shows the proportion of children in relative low-income households, both before and after housing costs.



**2.25** If child poverty is measured against a constant level of real income, the proportion of children in low-income households fell only slowly during the 1980s and the early 1990s, showing that poor families with children did not share significantly in the economic growth which took place during the period. Chart 2.8 shows the proportion of children living in absolute low-income households (those with incomes below 60 per cent of 1996-97 median household income).

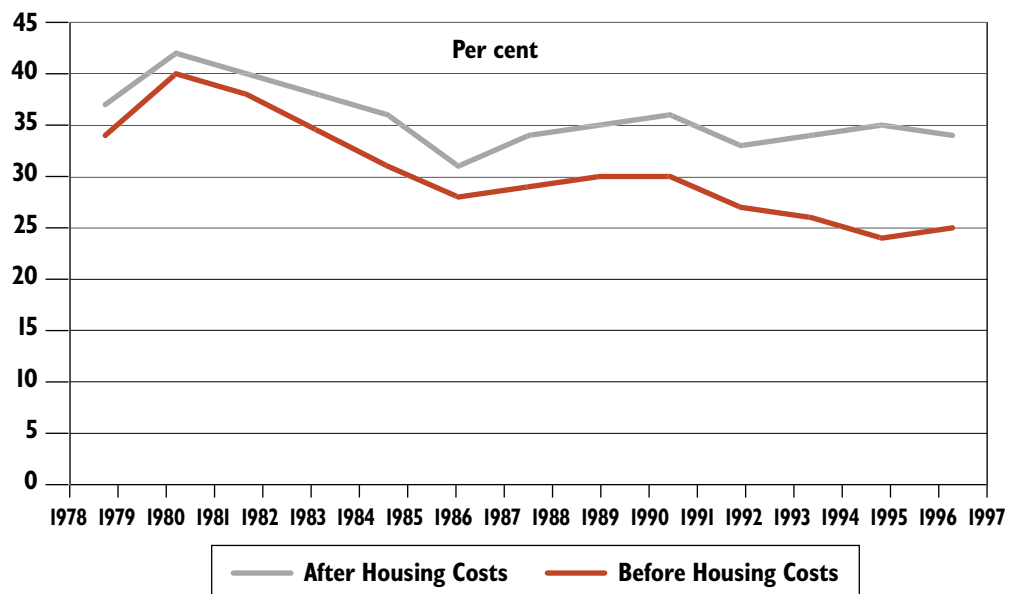
<sup>12</sup> *Poverty and worklessness in Britain*, Nickell, Royal Economic Society Presidential Address, *Economic Journal*, 2004.

<sup>13</sup> Equivalised incomes reflect the number of adults and the number and ages of children in the household, allowing the incomes of differently sized households to be compared.

<sup>14</sup> *Households Below Average Income 1994-95 to 2002-03*, DWP, 2004.

<sup>15</sup> European Community Household Panel Survey.

**Chart 2.8: Proportion of children in absolute low-income households**



Source: Households Below Average Income 1994-95 to 2002-03.

**2.26** During the 1980s and the 1990s financial support was available through Income Support for out-of-work families and for working families on low incomes (through Family Income Supplement and from 1988 through Family Credit). In addition, Child Benefit provided universal support for families. Nevertheless as Chart 2.7 shows, an increasing proportion of children were being left behind relative to the standard of living across society as a whole. In addition to the increasing numbers of children in workless households, the level of financial support fell in relative terms with benefits rising only in line with prices<sup>16</sup>.

**The impacts of child poverty**

**2.27** By the late 1990s there was a wealth of evidence about the negative impacts of growing up in poverty on children’s short and longer-term outcomes. Research showed that poverty and its negative impacts were transferred from one generation to the next, leading to cycles of deprivation within families and areas. Intergenerational effects appear to have strengthened over time, with the correlation between a son’s earnings and parental income rising between those born in 1958 and those born in 1970<sup>17</sup>. This is at least partly due to a stronger association between qualifications and earnings and between parental income and the qualifications of their children<sup>18</sup>.

**2.28** The determinants of the intergenerational transmission of poverty are not well understood but include linked factors such as: low income in childhood; growing up in a workless household; poor educational attainment; and family attitudes, expectations and aspirations<sup>19</sup>.

<sup>16</sup> *One hundred years of poverty and policy*, Glennerster, Hills, Piachaud and Webb, Joseph Rowntree Foundation, 2004

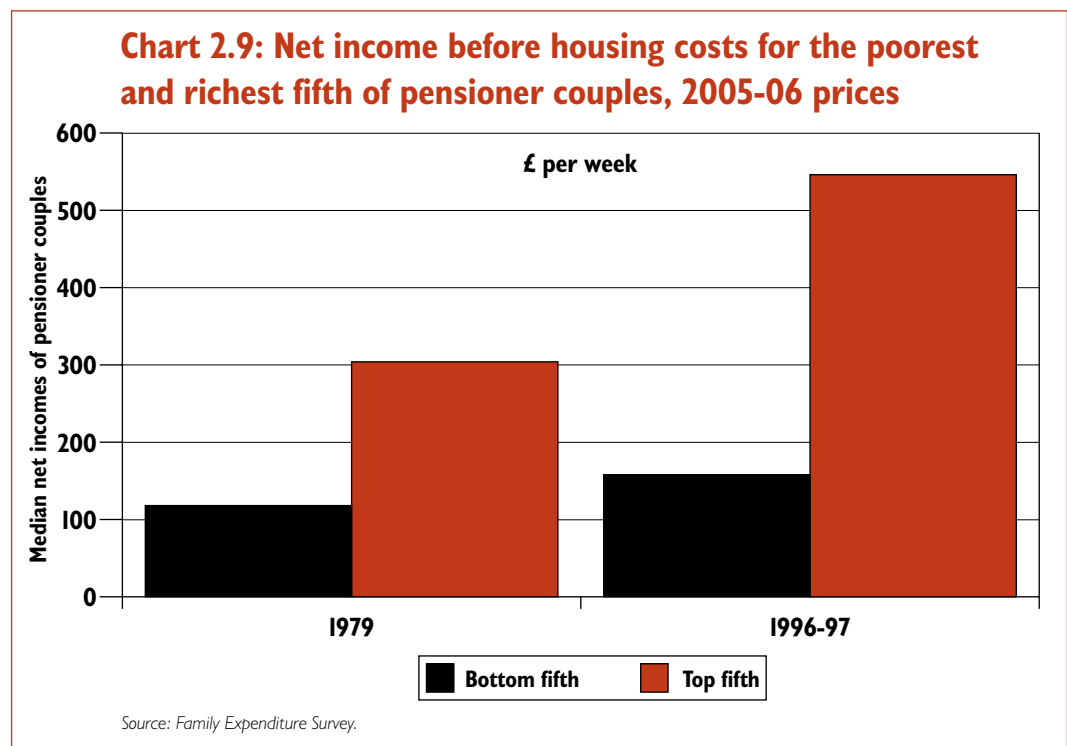
<sup>17</sup> *Comparing the 1958 cohort in the National Child Development Study and the 1970 cohort in the British Cohort Study*. Blanden, Goodman, Gregg and Machin; *Changes in inter-generational mobility in Britain*. Centre for Market and Public Organisation, University of Bristol, Working Paper Series No 01/43 2001.

<sup>18</sup> *Inequality and the state*, Hills 2004 Oxford University Press.

<sup>19</sup> *Life chances and social mobility: an overview of the evidence*, Aldridge; Discussion Paper, Prime Minister’s Strategy Unit. 2004 [www.strategy.gov.uk](http://www.strategy.gov.uk).

**Rising poverty among pensioner households** **2.29** Other vulnerable groups in society also saw their risk of poverty rise. Increasingly the poorest pensioners found themselves falling behind both pensioner households on average and society as a whole. In part this was due to the adverse employment trends for older workers noted above.

**2.30** While pensioner income had risen over previous decades owing to the growth of occupational pensions and the maturing of the State Earnings Related Pension Scheme (SERPS), that growth had been unevenly distributed. Between 1979 and 1996-97 the net income of the richest fifth of pensioners rose by 80 per cent before housing costs compared to a rise of just 34 per cent for the poorest fifth. Many of the poorest pensioners had to rely on Income Support, the value of which had not been increased regularly in real terms.



## Incentives to work

**2.31** While the tax and benefit system had failed properly to support those in greatest need, contributing to increased poverty among families with children and pensioners, it also undermined incentives to work. This had both immediate effects – through higher worklessness and lower saving – and longer term ones, as worklessness increased the risk of poverty now and in old age.

**2.32** Before setting out how the tax and benefit system affected work incentives, it is important to distinguish the two ways in which work incentives can be inadequate. First, the incentive to move off benefits into work can be weak, because the difference between in-work and out-of-work income is too small – the unemployment trap. Second, when those in work have limited incentives to increase their hours or to move up the earnings ladder because it may leave them little better off, there is a poverty trap.

**2.33** For people with low potential earnings the falling financial reward from work is one key element in the rise in worklessness between the late 1970s and the late 1990s. In 1998, in its first report, the Low Pay Commission presented evidence on the extent of very low pay, showing that two-thirds of a million employees were being paid £2.50 per hour or less in 1997<sup>20</sup>. The Commission found that particular groups of workers were at much greater risk of low pay, including disabled workers and lone parents<sup>21</sup>.

**The burden of tax on the low paid**

**2.34** In addition, the structure of the tax and benefits system created financial barriers to work for people with low potential earnings, and families in particular:

- the burden of income tax and national insurance contributions on low-paid workers was disproportionate;
- although in-work financial support for families had been introduced, it was narrowly focussed and help with the costs of childcare was limited;
- the administration of Housing Benefit and its interaction with in-work support further reduced the financial incentive to move into or progress in work;
- in some cases the benefits system encouraged long-term dependence on benefits and there was little support or incentive to search for work; and
- there was insufficient support during the transition into work and lack of certainty about the likely level of in-work income.

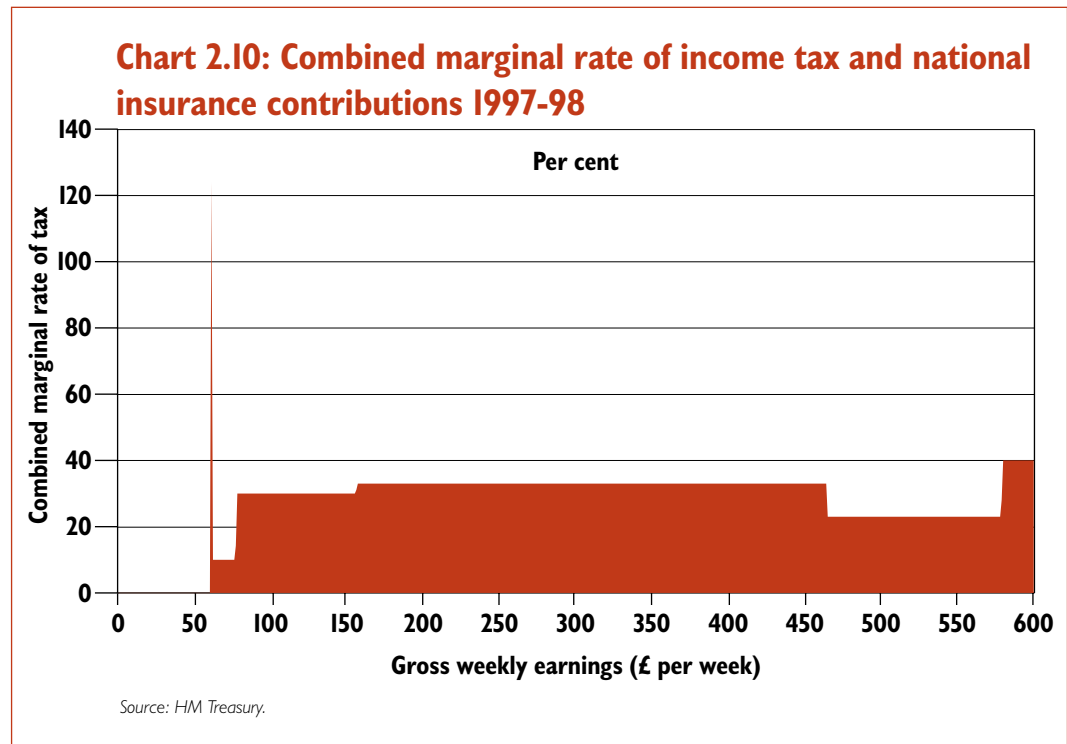
**2.35** The structure of national insurance contributions (NICs) and income tax created an excessive tax burden on the low paid and discouraged job creation at the lower end of the earnings distribution:

- both employer and employee NICs were payable from a lower level of earnings than income tax, reducing take home pay for workers with the lowest gross earnings and raising the costs to employers of hiring these workers;
- the structure of both employee and employer NICs distorted the labour market, discouraging progression up the earnings ladder. These distortions were greatest at the Lower Earnings Limit, where an employee began to pay NICs, because a one pence rise in earnings triggered a NICs charge (the so-called “entry fee”) for employees of 2 per cent of their total salary and just over this amount for employers; and
- the income tax system made little contribution to improving work incentives for the low paid. In 1997 the marginal income tax rate for a low-paid worker was only slightly below the marginal rate for a person earning average male wages.

**2.36** Taking into account an employee’s NICs and income tax the combined marginal rate of tax was lower for some employees whose earnings were well above average than for many low paid employees. This is shown in Chart 2.10 which also illustrates the impact on work incentives of the “entry fee” in NICs.

<sup>20</sup> *The National Minimum Wage, First Report of the Low Pay Commission, 1998.*

<sup>21</sup> *ibid.*



**Work incentives for families and disabled people**

**2.37** The unfair burden of income tax and NICs affected low-paid workers in general, but parents and other groups, such as people with disabilities, faced much greater financial barriers to work. Benefits for out-of-work families recognise the extra costs of bringing up children through additional allowances, paid on top of support for the adults in the family. Similarly, out-of-work support levels are higher for incapacity benefits claimants. While providing essential support, higher out-of-work income levels can reduce work incentives, where in-work support is inadequate.

**2.38** In-work support was available for families and for disabled workers in 1997-98 in the form of Family Credit and Disability Working Allowance but its scope was relatively limited. The maximum support available, the level of income at which support began to be withdrawn and the high withdrawal rate combined to ensure that only those with very low in-work incomes could benefit. Families and disabled people with earnings which were far below average could find they received no in-work support.

**2.39** Earlier in this chapter it was noted that one of the factors generating an increase in the proportion of children in relative low-income households was the tendency to uprate benefits for workless families in line with prices. With comparatively limited in-work financial support, increasing support for families out-of-work would risk damaging work incentives. Further, where families faced additional in-work costs, such as childcare, Family Credit offered limited support, and its interaction with Housing Benefit could create deep unemployment and poverty traps.

**In-work childcare costs**

**2.40** The in-work cost of childcare is an additional barrier to work for lone parents and second earners in couples. Although Family Credit provided help with childcare costs, because of the way this support was offered, parents with the lowest incomes were not able to benefit or could only receive partial help. This affected lone parents in particular who are more likely to have very low incomes and are least able to afford the cost of childcare. For example, a lone parent working part-time and with a low hourly wage could face a very low gain to work even with relatively modest childcare costs<sup>22</sup>.

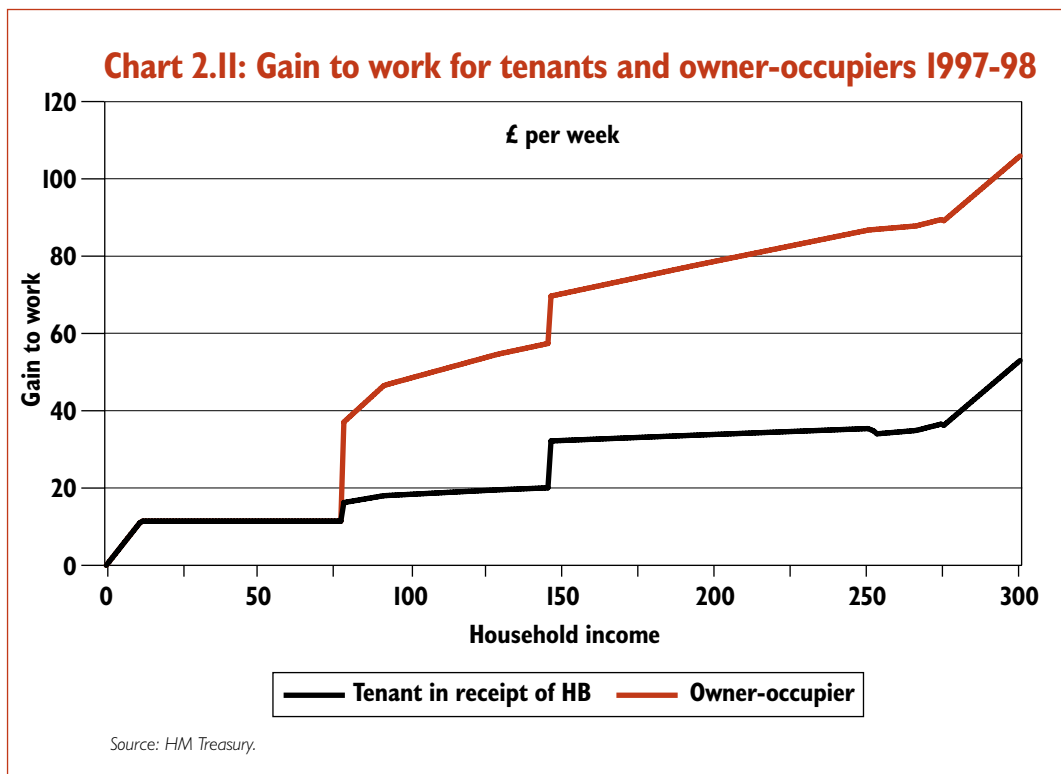
<sup>22</sup> Under Family Credit in 1997-98 a lone parent working 16 hours per week and paid £3.60 per hour with two children and weekly childcare costs of £40 had a gain to work of £16.80 per week (in 2005-06 prices).

**Housing Benefit and work incentives** **2.41** Housing Benefit (HB) provides essential help with housing costs for 3.8 million tenant households but the HB system that the Government inherited was complex and difficult to administer, deprived claimants of the responsibility for managing their housing costs and along with Council Tax Benefit significantly eroded work incentives.

**2.42** Households who rent their property are eligible for Housing and Council Tax Benefits if they have a low income, whether or not the household is working. In addition to the loss of out-of-work support for the children in a household, the move into work triggers a reduction in the value of Housing and Council Tax Benefit, reducing work incentives. Areas with high rental costs are particularly affected, as households with relatively high earnings continue to be eligible for HB.

**2.43** The impact of HB receipt on work incentives is shown in Chart 2.11. It compares the gain to work for a family with two children receiving Family Credit only with a tenant family also receiving HB. The level of rent assumed is for an average Local Authority property in England; in high rent areas the range of income over which HB impacts on the gain to work would be much greater.

**2.44** As well as reducing the gain to work for families, HB has a major impact on the incentive to progress in work. For each additional £1 of income earned, entitlement to HB is withdrawn at a rate of 65 per cent. HB and Family Credit were the two main benefits which led to nearly three quarters of a million working households facing a Marginal Deduction Rate<sup>23</sup> above 70 per cent in 1997-98.



**Failing to support the move into work** **2.45** Other aspects of the tax and benefit system were not well designed to help people move into work. The employment service and benefits agency were separate so for those on benefits such as Income Support and Incapacity Benefit there was no requirement to consider work as an option.

<sup>23</sup>The Marginal Deduction Rate is the combined rate at which tax is paid and benefits withdrawn.

## The structure of financial support in the 1997 tax-benefit system

**2.46** The first part of this chapter showed that trends in the labour market during the 1980s and 1990s had led to unprecedented levels of worklessness and child poverty. However, the tax and benefit system had not been reformed to respond to these new challenges. First, the level and scope of support was inadequate:

- the level of benefits for out-of-work families with children and for pensioners had not increased in line with rising national prosperity, resulting in increased poverty rates among these groups;
- working families with low incomes received only limited financial support and there was little additional help for childcare costs, making many families little better off in work than on benefits;
- in-work financial support for disabled people was insufficient and there was no support for older people returning to work after a period out of the labour market; and
- there was very little support for people during key transitions in their lives such as moving into work and becoming a parent.

**2.47** Second, the mechanisms for providing support were out of date and in some cases stigmatising:

- working age adults were often not aware of whether they would be better off in work and, without a National Minimum Wage, there was no guaranteed minimum income for working households;
- financial support for families was provided to those with the lowest incomes only, which risked stigmatising those who were eligible; and
- the poorest pensioners were means-tested through Income Support on a weekly basis, with even the smallest change in their income affecting their entitlement.

**2.48** The Government's reforms to modernise the tax and benefit system have been designed to tackle the problems of poor incentives to work, and to increase financial support to vulnerable groups. Chapters four to six set out these reforms in more detail, and the next chapter describes the principles behind these reforms. In particular it discusses the structure of financial support in tax and benefits systems.

**2.49** All of the reforms to the tax and benefit system that are set out in Chapters four to six require macroeconomic stability as their foundation. The labour market consequences of instability contributed to the problems of worklessness and poverty set out earlier in this chapter. But the importance of macroeconomic stability for welfare reform goes wider than the labour market. The links between stability in macroeconomic variables such as inflation and the long-term growth rate and their impact at the household level are discussed in Box 2.1.

**Box 2.1: Macroeconomic stability and welfare reform**

The Government's reforms of the tax and benefit system have been built on a foundation of macroeconomic stability. The frameworks for monetary and fiscal policy provide a coherent policy for maintaining high and stable levels of growth and employment, and in recent years the UK has experienced an unprecedented period of stability:

- the UK economy has now grown for 50 consecutive quarters;
- since 1997 inflation has been low and stable; and
- employment has risen by 2 million since 1997 and unemployment is at its lowest level for 30 years.

The volatility of real GDP growth and inflation are now at their lowest sustained levels in 50 years, and since the introduction of the new macroeconomic framework in 1997, the UK has been the most stable of all G7 economies.

In the past, the UK saw considerable periods of economic instability. This had a negative effect on the economy as a whole, increasing long-term interest rates and reducing the willingness of companies to undertake long-term investment. In addition, high and persistent unemployment affected millions of people as it:

- deprived many older workers of the chance to build a decent retirement income;
- eroded skills and discouraged those unable to find new employment; and
- reduced the resources available to provide financial support for the poorest children and pensioners.

While there has been much discussion of the extent to which high and volatile inflation can damage a country's economic growth potential, inflation is also associated with increased poverty and income inequality. Cross-country studies<sup>a</sup> have shown that countries with lower inflation tend to have lower levels of poverty and less income inequality. This underlines the importance of macroeconomic stability not only in promoting long-term economic growth, but also in helping to protect the incomes of the poorest in society.

Macroeconomic stability has helped to tackle poverty in other ways:

- there are now around 481,000 fewer children in households where no one works. With work providing the surest route out of poverty, reducing worklessness contributes to the Government's aim of tackling child poverty; and
- the cost of support for unemployed people has fallen by £5 billion, freeing up valuable resources to provide support to those who need it most.

<sup>a</sup>A summary of the evidence is provided in Chapter 4 of *Reforming Britain's Economic and Financial Policy*, Balls and O'Donnell (eds.), 2002.

# 3

## MODERNISING THE TAX AND BENEFIT SYSTEM

**3.1** The Government's aim is to promote a fair and inclusive society where everyone shares in rising national prosperity and no one is held back from achieving their potential through disadvantage or lack of opportunity.

### Modernising the tax and benefit system

**3.2** The Government believes that for those who can, work provides the best form of security and independence. This belief lies at the heart of the Government's reforms of the tax and benefit system. People of working age have the responsibility to work if they are able to and the right to expect a tax and benefit system that supports them in moving into work. Employment opportunity for all, the modern definition of full employment, is essential to reducing the risk that children grow up in poverty and to ensuring that those of working age today can provide for their own security in retirement.

**3.3** However, employment opportunity for all is not sufficient in itself. It is vital that the most vulnerable and disadvantaged also share in rising national prosperity. The tax and benefit system should provide guaranteed support for adults of working age who cannot work due to a health condition or disability, and for pensioners to underpin their security and independence in retirement. And it should help ensure that every child, irrespective of their parents' circumstances, has the best possible start in life.

### The need for modernisation

**3.4** The system of financial support in 1997 often failed to meet these requirements. The key to understanding its weaknesses lies in the complete separation of payments made to government through income tax and national insurance contributions and support from government through the benefits system.

**3.5** Most working-age households pay income tax and national insurance contributions (NICs) for most of their working lives. At various times, they also receive financial support from government, for example through Child Benefit. And of course almost all households receive state financial support in retirement. So as their children grow up this means that at different points in their life-cycle households may be:

- net contributors to the Exchequer, when their tax liability exceeds the financial support they receive from the state; or
- net beneficiaries from the Exchequer, when the financial support received exceeds their tax liability; or
- neither net contributors to the Exchequer nor net beneficiaries from it, when the two cancel out.

**3.6** Before the Government's reforms, the system for assessing and collecting income tax liabilities was quite separate from the system for providing financial support for families and disadvantaged or vulnerable groups. This separation between the tax and social security systems tended to obscure the fundamental financial relationships between government and individuals or families over their life-cycles and to label people as either "taxpayers" or "claimants". The stigma potentially attached to claiming benefits – even in-work benefits – was one of the factors thought to explain low take up.

**3.7** Support through the social security system often involved complex and burdensome means-testing. The tax system, which has been based on the principle of independent taxation since 1990, was less intrusive. But it could not easily take account of different

household circumstances, and joint incomes, or make payments to households. This made it a very ineffective means of targeting support on families, particularly for increasing numbers of people who were choosing to combine work with care for their children<sup>1</sup>.

**3.8** It is possible to use the income tax system to improve work incentives for the low paid, but the range of options is limited. Special tax allowances can provide a degree of targeting but they cannot reach those on the lowest incomes because they cannot reduce an individual's tax liability below zero.

**3.9** It is often suggested that increasing the personal allowance is a good way of providing support for low-income working people. However, tax credits provide a number of advantages over increasing the personal allowance, discussed in more detail below.

**3.10** Whereas tax credits can make payments to households, increasing the personal allowance can only reduce a household's tax bill to zero. Tax credits mean that a family with two children and a full-time earner on £15,500 a year, around half male mean earnings, is receiving a net tax payment of £2,200 a year. If tax credits were abolished, and the money used to increase the personal allowance, this family would instead find itself making a net tax payment to the Exchequer of around £900 a year. In addition:

- tax credits can tailor support according to family circumstances – providing more support to families with more children or those who care for disabled children, while increases in the personal allowance benefit all taxpayers irrespective of their circumstances; and
- tax credits can provide the same financial support irrespective of the household's marginal rate of tax, while increasing the personal allowance provides greater benefit to those with higher marginal tax rates – so a higher rate tax payer would gain four times as much from an increase in the personal allowance as a starting rate taxpayer whose marginal tax rate is 10 pence in the pound.

**3.11** With tax credits, the support people receive from the tax system is not limited by the amount of tax they are liable for. Instead, they can receive tax credit payments from the Inland Revenue even where they would get no benefit from an increase in the personal allowance. All single earner households pay no tax on their first £4,895 of income. For a two child family, Child Benefit cancels out their income tax until they earn around £12,700 and tax credits mean they pay no net income tax until they earn £21,200. Increasing the personal allowance by £500 would raise the point at which this family's income tax liability was cancelled out by Child Benefit to £13,200, an increase of £500, but putting the same money into the Child Tax Credit would raise the point at which they start to pay net income tax to £22,500, an increase of around £1,300. So tax credits help more people to pay no net tax. The result is while the net tax rate for a single earner family with two children on half male earnings rose by 4 percentage points between the introduction of Child Benefit in 1977-78 and 1997, as shown in Chart 5.2, between 1997 and 2004-05 their net tax rate has fallen by around 23 percentage points and living standards have risen by 34 per cent.

**Negative Income Tax 3.12** Probably the most comprehensive approach to addressing these issues would be to design an entirely new tax and benefit system which delivered government financial support as payable tax credits, and paid credits to non-taxpayers in the same way as it pays tax refunds to taxpayers. In broad terms, a fully integrated tax and benefit system of this kind would

<sup>1</sup> Some 36 per cent of people in work have a dependent child. The way government supports parents in balancing work and caring for their children is set out in more detail in *Balancing Work and Family Life: enhancing choice and support for parents*, HM Treasury 2003

assess the family's overall tax position by taking account of its joint income, and its entitlements to state support (e.g. for children, or a disabled worker). Financial support would therefore be delivered through the tax system – either by reductions in the family's tax bill or through payments of “negative tax”. Such “negative income tax” systems have been the subject of extended debate in the economics literature<sup>2</sup>.

**3.13** In a system of this kind the tax burden effectively borne by a family is measured by:

- its **net tax liability** after taking account of its tax credit entitlements; and
- its **net (average) tax rate** which expresses that burden as a rate<sup>3</sup>.

**3.14** Both the values of the family's net tax liability and effective tax rate in a particular tax year could be positive, zero or negative, depending on the balance between tax liabilities and tax credits for the family in that year.

**3.15** The main advantages of the pure negative income tax approach to tax-benefit integration are that it would:

- enable the government to target support through the tax system to give help to those who need it, cutting out the requirement to contact different agencies, and fill in different forms, to claim support and pay tax;
- produce a single annual assessment of liabilities and entitlements, and a single overall net tax bill, with a single flow of payments to or from the government;
- make more transparent the financial relationship between the government and the individual or the family; and
- by fully integrating state support into the income tax system, eliminate any stigma attached to claiming benefits. This would help maximise take up of support by those entitled to it.

**3.16** But this purist approach to tax-benefit integration would also have important disadvantages, because it would entail:

- abandoning the Government's commitment to the important principle of independent taxation<sup>4</sup>;
- substantial and potentially very disruptive changes to the income tax and social security systems and payment and collection mechanisms;
- the risk of undermining the Government's approach of matching rights and responsibilities which requires the unemployed to seek work; and
- (assuming an acceptable level of guaranteed income out of work) the potential for very high marginal tax rates or large costs to the Exchequer.

**3.17** Whatever the balance of theoretical advantage in moving to a fully integrated system of negative taxation, it would undermine some of the key principles in the current system and

<sup>2</sup> *The Negative Income Tax and the Evolution of U.S. Welfare Policy*, Moffitt, Journal of Economic Perspectives 2003 provides a useful summary. Precursors to the concept of a negative income tax can be traced back as far as the Speenhamland system which operated in parts of England in the early part of the 19<sup>th</sup> century.

<sup>3</sup> The definition of tax liability and the tax rate would depend on whether NICs were included. For some purposes it would be appropriate to include NICs but in other cases it may not be because they finance pension entitlements and health services via the National Insurance Fund, and are therefore distinct from general taxation.

<sup>4</sup> Chancellor of the Exchequer's speech at the Institute of Fiscal Studies, May 1999. Available at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)

the risks involved in the implementation of such systems are clearly very large<sup>5</sup>. Instead the Government has embarked on a fundamental programme to modernise the tax-benefit system – the most significant since the Beveridge reforms of the 1940s – but it has also introduced reforms in carefully planned stages, to minimise risks.

**3.18** The reforms have brought many of the key attributes of a system of negative taxation. These include reduced stigma; increased financial support for the vulnerable; a fairer distribution of that support across households and improved work incentives. They have also brought into sharper focus the fundamental financial relationship, described at paragraph 3.5 above, between the government and individuals or families.

**Integrating  
the tax and  
benefit  
systems**

**3.19** The various policy changes which have so far made up this programme of tax-benefit integration have been guided by five key principles, that were set out in November 2000<sup>6</sup>:

1. **to promote incentives to work**, by reducing the tax burden on the low paid and the number of low-income households on high marginal withdrawal rates;
2. to ensure it is targeted on those who need it most, **financial support should be assessed on a household basis where possible**, while respecting the principle of independent taxation;
3. **to tackle poverty**, minimum levels of income should be guaranteed for the most vulnerable in society – the elderly, families and those who cannot work because of illness or disability;
4. **to reduce stigma and maximise take up** the income test should not be intrusive and the hassle of claiming should be minimised; and
5. **to improve customer service and increase efficiency**, the administration of tax and benefits should be modernised and brought closer together.

**3.20** This document focuses on the first three of these principles, covering work incentives and financial support in Chapters four to six. Issues related to the last two principles are also discussed.

**3.21** The reform programme has been accompanied by substantial increases in financial support. Based on the principle of **progressive universalism**, these changes ensure that while the vast majority of families and pensioner households have benefited, the largest increases in support have been directed to those with the greatest needs.

**3.22** The most radical of the reforms outlined in the remaining chapters is the introduction of payable tax credits. This has brought about a step change in the way in which individuals and families draw support from the Exchequer. Tax credit awards reflect, and respond to, the needs and circumstances of different households. For couples, they are based on joint tax-year income. Tax credits follow broadly the same rules and definitions as income tax, are closely aligned with the tax system and are administered and paid by the Inland Revenue.

**3.23** Under the new system, families receive state support for their children from the Inland Revenue through the Child Tax Credit and Child Benefit. Workers on low incomes, and

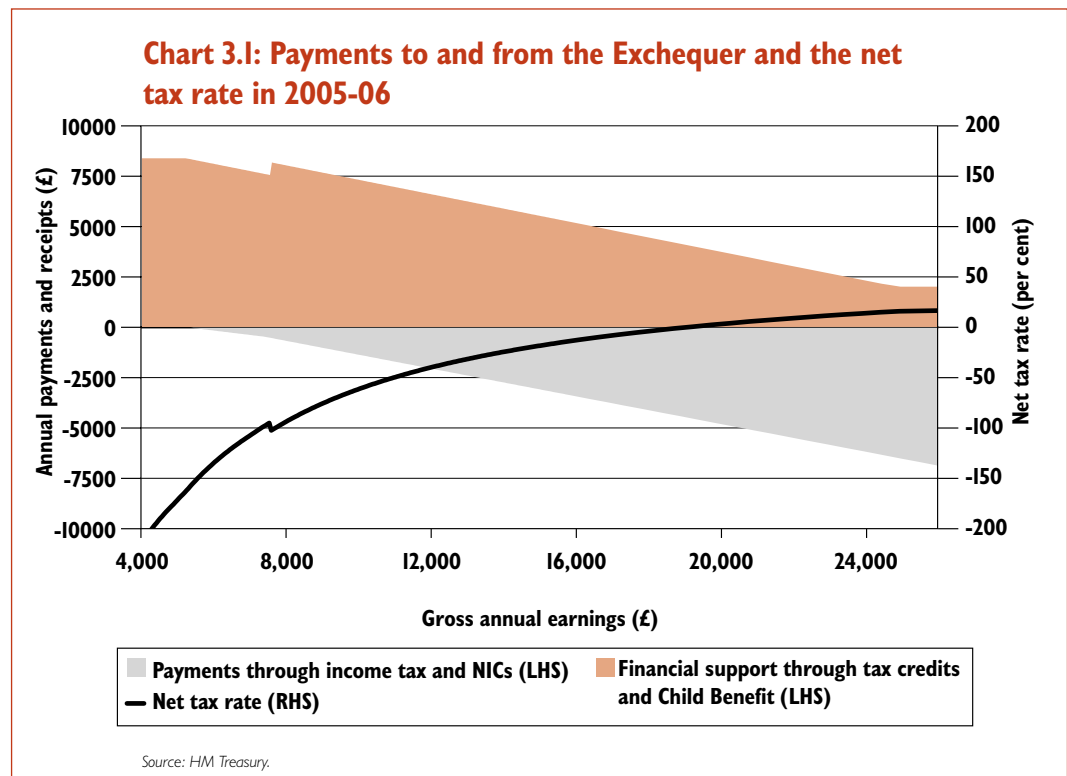
<sup>5</sup> It is interesting to note that although a Negative Income Tax system was the subject of extensive consideration in the United States in the late 1960s and early 1970s it was not implemented. Instead the Earned Income Tax Credit (EITC) was introduced in 1975; the EITC subsequently provided a model for the Working Families' Tax Credit. Similarly, "Proposals for a tax credit system" in the UK (October 1972, Cmnd 5116) gave rise only to Child Benefit.

<sup>6</sup> *The Pension Credit: a consultation paper*, Department for Social Security, November 2000.

those with a disability, receive additional support through the Working Tax Credit. Parents can get help with their in-work childcare costs through the childcare element of the Working Tax Credit.

**Calculating net tax 3.24** To work out a family’s net tax liability and effective tax rate, the tax credits and Child Benefit payments the family receives are set against any income tax (and in some illustrations NICs) paid. These measures have the same effect on a family’s financial position as those associated with a negative income tax system (see paragraph 3.11). But there are practical differences. For example, for a couple household income tax is not assessed on joint income and their tax payments to the Inland Revenue are distinct and they receive tax credit and Child Benefit payments separately.

**3.25** As with a pure negative income tax system, both the family’s net tax liability and its effective tax rate in the new, more integrated, tax system will depend on its precise circumstances, including the number of children in the household. This is illustrated in Table 4.2 in the next chapter which shows the lowest net tax rates for different household types.



**3.26** Chart 3.1 shows how the net tax payments and the effective tax rate of a single-earner family with two children vary with family income. It shows that with an income of less than £18,700 the family receives net tax payments from the government. It pays no net tax until income rises above that level.

**3.27** Table 3.1 shows how the breakeven point at which a single-earner family with two children pays no net tax has increased since 1997-98 as a result of the government’s tax-benefit reforms and other measures. It shows the breakeven point calculated when NICs are included and when NICs are excluded from the calculation. The proportion of families with children paying no net tax has risen from 34 per cent in 1997-98 to 42 per cent in 2005-06 when NICs are excluded; the proportion of families paying no net tax including NICs has risen from 31 per cent to 39 per cent. The number of families paying net tax has fallen by around 500,000 on either basis.”

**Table 3.1: Earnings level where the net tax rate is zero per cent**

Year	Earnings level <sup>1</sup> (£ per year)	
	Including NICs	Excluding NICs
1997-98	13,600	15,100
1998-99	13,600	15,100
1999-00 <sup>2</sup>	15,900	17,900
2000-01	16,600	18,700
2001-02	17,400	19,500
2002-03	17,600	19,800
2003-04	18,000	20,500
2004-05	18,500	21,000
2005-06	18,700	21,200

<sup>1</sup> For a single earner family with two children aged 11-15.

<sup>2</sup> The figures include Family Credit in 1997-98 and 1998-99. Although Working Families' Tax Credit was introduced in October 1999 the figures assume it was in place throughout 1999-00.

**3.28** Tax credits have therefore greatly enhanced the extent to which the tax system can be used to target support and improve work incentives. Together with the Pension Credit and other reforms of the tax-benefit system, tax credits promote a new way of thinking about how people contribute to or draw on support from the Exchequer over the life-cycle, providing additional net financial support when expenditure increases because of the costs of raising children and again in retirement when income is likely to be lower.

**3.29** The next three chapters set out what the reforms since 1997 have achieved and how they are informed by the principles set out above. Most have been developed and introduced in stages, and continue to evolve. For example, the Child and Working Tax Credits build on the experience and achievements of the Working Families' and Disabled Person's Tax Credits which took the first steps in integrating the tax and benefits systems. Similarly the Pension Credit built on the Minimum Income Guarantee for pensioners.

# 4

## INCENTIVES TO WORK

**4.1** The first principle of tax and benefit reform stated above is that a modernised welfare system should *promote incentives to work, by reducing the tax burden on the low paid and the number of low-income households on high marginal withdrawal rates*. This section shows how the Government's reforms put this principle into practice across the tax and benefit system by:

- introducing a National Minimum Wage;
- reducing income tax and reforming national insurance contributions; and
- improving work incentives for families and people with a health condition or disability.

### Tackling low pay and improving work incentives

**4.2** The National Minimum Wage (NMW) was introduced in April 1999 to ensure a decent minimum rate of pay for all employees. In addition it provides a foundation for in-work tax credits. The NMW and tax credits work together to provide a Minimum Income Guarantee for all working households. Table 4.1 shows the increase in the Minimum Income Guarantees since 1999.

**Table 4.1: Weekly Minimum Income Guarantees**

	April 1999	October 1999	October 2005
Family <sup>1</sup> 1 child, full-time work (35 hours)	£182	£200	£260
Family <sup>1</sup> 1 child, part-time work (16 hours)	£136	£144	£202
Single person, no children, 25 or over, full-time work (35 hours)	£113	£113	£169
Couple, no children, 25 or over, full-time work (35 hours)	£117	£117	£200
Disabled person (single), working full-time (35 hours)	£139	£155	£211
Disabled person (single), working part-time (16 hours)	£109	£112	£153

Notes: assumes a single earner household, the prevailing rate of the National Minimum Wage and that the family is eligible for the Working Families' Tax Credit or Disabled Person's Tax Credit and the Working Tax Credit/Child Tax Credit.

<sup>1</sup> applies to one parent families and couples with children alike.

**4.3** The NMW and tax credits complement each other in achieving fairness combined with flexibility in the labour market. The NMW underpins in-work tax credits by ensuring a minimum rate of pay but it does not respond to household needs or the income of other workers in the household. By contrast, tax credits provide flexible support that can be tailored to an individual household's needs, for example, reflecting the number of children in a family. They can also help parents balance work and family life by providing more support to those working fewer hours.

**4.4** The NMW brought to an end the long-term trend of wages at the bottom of the wage distribution growing more slowly than average earnings. Box 4.1 describes this in more detail. In addition, there is no evidence that the introduction of the NMW has reduced aggregate employment<sup>1</sup>, or total employment in the low-paying sectors as a whole<sup>2</sup>.

<sup>1</sup> *The impact of the introduction of the UK National Minimum Wage on the employment probabilities of low-wage workers*, Stewart, University of Warwick mimeo, 2003; *Estimating the Impact of the Minimum Wage Using Geographical Wage Variation*, Stewart, Oxford Bulletin of Economics and Statistics, 2002.

<sup>2</sup> Since 1999 aggregate employment has increased by nearly 1.5 million. Over the four years to September 2004 the number of employee jobs increased by over 300,000 in retail and hospitality, the two largest low paying sectors (Low Pay Commission Report, 2005).

### Box 4.1 Assessing the impact of the National Minimum Wage

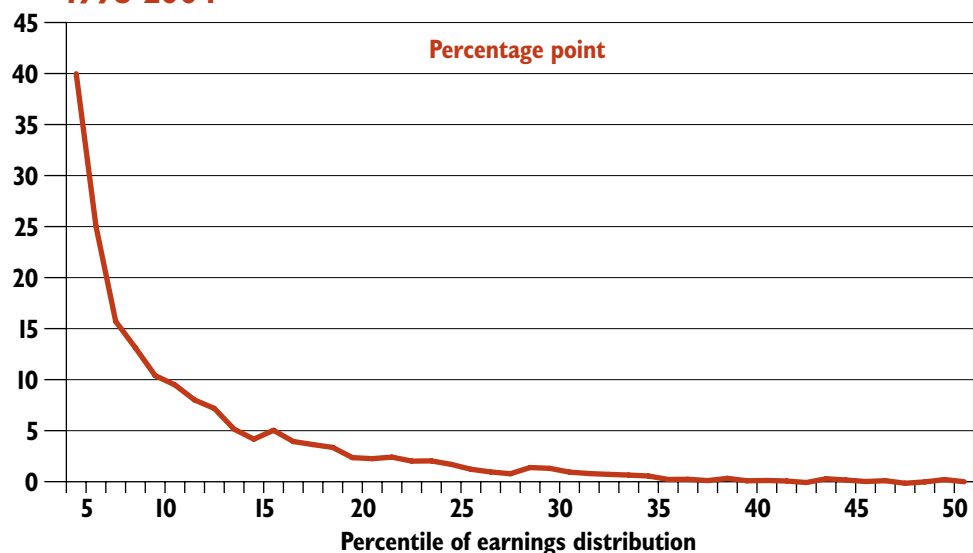
The National Minimum Wage (NMW) was introduced in April 1999 at a rate of £3.60 per hour for adults aged 22 and over. Since its introduction, the adult rate has been increased by 35 per cent in nominal terms to £4.85. By October 2006 the rate will be £5.35 and the cumulative increase just under 50 per cent.

The standard measure of the impact of the NMW has been the 'expected number of beneficiaries', the number of workers whose pay would otherwise be expected to be below the new NMW rate. However this measure does not include the impact of the NMW on the wage distribution more generally. For example, many firms increase their lowest pay levels to ensure that they remain slightly above the NMW rate. These low paid workers, who are benefiting indirectly from the increases in the NMW, are not captured by the 'expected number of beneficiaries' measure.

The NMW has helped to increase significantly the earnings of the lowest paid workers. The chart below shows the total increase in hourly pay across the bottom half of the earnings distribution between 1998 and 2004. The increase in median pay over that period of 25 per cent has been netted off, so that the chart highlights movements above the median. The lowest paid workers have benefited from above-average increases in pay in recent years – pay at the 10th percentile of the distribution has risen nearly 10 percentage points faster than median pay growth.

As a result, the introduction and uprating of the NMW has brought to an end the long-term trend of average wages rising faster than those of the lowest paid workers.

#### Increase in earnings net of median earnings growth, 1998-2004



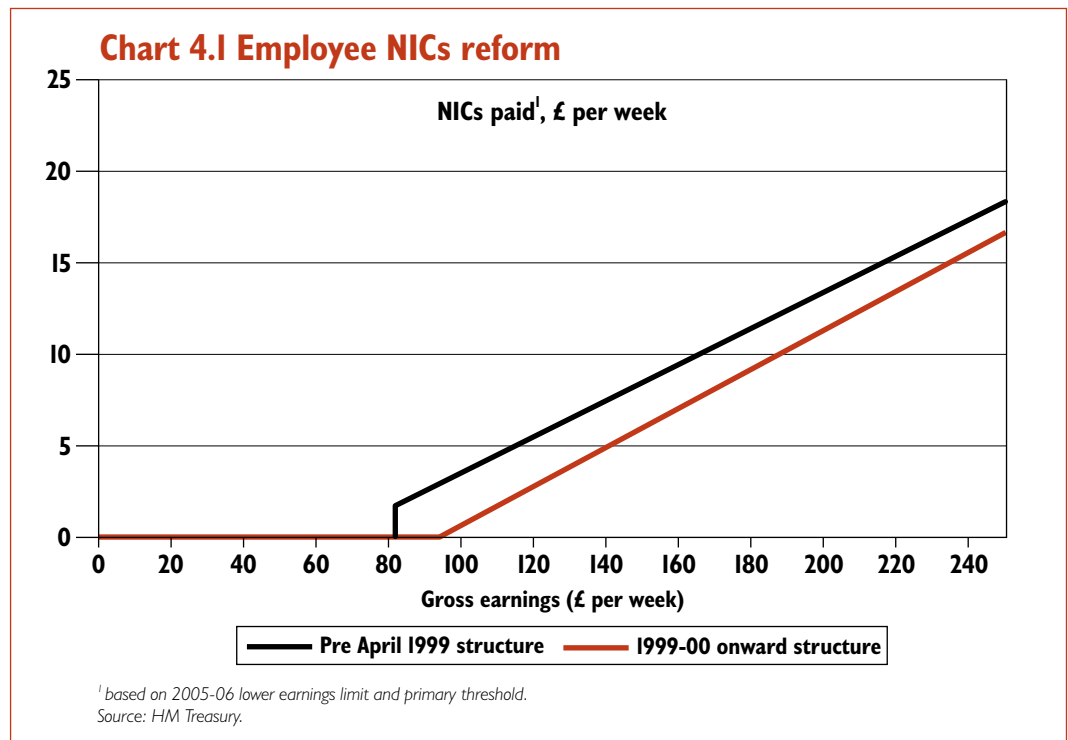
Source: Annual Survey of Hours and Earnings.

**Reducing the tax burden on low paid workers**

**4.5** Following the recommendations of a review of work incentives by Martin Taylor<sup>3</sup> the Government reformed both income tax and national insurance contributions (NICs) to reduce the burden on low-paid workers. These reforms included:

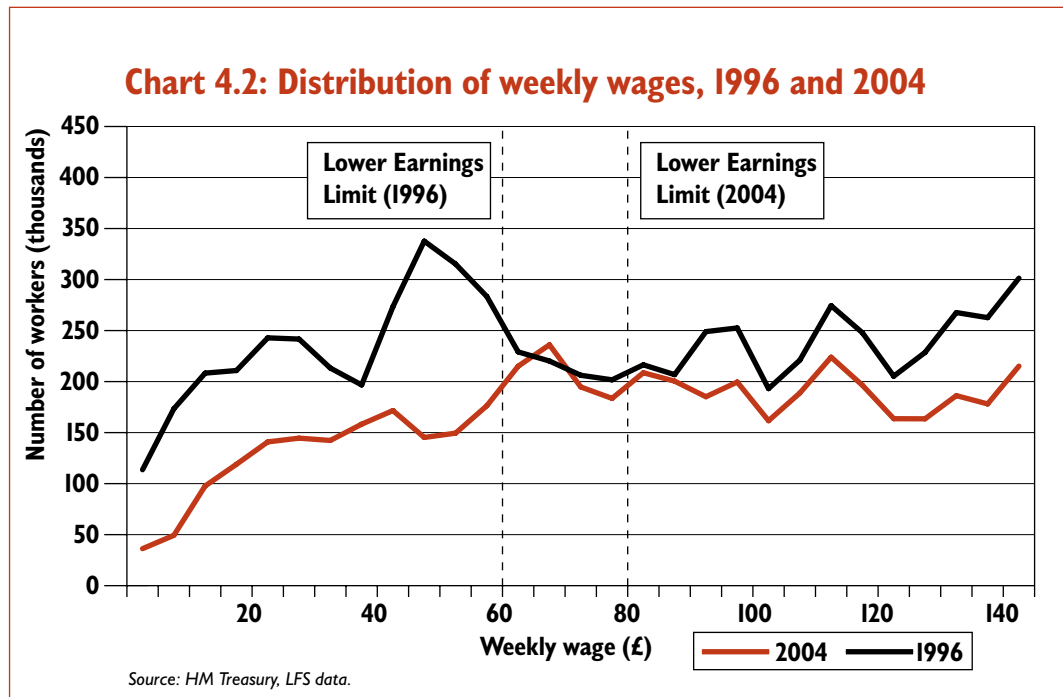
- abolishing the “entry fee” in employee contributions;
- raising the threshold for contributions, aligning it with the personal allowance in income tax;
- simplifying the structure of employer’s NICs, replacing the series of stepped contribution rates with a single rate; and
- introducing the 10 pence rate of income tax, the lowest starting rate of income tax since the 1960s.

**4.6** Together, these changes removed some of the most distortionary features of the tax and benefit system for those moving off welfare and into work. The impact on employee’s NICs is illustrated in Chart 4.1.



**4.7** The effect of abolishing the “entry fee” in employee contributions can be seen by looking at changes in the distribution of earnings between 1996 and 2004 as illustrated in Chart 4.2. It shows the significant bunching of employees with earnings just below the lower earnings limit (LEL) has diminished over time.

<sup>3</sup> *Work Incentives, A report by Martin Taylor*, HM Treasury, 1998.



#### Tax credits for adults with low incomes

**4.8** The reforms to income tax and NICs reduced the burden of tax on low-paid workers. However, as discussed in Chapter three, there was a limit to how much could be achieved through changes to the tax system: neither income tax nor NICs can be reduced below zero. Many low-paid people could still find that work paid little more than benefits. This was of greatest concern for couples whose out-of-work benefits are higher than for single people.

**4.9** The Working Tax Credit (WTC), which was introduced in April 2003, fundamentally changed the structure of financial support for working people with low incomes. For the first time, low-income working people without children or a disability could actually receive a net tax payment from government. For example, a couple with one earner working full-time<sup>4</sup> and paid at the NMW receives gross wages of £169.75 per week and pays income tax of £11.81 and NICs of £8.33 each week. This produces a net tax rate of 13 per cent. The WTC award of £48.74 more than offsets the income tax and NICs, so that the household receives a net tax payment of £28.60. Taking account of WTC, the household's net tax rate falls to minus 17 per cent.

**4.10** The WTC provides support tailored to individual household's circumstances. This means the net tax payment and the net tax rate faced by different households will vary. Table 4.2 shows the lowest net tax rates faced by different households<sup>5</sup>.

**Table 4.2: Lowest net tax rates<sup>1,2</sup>**

		Lowest net tax rate (%)
Single person	30 hours	-10
Couple	30 hours	-31
Disabled worker	16 hours	-94
Disabled worker, in a couple	16 hours	-133

<sup>1</sup>The net tax rate is equal to the difference between the amount of income tax and national insurance contributions paid and the amount of tax credits received, as a proportion of gross earnings.

<sup>2</sup>Figures in 2005-06 prices.

Source: HM Treasury.

<sup>4</sup>Full-time work is assumed to be 35 hours per week.

<sup>5</sup>These lowest net tax rates are based on the minimum hours of work which trigger eligibility for WTC with earnings per hour assumed to be the adult rate of the NMW, currently £4.85. Single people and couples without children are eligible for WTC if they work 30 hours per week while disabled workers are entitled if they work 16 hours per week or more.

## Improving work incentives for people with a health condition or a disability

**4.11** Tax credits are part of a coherent strategy to support people with a health condition or disability to find, remain and progress in employment. Jobcentre Plus is now providing a work-focused service to all people making a new claim for incapacity benefits. In addition the New Deal for Disabled People is providing employment support and advice for workless people with disabilities.

**4.12** The Pathways to Work pilots<sup>6</sup> are testing a new system of support and advice – from Jobcentre Plus, the health service and the voluntary and private sector – that has not previously been available to incapacity benefits claimants, including:

- a new framework of Work Focused Interviews within Jobcentre Plus;
- better links with New Deal for Disabled People job brokers; and
- improving employer and GP awareness of the implications of sickness absence.

**4.13** Many incapacity benefits claimants are concerned about the security of their income when they move into employment, so the Pathways pilots are also testing the effectiveness of a new Return to Work Credit, paid on top of any WTC entitlement. This is a payment of £40 per week, payable for 52 weeks<sup>7</sup>.

## Improving work incentives for families

**4.14** Families with children had often faced poor work incentives as they received more generous out-of-work support through the benefits system compared to those without children. As a first step towards delivering a better system of support for families with children, the Working Families' Tax Credit (WFTC) was introduced in October 1999:

- to provide more generous financial support to tackle poverty among working families on low earnings;
- to improve the incentives to move into and progress in work; and
- to tackle childcare costs as a barrier to work through the childcare tax credit.

**4.15** Box 4.2 sets out the key evidence on the impact of the WFTC, which extended financial support to many more families than had benefited from Family Credit. By November 2002 WFTC was providing financial support to over 600,000 extra families, and had increased the average award by over 30 per cent in real terms compared with the Family Credit system five years earlier<sup>8</sup>. WFTC also improved work incentives: the gain to work for a couple family with a single earner on half male mean earnings increased by one third<sup>9</sup>.

<sup>6</sup>The pilots started in October 2003 and are currently operating in around 10 per cent of the country.

<sup>7</sup>The credit is available to people who move from incapacity benefits to work of 16 hours a week or more and is payable to anyone whose annual earnings are less than £15,000. To ensure that it is a straightforward and visible incentive, the credit is disregarded for income tax, national insurance, tax credits, Housing and Council Tax Benefit and income-related benefits of any partner.

<sup>8</sup>Comparison of WFTC and Family Credit awards in November 2002 and November 1997 respectively. Compared with the peak Family Credit caseload in May 1999, the increase under WFTC was 556,000 families. Data available from [www.inlandrevenue.gov.uk](http://www.inlandrevenue.gov.uk)

<sup>9</sup>The real terms change in the gain to work between 1997-98 and 2002-03, estimated using half male mean earnings in 1997-98 (£208.40 per week). The calculation reflects the impact of increased tax credits on Housing and Council Tax Benefit.

**Box 4.2 Assessing the impact of the Working Families' Tax Credit**

The reforms introduced through the WFTC were aimed at improving take up of in-work financial support, increasing work incentives and tackling poverty for families with low potential earnings. Research using the Families and Children Study<sup>a</sup> showed that WFTC had a substantial impact on working families' incomes. For example, WFTC:

- boosted average income by 14.1 per cent among families receiving WFTC in 2000 who had also received Family Credit in the previous year;
- increased the income of lone parents who moved into work by 44 per cent on average, among those who had been receiving Income Support in 1999, and moved into work and were receiving WFTC in 2000; and
- reduced sharply the risk of severe hardship compared with Family Credit, both for lone parent and couple families.

The Inland Revenue commissioned independent research into the impacts of WFTC, in particular on the labour market effects<sup>b</sup>. Key findings were:

- by 2002-03 take up of WFTC exceeded take up of Family Credit and was higher among those in most need;
- WFTC led to an estimated net increase in labour supply of 81,000 extra individuals and added over five percentage points to the lone parent employment rate;
- there was no evidence to support the view that WFTC had an adverse effect on wage progression, and may even have encouraged it;
- stigma associated with claiming support fell under WFTC compared to its predecessor, Family Credit; and
- the childcare tax credit element of WFTC has helped families get back into work and has enabled more choice in securing childcare provision.

The findings on the positive impact of WFTC on lone parents' labour supply and on the effectiveness of the childcare element of WFTC in helping families move into work have been confirmed by other academic studies<sup>c</sup>.

<sup>a</sup> *Low/Moderate-income families in Britain: Changes in Living Standards*, Vegeris and McKay, 2002.

<sup>b</sup> The research can be found at [www.inlandrevenue.gov.uk/research](http://www.inlandrevenue.gov.uk/research).

<sup>c</sup> *The consequences of 'in work' benefit reform in Britain: new evidence from panel data*, Francesconi and Van der Klaauw, University of Essex, 2004.

**4.16** The next steps in the process of reform came with the introduction of the Child and Working Tax Credits in 2003. This represented a fundamental change in the way support for families and low-income workers is provided. Building on the achievements of WFTC, the Child and Working Tax Credits:

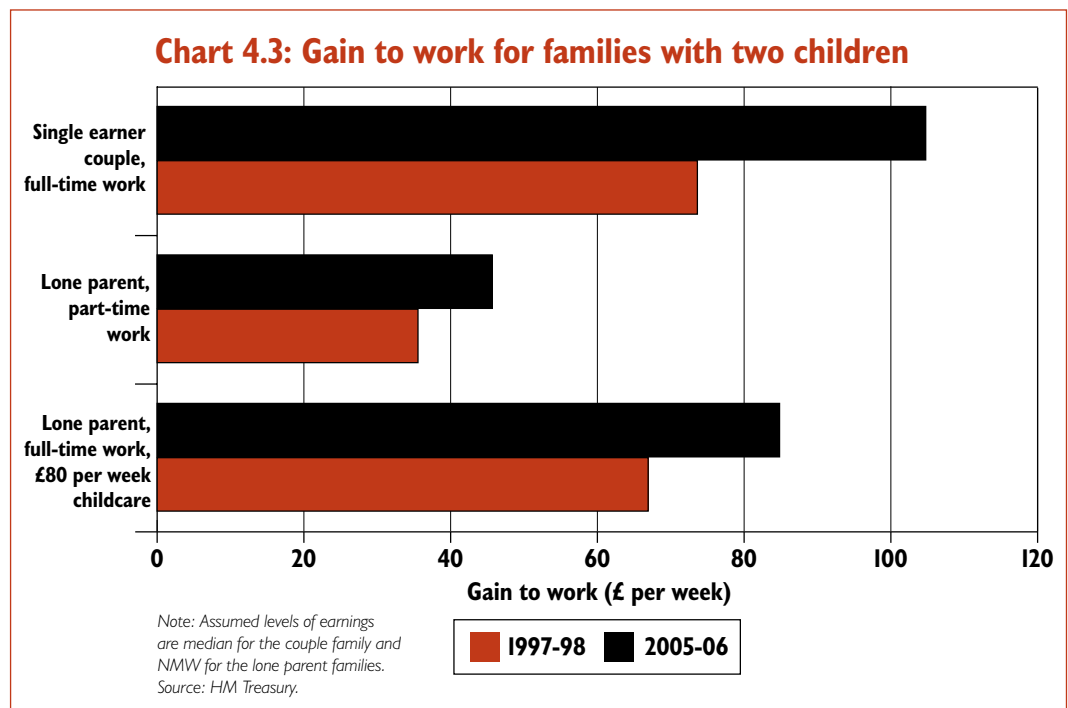
- provide, through the Child Tax Credit, a single system of support for families with children, which is independent of the parents' employment status. This provides a stable source of income as parents move into work, easing the transition to paid employment;
- enhance work incentives for second earners through a new and fairer assessment of family income, and a reduction in the rate at which awards are withdrawn;
- increase the gain to work for tenants working part-time through improving the interaction between Working Tax Credit and Housing Benefit; and
- reduce the number of working families in the poverty trap.

**Tackling the unemployment trap**

**4.17** Tax credits improve gains to work for families on low incomes by integrating the system of support for families both in and out of work, increasing financial security during the move into work. In addition the WTC provides substantial help with childcare costs, which can be a major barrier to work. Families with childcare needs have up to 70 per cent of their costs met, helping to ensure that even parents on the lowest incomes can afford to pay for the childcare which enables them to work.

**4.18** Families who live in a rented property face the additional barrier to work of high withdrawal rates in Housing Benefit (HB). The tax credits system has increased help for those moving into work part-time (who tend to face poorer work incentives than full-time workers) by ensuring that less of the additional tax credits support is off-set by a reduction in HB. Further, childcare costs are now also fully disregarded in HB, so that tenant families with low earnings will still be better off in work even with very high childcare costs.

**4.19** Compared to previous systems of support, the Child and Working Tax Credits also provide support further up the income scale. This helps to ensure that more families on moderate incomes can now receive help with their childcare costs. For example, a family with two children and income of up to £24,000 per year can benefit from maximum support through the childcare element. In addition, incentives for second earners moving into part-time work have also been improved. The impacts of the reforms on gains to work for specimen families are shown in Chart 4.3 below.



**Tackling the poverty trap**

**4.20** As a result of the introduction of tax credits, in combination with the reforms to NICs and the new 10 pence starting rate of income tax, the number of working families facing Marginal Deduction Rates in excess of 70 per cent has fallen by just over half a million since 1997-98. The reforms have also sharply reduced the number of working families with the highest MDRs – of over 90 per cent – from 130,000 to 30,000.

**Table 4.3: The effect of the Government's reforms on high Marginal Deduction Rates**

Marginal Deduction Rate <sup>1</sup>	Before Budget 1998	2005-06 system of tax and benefits
Over 100 per cent	5,000	0
Over 90 per cent	130,000	30,000
Over 80 per cent	300,000	165,000
Over 70 per cent	740,000	235,000
Over 60 per cent	760,000	1,730,000

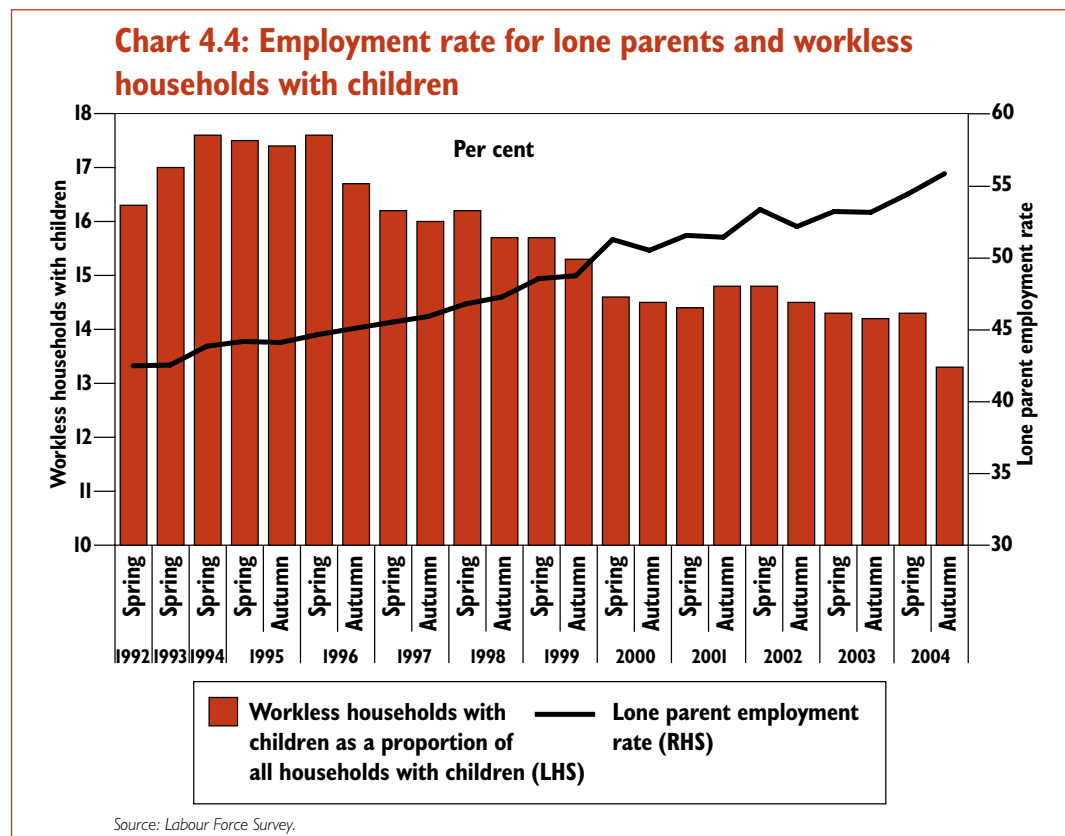
<sup>1</sup>Marginal Deduction Rates are for working households in receipt of income-related benefits or tax credits where at least one person works 16 hours or more a week, and the head of the household is not disabled.

Note: Figures are cumulative. Before Budget 1998 based on 1997-98 estimated caseload and take-up rates; the 2005-06 system of tax and benefits is based on 2003-04 caseload and take-up rates.

### Children in workless households

**4.21** The reforms to financial support for families have contributed to a significant reduction in the number of children living in workless households. As well as providing the most sustainable route out of poverty, there is evidence that by having employment, parents positively influence educational attainment among older children, and their prospects of employment in later life. The number of children in workless households has fallen by 481,000 since 1997.

**4.22** A significant share of the reduction in the number of children in workless households is due to increased employment among lone parents. The introduction of tax credits means work is more financially rewarding and the New Deal for Lone Parents has provided additional support and advice on moving into work. Underpinned by macroeconomic stability, these policies have together contributed to a rise in the lone parent employment rate of 9 percentage points to over 54 per cent – the highest rate on record<sup>10</sup>. There are now almost one million lone parents in employment, an increase of 40 per cent since 1997.



<sup>10</sup>Between spring 1997 and spring 2004.

## Reforms to support improved work incentives

**4.23** The Government has introduced a set of reforms which complement the improvements to work incentives described in this chapter. The complexity of Housing Benefit is being tackled through the introduction of Local Housing Allowances. Further, there is extensive empirical evidence showing that help with the transition to work and improved work incentives are more effective when combined. The Government has introduced Jobcentre Plus to integrate the employment service and the benefits agency.

### Simplifying Housing Benefit

**4.24** The Housing Benefit (HB) system is complex and often poorly administered. As well as increasing the hassle of claiming support, delays in HB administration lead to rent arrears and deter tenants from moving into work. This is confirmed by research carried out for the Department for Work and Pensions which shows widespread concern about the transition to work amongst those who were close to entering employment<sup>11</sup>.

**4.25** As a result the Government has introduced a radical reform programme for HB which moves away from a system of payments to the landlord on behalf of a tenant and at the same time simplifies the assessment of the amount of support to which a tenant is entitled. These improvements in HB administration should lead to increased labour market flexibility and improved employment choices available to those in receipt of HB<sup>12</sup>.

### Local Housing Allowances

**4.26** Most rent payments made by the HB system go direct to the landlord, so that claimants have little interest in rent levels and no responsibility for ensuring that rent is paid on time. The rent assessment is excessively complex, creating uncertainty about the amount of benefit available. Flat-rate Local Housing Allowances (LHAs) are changing this: they are paid to the tenant and greatly simplify the assessment of rent. They have been implemented successfully in nine pathfinder areas for private sector tenants, and over 35,000 tenants are now receiving the LHA.

**4.27** Tenants taking part in these pilots know their benefit entitlement before signing a tenancy agreement, giving them the opportunity to choose where they live, keeping the difference if the rent is below the LHA or finding the extra money if it is above. The new system means that tenants are empowered to make choices about accommodation and employment. It also gives them the responsibility for paying the rent to the landlord, making the transition into work easier. The simplicity of the new flat-rate allowance should also allow much quicker claims processing.

**4.28** Qualitative evidence from this first round of Pathfinders is encouraging. The Government will introduce a second round in the private sector from April 2005<sup>13</sup> which will help develop best practice before the LHA is introduced nationally. However, the Government is also committed to developing a flat-rate LHA system for the social sector.

### Integrating financial support with worksearch

**4.29** There is widespread international evidence that active labour market policies and reforms such as tax credits which improve the financial incentives to work are more effective working together than in isolation<sup>14</sup>. A practical example in the UK context is the “better off

<sup>11</sup> *Easing the transition into work part 2 – client survey*, Woodland, Mandy and Miller, Research Report 186, DWP, 2003.

<sup>12</sup> The Government set out its strategy to reform the Housing Benefit system in the Green Paper *Building choice and responsibility: a radical agenda for Housing Benefit*, DWP, 2002.

<sup>13</sup> The second round of nine LHA pilots will be in Argyll-Bute, East Riding of Yorkshire, Guilford, Norwich, Pembrokeshire, Salford, South Norfolk, St Helens, Wandsworth.

<sup>14</sup> *What works among active labour market policies: Evidence from OECD countries' experience*, Martin, Mimeo, OECD, 1998; *Financial Incentives for Increasing Work and Income among Low-income Families*, NBER Working Paper No 6998, Blank, Card and Robins, 1999.

calculation” showing the gain to work for a particular individual, which is provided as part of a Work Focused Interview, and is one of the most effective tools in persuading benefits claimants to return to work<sup>15</sup>.

**4.30** Jobcentre Plus brings together benefits and labour market advice for all people of working age – providing an active work focus for those on incapacity benefits and Income Support as well as for those on Jobseeker’s Allowance who are required to seek work, and reinforcing the link between rights and responsibilities. The creation of Jobcentre Plus is at the heart of the increasing focus on helping economically inactive people back into work.

**4.31** Instead of treating people on incapacity benefits and Income Support as incapable of or uninterested in work, Jobcentre Plus ensures that all working-age benefit claimants have the opportunity to return to work by providing tailored worksearch support through a personal adviser and access to a range of labour market programmes including the New Deals. For example, the New Deal for Lone Parents provides voluntary access to a comprehensive package of support including a personal adviser; training, education and childcare; and advice on benefits, in-work financial support and self-employment.

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<sup>15</sup> *Integrated Findings from The Evaluation of the First 18 Months of Lone Parent Work Focused Interviews.*, Thomas, and Griffiths, DWP Research report W184, 2004.

# 5

## FAIRNESS IN FINANCIAL SUPPORT

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**5.1** The second of the Government's five principles for modernising the tax and benefit system is that financial support should be provided fairly: *to ensure it is targeted on those who need it most, financial support should be assessed on a household basis where possible, while respecting the principle of independent taxation.*

**5.2** This chapter sets out how existing structures of financial support in the tax and benefit system were not well designed to provide financial support for families which take into account household resources. It goes on to describe how the Child Tax Credit and Child Benefit together provide financial support on the model of progressive universalism, showing how tax credits have reduced the net tax rate for families on low and moderate incomes. The last part of this chapter shows how Pension Credit has ensured that the increased support for pensioners has been provided fairly, and sets out improvements to the delivery mechanisms of financial support.

### **The structure of financial support for families**

**5.3** Since 1999, the Government has put in place a number of reforms to improve financial support for families with children. Introduced from October 1999, the Working Families' Tax Credit (WFTC) increased support and extended help to more working families than its predecessor, Family Credit. In addition, for the first time in a generation the additional costs of raising a family were explicitly recognised by the tax system through the Children's Tax Credit, a tax allowance which provided support for families paying income tax, introduced in April 2001.

**5.4** These were important reforms to help make work pay, tackle child poverty and support family life. However, because they were developments of existing forms of support, some disadvantages remained. In particular:

- as an additional allowance in the income tax system, the Children's Tax Credit could not provide support to families on the lowest incomes, who had no tax liability;
- financial support for families should take account of the income of both parents in a couple, since they share the responsibility of providing for their children. But a tax allowance can only take account of the income of one individual;
- because Children's Tax Credit was an income tax allowance, in practice support was unfairly distributed between single and dual earner couples;
- WFTC retained some of the features of Family Credit. For example, awards were assessed over the six weeks prior to the claim and were unresponsive to changes in a family's income and circumstances. As a result awards could become insufficient to meet a family's needs or, if income increased substantially, unfair to other claimants; and
- the interaction of Children's Tax Credit and WFTC was complex and families receiving WFTC could not benefit in full from the additional tax allowance through Children's Tax Credit.

**5.5** The WFTC and the Children's Tax Credit were introduced in response to the urgent need to improve work incentives and increase financial support for families, but there was a clear case for more fundamental reform.

**The Child and Working Tax Credits**

**5.6** In April 2003, the Government introduced the new tax credits, the Child and Working Tax Credits. Their key advantages over all previous systems of income-related support are:

- the new tax credits are aligned with the tax year: awards generally last for the duration of the tax year and are assessed against income across a whole tax year, ensuring a fair assessment of family resources;
- unlike Children's Tax Credit, awards are based on family income, ensuring that support is fair between dual and single earner couples;
- they are also far more inclusive, with around nine out of ten families eligible for the Child Tax Credit; and
- tax credit awards take account of families' changing circumstances – for example, a reduction in income or a significant change in childcare costs.

**5.7** Around 6 million families are benefiting from the Child Tax Credit (CTC), and 3.5 million families have benefited from the increases in the per child element of the CTC. Box 5.1 sets out how tax credits have extended financial support to more working families than ever before.

**Box 5.1 Families benefiting from the Child and Working Tax Credits**

The introduction of the Child and Working Tax Credits has sharply increased the number of working families benefiting from financial support for their children. The table below shows how the numbers of households benefiting from financial support through tax credits has increased since 1997.

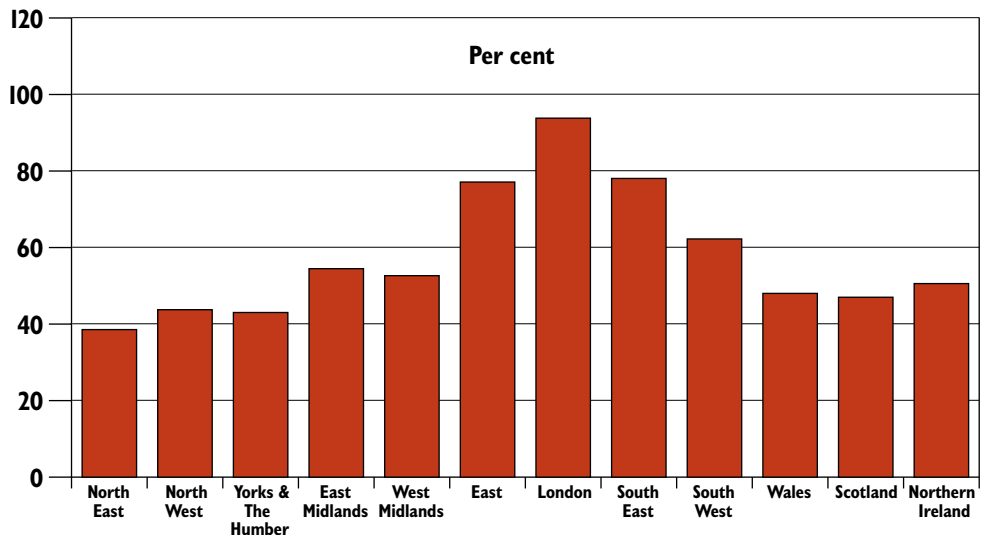
Thousands of working families	Family Credit/Disability Working Allowance <sup>1</sup>	WFTC and DPTC	Child and Working Tax Credits
	November 1997	November 2002	December 2004
Families with higher incomes	–	– <sup>2</sup>	2,075
Families with low and moderate incomes	766	1,394	2,186
Families with childcare costs	33	180	331
Families with a disabled child	0	32	116
Households with a disabled worker	14	38	87

<sup>1</sup> Great Britain only

<sup>2</sup> Children’s Tax Credit was available to most families paying income tax in 2002-03. The number of families with higher incomes who benefited is not readily identified.

More families in every region and country of the UK are benefiting from the additional support provided through the Child and Working Tax Credits. The chart shows that London has seen the largest increase with 94 per cent more working families receiving an award of Child Tax Credit above the family element<sup>a</sup> compared with the number receiving WFTC two years previously. Research had shown that take up of WFTC in London (and to a certain extent the South East) was lower than elsewhere in the UK, so the greater increase in caseload is encouraging.

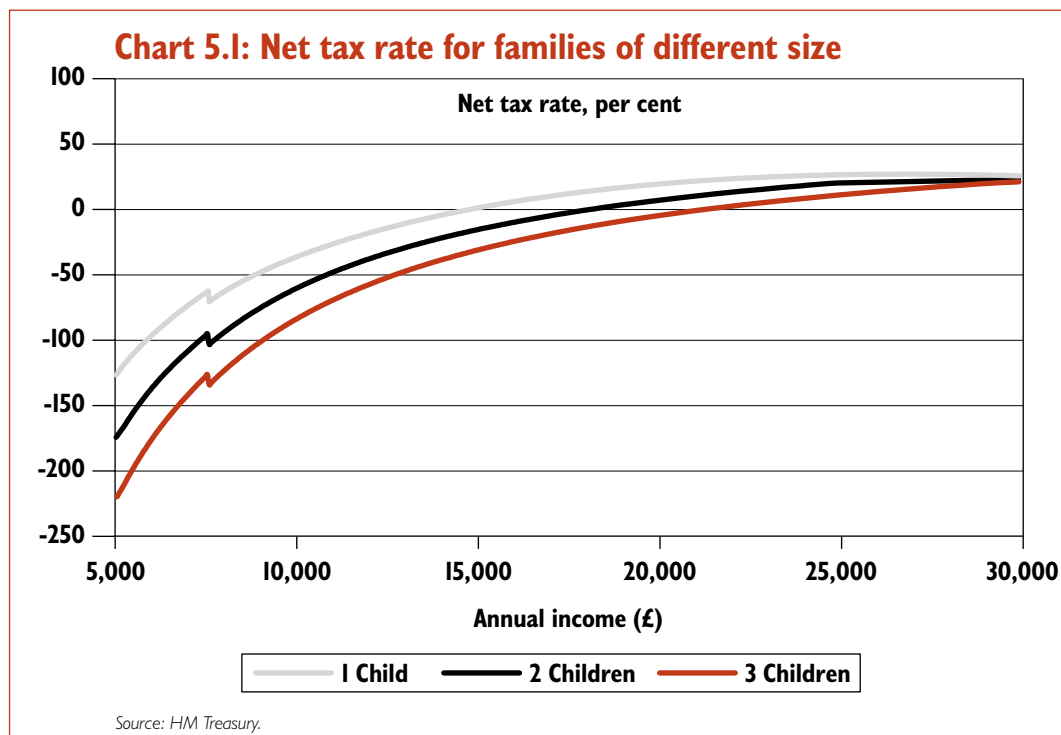
**Increase in working families benefiting from tax credits by region, November 2002 to December 2004**



Source: Inland Revenue.

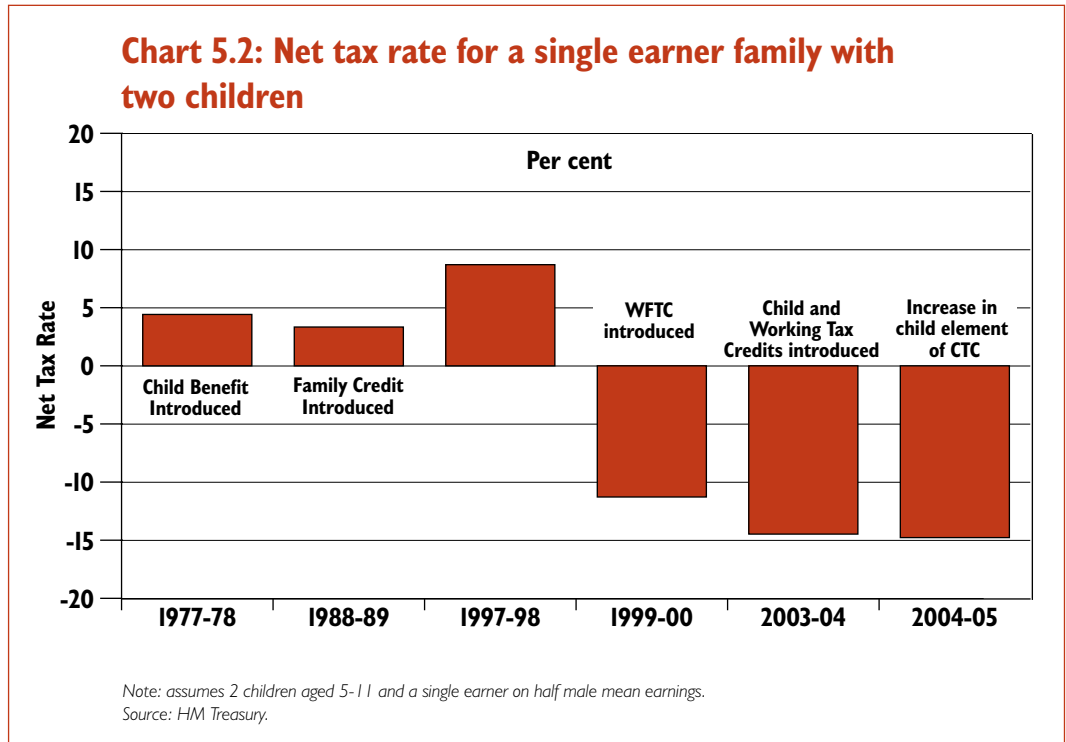
<sup>a</sup> Families receiving more than the family element of Child Tax Credit have low or moderate incomes and are therefore the closest comparators to families eligible for the WFTC.

**Reducing the tax burden on families** **5.8** Chapter 3 introduced the concept of net tax rates and explained how – through the Child and Working Tax Credits – the net tax rate faced by a family will depend on its precise circumstances, including the number of children in the household. Chart 5.1 shows how the net tax rate including national insurance contributions (NICs) varies with income and family size.



**5.9** The Child and Working Tax Credits mean that, including NICs, a family with one child will not begin to pay net tax until income reaches £15,400. For a family with two children the level is £18,700 and with three children £21,900. Excluding NICs a family does not begin to pay net tax until income is £17,300 with one child, £21,200 with two children and £25,100 with three children.

**5.10** As new systems of financial support have been introduced over the past 25 years, the overall financial support provided to particular families has changed. Chart 5.2 shows the net financial support for a family with one earner on half male mean wages. Although Family Income Supplement was introduced in the early 1970s, Child Benefit in the late 1970s and Family Credit in the late 1980s, it was only with the introduction of tax credits that this family benefited from a negative net tax rate.



**5.11** As set out in Chapter 3, tax credits are an effective means of ensuring that families with low incomes face a negative net tax rate, taking into account both tax paid and support received. Compared with the income tax system or Child Benefit, they provide a much more flexible way of providing support to families who need it most, because they can respond both to family income and circumstances. Further, because pension contributions are disregarded in the income test for tax credits, they can enhance the return to saving, as the Pensions Commission noted in its First Report<sup>1</sup>.

**Achieving fairness for pensioners**

**5.12** Just as tax credits were necessary to provide increased support for families on a progressive basis, the Government has introduced Pension Credit to improve support for pensioner households. At the same time, the Government has reduced the income tax burden on pensioners through higher personal tax allowances available to those aged 65 or over.

**5.13** Pension Credit replaces the weekly means test with a less intrusive form of assessment and fixes support over a much longer time period, up to five years, from age 65. Further, Pension Credit is assessed on a household basis, ensuring that financial support is fair, especially to those who may not have been able to build up pension rights because of a disability, or due to caring responsibilities.

**5.14** The introduction of Pension Credit, which includes the Savings Credit, also ends the unfair penalty on those who have saved for their retirement. Previously, support was withdrawn pound-for-pound meaning that many households with modest savings were no better off than if they had not saved at all. Around 1.9 million pensioner households benefited from the introduction of the Savings Credit. Pension Credit has also abolished the upper capital limit, increased the amount of liquid savings disregarded to £6,000, and halved the assumed rate of return on capital.

**5.15** The Government is committed to further improvements in financial support for pensioner households, on the model of progressive universalism. The guarantee element of Pension Credit will rise in line with average earnings up to 2007-08, ensuring that the poorest pensioners continue to share in rising prosperity.

<sup>1</sup> *Pensions: Challenges and Choices, The First Report of the Pensions Commission*, Pensions Commission, 2004.

**Abolishing the weekly means test** **5.16** Extending financial support to a larger number of families with children, and to many more pensioner households, brings with it the challenges of providing support more efficiently, with less hassle for claimants, and without imposing an intrusive assessment of household resources. The Child and Working Tax Credits, and Pension Credit provide a step change in improving access to financial support.

**5.17** The Child and Working Tax Credits share a single income test and use a definition of income which is very close to taxable income. As a result tax credits enable families to use information they already have, for example the P60 form which employers provide after the end of the tax year, to make or renew their claim.

**5.18** Families with children no longer have to claim different forms of support depending on their employment status and income because financial support for children is integrated in CTC. Before CTC was introduced a family would receive support for their children through the benefits system if the parents were out of work, through Working Families' Tax Credit where they were working and had a modest income, and through Children's Tax Credit if they were paying income tax. Over a period of several years a family could move between these systems of support, triggering new claims and the hassle that went with them.

**5.19** Pension Credit replaces the means test with a far less intrusive form of assessment. From age 65 most pensioners receive an entitlement which lasts for five years at a time. This greatly enhances their financial security and they have the option of receiving more help if their income falls. A recent independent survey found that around 70 per cent of people claiming Pension Credit thought the application process was easy, with 85 per cent saying they would recommend Pension Credit to others<sup>2</sup>.

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<sup>2</sup>Age Concern Pension Credit Report, 2004.

# 6

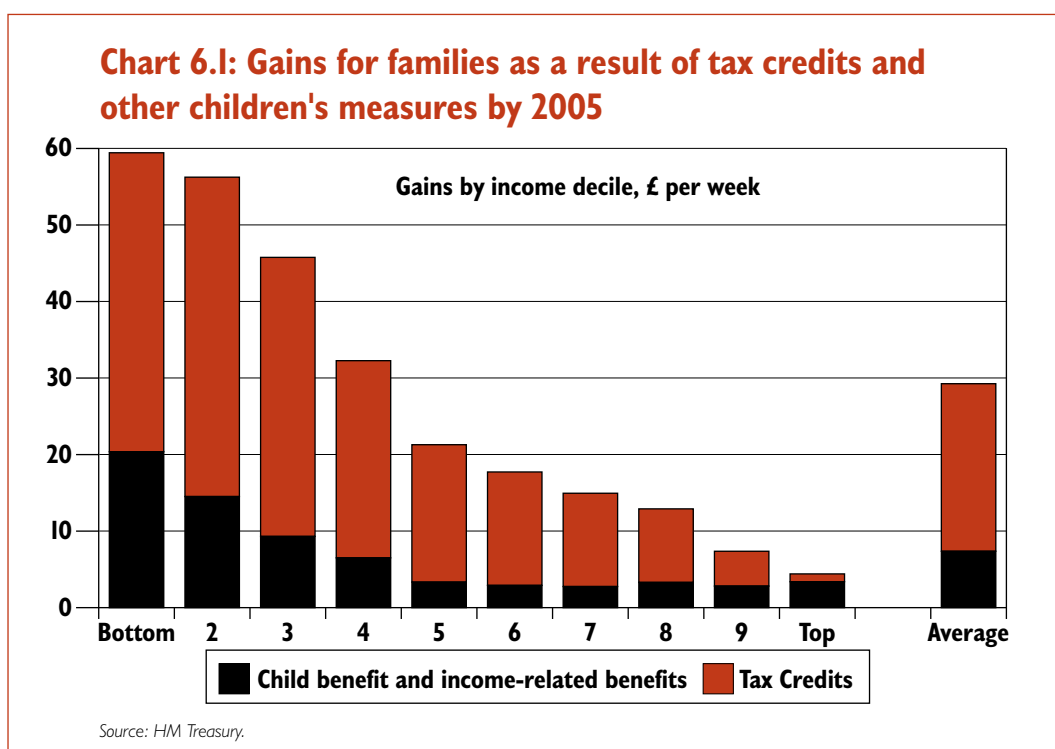
## TACKLING POVERTY AMONG VULNERABLE GROUPS

**6.1** The third principle guiding the Government's reforms of the tax and benefit system is that: *to tackle poverty, minimum levels of income should be guaranteed for the most vulnerable in society – the elderly, families and those who cannot work because of illness or disability.* The first section in this chapter sets out how the Government's reforms have increased financial support for families and the following one describes how the Government's reforms have increased pensioners' incomes.

### Financial support for families

**6.2** Child Benefit was first introduced in 1977, and is payable to every family in the UK in respect of each child. The Government believes it is right that society should recognise the importance of family life by providing financial support for every family with a dependent child. Since 1997 the value of Child Benefit for the first child has been increased by 25 per cent in real terms.

**6.3** The increased support for families with children through tax credits builds on Child Benefit. Overall support has been increased in line with the principle of progressive universalism, providing most support for those with the greatest needs. Chart 6.1 below shows the gains for families by income decile as a result of policy changes since 1997-98.



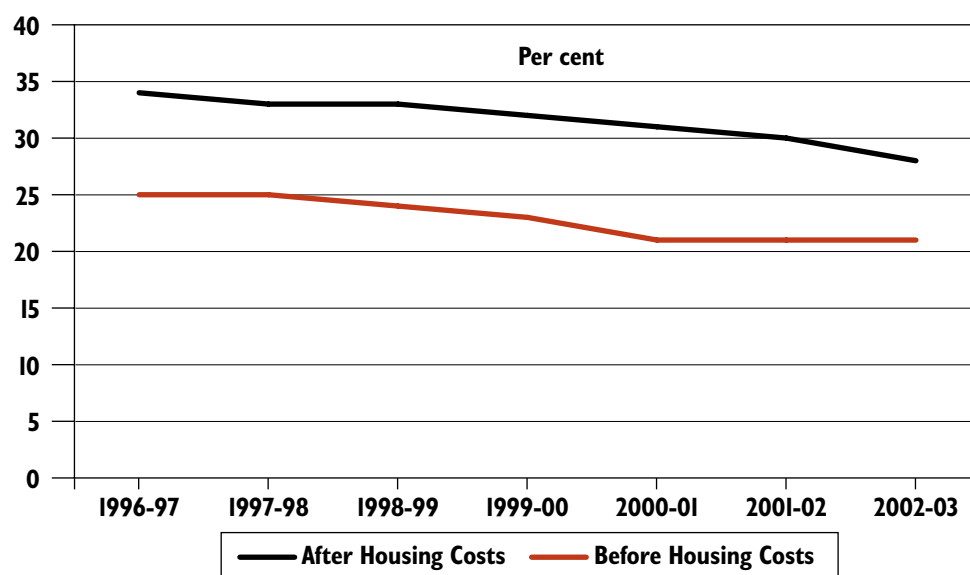
**6.4** While the extra expenditure on children has benefited all families, those with the lowest incomes, families with young children and those with disabled children have seen the largest increases in support. Box 6.1 sets out the impact of the additional support on families with the lowest incomes, showing how the extent of material deprivation has reduced in recent years. The next section, which looks at the Government's progress against its target to reduce the proportion of children in low-income households, is followed by a section discussing the increase in support for families with young children.

## Progress in reducing child poverty

**6.5** Since 1997 the proportion of children in low-income households has fallen and the Government is on track to reach the first milestone on the way to its long-term goal of eradicating child poverty by 2020. This requires a reduction in the number of children in relative low-income households of one quarter between 1998-99 and 2004-05. By 2002-03, the proportion of children in households with equivalised incomes below 60 per cent of the contemporary median fell from 24 per cent to 21 per cent measured on a before housing costs basis and from 33 per cent to 28 per cent on an after housing costs basis, a reduction of 5-600,000 children, shown in Chart 6.2 below.

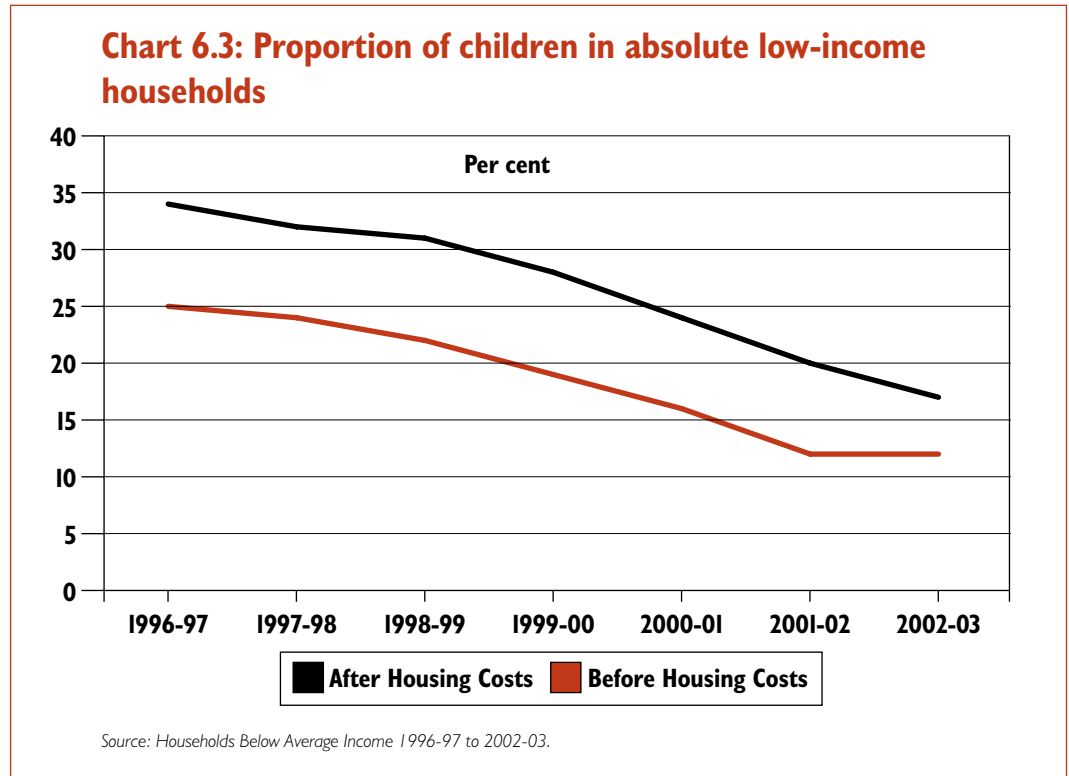
**6.6** This reflects a number of factors such as the reduction in unemployment and worklessness including among lone parents, increased levels of benefits and tax credits related to children, and more evenly distributed growth in real income across the population.

**Chart 6.2: Proportion of children in relative low-income households**



Source: Households Below Average Income 1996-97 to 2002-2003.

**6.7** Measured against a constant level of real income, the decline in the number of children in low-income households has been dramatic, reflecting the same factors as the relative income data, together with sustained and stable economic growth. By 2002-03, the number of children in absolute low-income households fell from 3.2 million in 1996-97 to 1.5 million before housing costs and from 4.3 million to 2.2 million after housing costs.



### A new measure of child poverty

**6.8** The next milestone towards meeting the long-term goal of eradicating child poverty by 2020 is to halve the number of children in relative low-income households by 2010. In addition, the Government will reflect international best practice<sup>1</sup> in measuring poverty and monitoring progress, providing a balance between clarity and comprehensiveness. It will use three tiers:

- the number of children in households with less than 60 per cent of contemporary median income – to see whether the poorest families are keeping pace with the growth of incomes in the economy as a whole;
- the number of children in households with less than 60 per cent of median income held constant in real terms from a 1998-99 base – to see whether the poorest families are seeing their incomes rise in real terms; and
- the number of children experiencing material deprivation and living in households with less than 70 per cent of contemporary median income – to provide a wider measure of families' living standards.

**6.9** The choice of these tiers reflects the results of substantial public consultation, capturing different aspects of poverty whilst respecting the finding that income is at the core of people's conception of poverty<sup>2</sup>. The Government's approach to tackling child poverty reflects this complexity. The strategy hinges on ensuring decent family incomes through full employment and a modernised tax and benefit system, but it goes beyond this to include delivering excellent public services to improve children's life chances and break cycles of deprivation. The Child Poverty Review, published in the 2004 Spending Review, provides further details of this approach.<sup>3</sup>

<sup>1</sup> *Child poverty in rich countries 2005.*, UNICEF 2005, Report Card No. 6, Innocenti Research Centre. Best practice in measuring child poverty includes: avoiding unnecessary complexity; measuring material deprivation; basing poverty lines on social norms; establishing a regular monitoring system; establishing a "backstop" poverty line; and setting targets.

<sup>2</sup> *Measuring child poverty*, DWP 2003, <http://www.dwp.gov.uk/consultations/consult/2003/childpov/final.asp>

<sup>3</sup> *Child Poverty Review*, HM Treasury, 2004, [www.hm-treasury.gov.uk/spending\\_review](http://www.hm-treasury.gov.uk/spending_review)

**Box 6.1 Impacts of increased financial support on material deprivation**

Since 1997 increases in weekly incomes through employment and a more generous tax and benefit system have been accompanied by tangible improvements in poor children's lives. As shown in the table below more low-income families have been able to afford key items that others might take for granted.

<b>Material deprivation among lone parents</b> (per cent of families who want but cannot afford)	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Cooked main meal every day	8	6	5	3
Fresh fruit on most days	17	14	11	8
Celebration with presents at special occasions	27	23	17	14
Toys/sports gear for each child	24	21	15	12
Two pairs of shoes for each child	25	19	15	13

In addition to increased affordability of key items there are signs of reduced financial strain:

<b>Financial stress among lone parents</b> (per cent of families who experience)	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Problems with debts almost all the time	15	13	10	12
Always runs out of money before end of week	28	24	21	19
Worries about money almost always	45	38	33	30
Never has money left over	48	40	34	17

Source: Families and Children Survey

Case studies of the impact of Government policy since 1997 on families at risk of social exclusion<sup>a</sup> identified a range of positive impacts when an adult moved into employment, started training and experienced rises in incomes through benefits and tax credits. For example:

- moving into work often meant “extras” for children such as cinema trips, schools trips, trainers and clothes;
- people who had entered employment since 1997, particularly lone parents, talked of the benefits of meeting new people outside their homes;
- changes in employment were a primary source of improvements to well-being. People spoke of increased self-esteem, self confidence or generally feeling happier and children noticed the improvements in their parents' well-being; and
- tax credits were seen as pivotal in enabling people to return to work, especially part-time.

<sup>a</sup> *Making a difference to disadvantaged families? Qualitative case studies*, Social Exclusion Unit, 2004.

**Support in the early years** **6.10** With more parents combining the responsibilities of work with caring for their children, reform of the tax and benefit system needed to encompass appropriate financial support for parents to help them balance the demands of work and family during the early years of a child's life. It has achieved this by:

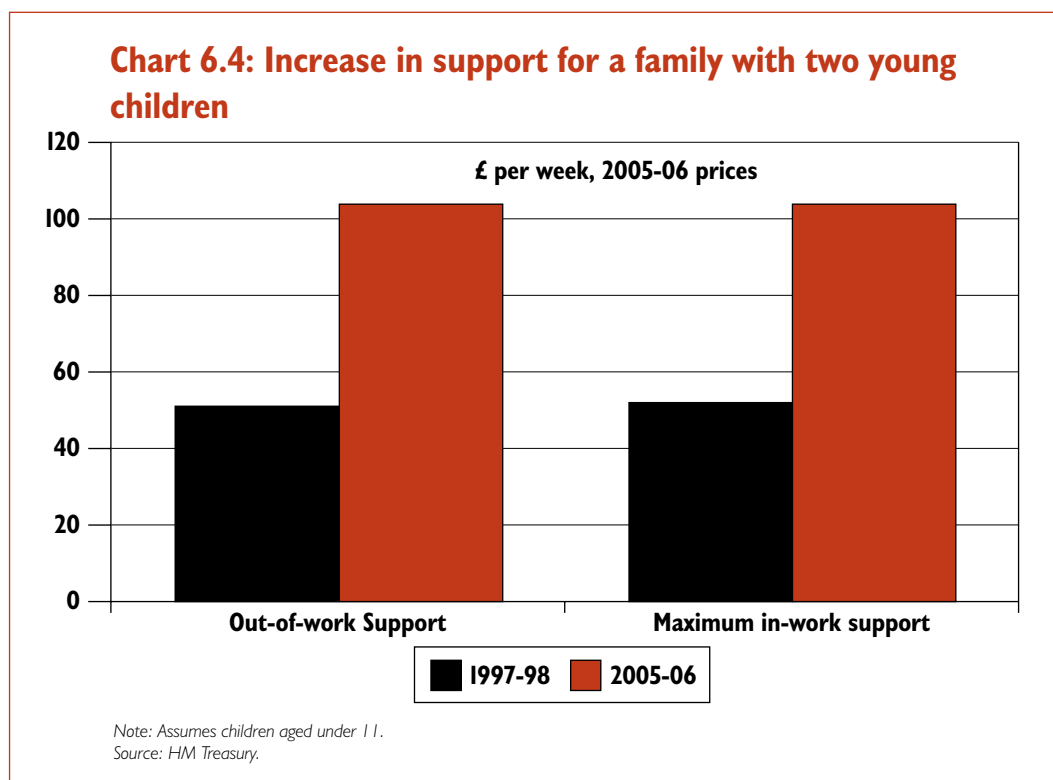
- increasing maternity pay and extending maternity leave;
- increasing support for young children in families with low and moderate incomes;
- introducing more generous help with the extra costs of a new baby for most families; and
- increasing dramatically the generosity of support for families with in-work childcare costs.

**6.11** Since 1997 the Government has introduced a range of measures to improve the choice parents face in balancing work and family during the first year of a child's life. From 2003-04 paid maternity leave for working mothers was extended from 18 to 26 weeks, with a right to a further 26 weeks' unpaid leave introduced. Paid maternity leave will be further extended to 39 weeks, with the goal of a year's paid maternity leave by the end of the next Parliament<sup>4</sup>.

**6.12** The level of Statutory Maternity Pay and Maternity Allowance has been raised from £55.70 a week in 1997-98 to £106 a week from 2006-07. With evidence suggesting that there is growing demand from fathers for increased involvement in caring for their children, paid paternity leave was introduced in 2003 for the first time. The Government is consulting on the introduction of a right for a mother to transfer a proportion of her maternity pay and leave to the father.

**6.13** The Government has also increased the amount of financial support available to families with young children (under 11), both in and out of work, as shown in Chart 6.4. A family with two young children and a full-time earner on £15,500 a year, half male average earnings, will receive over £103 a week in Child Tax Credit and Child Benefit next year, a real terms increase of 85 per cent since 1997-98.

<sup>4</sup>*Choice for parents, the best start for children: a ten year strategy for childcare*, HM Treasury, 2004, [www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr04](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04).



**6.14** The Child Tax Credit provides extra support to families with a new baby through an addition to the family element, which provides help to all families with incomes up to £66,000 per year. For families on low or moderate incomes more support is available with the costs of a new baby through the Sure Start Maternity Grant, a one-off payment of £500.

**6.15** Childcare costs are typically much higher for pre-school age children than for older children and good quality childcare is critical for later life development. Evidence from the Effective Provision of Pre-school Education (EPPE) project<sup>5</sup> shows that early education can have a positive effect on child outcomes, boosting cognitive development and improving social skills and confidence. Further, although it cannot wholly eliminate the impact of disadvantage, quality pre-school education can provide children from lower-income households with a better start at school.

**6.16** The Government has increased financial support to families with childcare costs through the tax credits system, through the Employer Supported Childcare scheme, and through the provision of early years education for three and four year olds. Since 1997 expenditure on childcare through tax credits has increased fifteen-fold in real terms. In addition, Sure Start programmes provide help with childcare for families in the most disadvantaged areas and the Government has significantly increased funding to support new childcare places.

## Financial support for other vulnerable groups

**6.17** To put the third principle of welfare reform into effect for the elderly the Government has promoted policies aimed at guaranteeing security in old age and ensuring that all pensioners can share in rising national prosperity. The immediate challenge faced by the Government in 1997 was pensioner poverty, which the Government has tackled by targeting resources on the poorest and most vulnerable pensioners.

<sup>5</sup> *The Effective Provision of Pre-School Education (EPPE) Project: Findings from the Pre-School Period, Summary of Findings*, Sylva, et al, Institute for Education, 2003.

**6.18** Pension Credit, introduced in October 2003, builds on the previous Minimum Income Guarantee and is at the heart of these reforms. From April 2005 Pension Credit will guarantee pensioners a minimum weekly income of £109.45 if they are single and £167.05 for a couple. These income levels are 31 per cent and 29 per cent higher in real terms than in 1997-98 when the minimum income for a pensioner household was provided through Income Support.

**6.19** In addition to increased support for those who need it most, the Government has provided an improved foundation of support for all pensioners. The Basic State Pension is central to this foundation and since 2002-03 the Government has guaranteed an annual increase in line with prices or 2.5 per cent (whichever is higher). Overall since 1997 there has been a 7 per cent real terms increase in the Basic State Pension and a cash increase of nearly £20 per week for single pensioners.

**6.20** The introduction of the 10 pence rate of income tax and the increase in the age-related income tax allowances in line with earnings during this Parliament have worked with the Pension Credit to enable pensioners to share in rising national prosperity.

**6.21** The Government has also introduced a series of measures to meet specific needs, particularly of older pensioners, and to give those on fixed incomes greater scope to manage irregular expenses:

- the £200 Winter Fuel Payment for households with someone aged 60 or over, rising to £300 for those over 80;
- additional support to help households with someone aged over 70 with Council Tax bills and other living expenses;
- free eyesight tests and local travel concessions for the over 60s; and
- free television licences for households with someone over age 75.

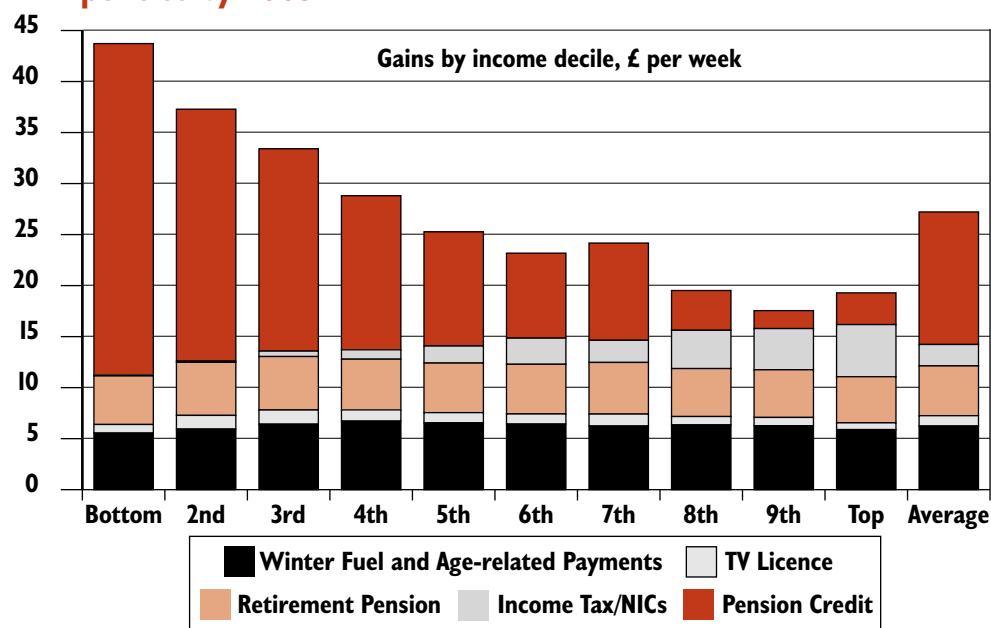
**6.22** Chart 6.5 shows the total impact of the Government's measures to improve support for pensioners since 1997-98, by income decile. The poorest 10 per cent of pensioners will be £44 a week better off in 2005-06 than they would have been under an indexed 1997 system<sup>6</sup>.

**6.23** By focussing on the most vulnerable, and on those who have had less opportunity to provide for themselves, while increasing support for the great majority of pensioner households, the Government's measures to improve incomes for pensioners have followed the principle of progressive universalism. Compared with a policy of uprating the Basic State Pension in line with average earnings, government support for pensioner households is both more generous and better focused on those who need it most:

- the Government has committed £7 billion more on support for pensioners in 2004-05 than if the Basic State Pension had been linked to earnings since 1998;
- on average the poorest 10 per cent of pensioners are £23 a week better off through the Pension Credit and other Government measures than if an earnings link had been applied to the Basic State Pension since 1997; and
- by 2005-06 pensioner households on average will be £1,350 a year better off in real terms as a result of personal tax and benefit measures introduced since 1997.

<sup>6</sup> Measures up to and including those announced in the 2004 Pre-Budget Report, in 2005-06 prices.

**Chart 6.5: Overall gains for pensioner families from benefit policies by 2005**



Source: Department for Work and Pensions.

**6.24** Women pensioners, who in the past have often not been able to build up an entitlement to a full Basic State Pension, have been among those to benefit the most from Pension Credit. Only 48 per cent of women currently receive a full Basic State Pension in their own right but twice as many women benefit from Pension Credit as men.

**Support for disabled people**

**6.25** The introduction of tax credits has led to increases in support for other vulnerable groups: disabled workers and families with disabled children. Since 1997 there has been a six-fold increase in the number of households with a disabled worker receiving in-work financial support. With increases in the National Minimum Wage and more generous support through tax credits the Minimum Income Guarantee for a single disabled worker working part-time will increase to £153 per week by October 2005.

**6.26** Through tax credits the level of financial support for disabled children has increased dramatically since 1997-98, and far more families are benefiting. Prior to the introduction of the Working Families' Tax Credit there was no income-related support for working families with a disabled child.

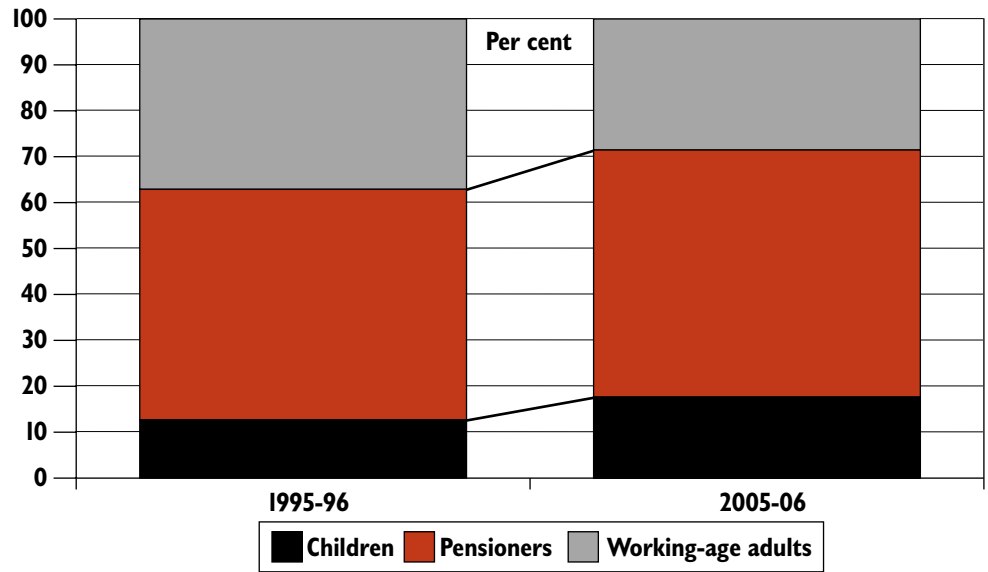
**6.27** The Child Tax Credit integrates income-related financial support for disabled children by replacing the disabled child premium in Income Support with a much more generous tax credit. Support for families with low incomes through Child Benefit, Child Tax Credit and Disability Living Allowance is now at least £100 per week, 250 per cent more than was available to a working family with a disabled child in 1997-98<sup>7</sup>.

**Directing resources to the most vulnerable**

**6.28** The increases in support for families with children and pensioners have led to a marked shift in the balance of total expenditure through the tax and benefits system since the early 1990s. With lower unemployment the share of spending on people of working age has fallen, enabling more resources to be directed to the most vulnerable groups.

<sup>7</sup> The comparison assumes the child is under 11 and eligible for the lower rate of Disability Living Allowance.

**Chart 6.6: Share of benefits and tax credit spending by age group**



Source: Department for Work and Pensions and HM Treasury.



# 7

## LOOKING AHEAD

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**7.1** The Government has put in place a series of reforms to the tax and benefit system. These reforms have been guided by the principles set out in Chapter three and have made progress towards achieving the Government's three over-arching objectives:

- to ensure adequate financial incentives to work;
- to reduce child poverty and increase financial support for all families; and
- to tackle poverty among the current generation of pensioners and support people in providing for their retirement

**7.2** The Government's policies to modernise the tax and benefit system constitute the most fundamental programme of welfare reform since the 1940s. Nevertheless there remain important areas where further reform could contribute to the Government's aims. This chapter looks at how progress to date can be built on and explains how future policies to reform Britain's welfare state will be guided by the principles for modernising the tax and benefit system and empirical evidence on the most effective interventions.

### Promoting incentives to work

**7.3** A modernised welfare state should *promote incentives to work, by reducing the tax burden on the low paid and the number of low-income households on high marginal withdrawal rates.*

**7.4** Financial incentives to work are essential in helping people make the transition from benefits to work and to remain in employment. There is, however, a growing body of evidence that to be most effective, financial incentives should be accompanied by a package of tailored support and information to help individuals make informed labour market decisions.

**7.5** Building on this evidence, the Government will continue to test and monitor different ways to engage with those not in work and to help them make the transition to work. For example, the Lone Parent In Work Credit and Work Search Premium pilots are providing valuable evidence on the effectiveness of these measures. In addition, the Employment, Retention and Advancement Pilot is testing how best to provide support to help low-income families progress in work.

#### Improving incentives to work for disabled people

**7.6** Achieving the Government's vision for incapacity benefits reform requires a balanced and principled approach across a number of fronts. The Pathways to Work pilots are a key component of a much wider programme of change – involving employers, GPs and ensuring civil rights for disabled people. The next stage is to reform the system of incapacity benefits, alongside the employment and health support offered through Pathways to Work.

**7.7** The current system of incapacity benefits is complicated, creates uncertainty and in many cases acts as a disincentive to work. The Department for Work and Pensions (DWP) Five Year Strategy<sup>1</sup>, set out the Government's plans to reform incapacity benefits to reward work and give more help than now to people with the most severe limitations.

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<sup>1</sup> *Opportunity and Security Throughout Life*, Department for Work and Pensions Five year Strategy, February 2005.

**7.8** The revised model for incapacity benefits would include a new payment for people with potentially more manageable conditions that might be called a Rehabilitation and Support Allowance. These claimants would receive a conditional extra payment for engagement in Work Focused Interviews and a further payment for fulfilment of an action plan agreed at the interview. People with the most severe health conditions or disabilities would receive a payment that might be called a Disability and Sickness Allowance and will get more money than now to reflect the increased risk of poverty that they face. The Government recognises the important contribution that external stakeholders have made to the development and delivery of the Pathways to Work pilots and intends to continue to work closely with interested parties to develop these proposals.

**7.9** The comprehensive support offered by Pathways to Work, combined with a reformed disability benefits system, will tackle the entrenched problems that have been created over the course of a generation. In parallel, the Government will consider carefully what changes can be made to tax credits to complement the reforms to incapacity benefits. While there are important differences between financial support for families with children and people with a health condition or disability, there may be valuable lessons from the development of tax credits, for example improving the fit between in-work and out-of-work support offered to disabled people.

**Improving incentives to work for families with children**

**7.10** The Child and Working Tax Credits have significantly reduced the average effective tax rates faced by low-income families with and without children. The 2004 Pre-Budget Report announced the new tax credit rates that will be payable from April 2005 and also announced increases in both the limits and percentage of childcare costs reimbursed by the childcare element of the Working Tax Credit. These changes will provide additional financial support to families with children.

**7.11** While the Government's reforms have done much to increase financial incentives to move into work, the improvements have been modest for those households in receipt of Housing Benefit (HB). Improved administration and the Local Housing Allowances currently being piloted offer significant advantages in terms of reduced uncertainty and greater choice for HB recipients. This will help those making the transition to work.

**7.12** However, the HB system is also problematic as it can reduce work incentives. Making further progress in the long term would therefore require a change in the overall structure of HB. The Government will examine the options for reform, including how HB could be more closely aligned with support provided through tax credits and the benefits system.

**Income Tax and National Insurance Contributions**

**7.13** Since Martin Taylor's report on work incentives in 1998<sup>2</sup>, the Government has been pursuing a policy of alignment of the tax and national insurance contribution (NICs) systems. This has resulted in the measures set out in Chapter four, which together amount to the most significant package of reforms of NICs since the 1970s. In taking this work forward the Government will be guided by the following principles:

- fairness for individuals, employers and tax payers;
- coherence of the tax and benefit systems, in the context of a modern labour market; and
- reducing administrative burdens.

<sup>2</sup> *Work Incentives, A report by Martin Taylor, HM Treasury, 1998.*

## Financial support should be assessed on a household basis where possible

**7.14** The second of the Government's five principles for modernising the tax and benefit system is that financial support should be fairly targeted: *to ensure it is targeted on those who need it most, financial support should be assessed on a household basis where possible, while respecting the principles of independent taxation.*

**7.15** Successive reforms have helped to deliver extra financial support to those who need it most including families with children, low-income workers, workers with disabilities and pensioners. In particular, tax credits, which use a household income test, have provided a foundation on which other forms of financial support can build. The Government has extended this principle through recent changes in the way young people are supported.

### Extending financial support for 16-19s

**7.16** Education Maintenance Allowances (EMAs) have shown the important role of financial support and incentives in delivering higher post-16 participation rates. In *Supporting young people to achieve*, published alongside Budget 2004, the Government set out how it proposes to achieve its ambition to ensure every individual is supported and encouraged to make the most of their potential through post-16 learning. The Government's long-term vision is to deliver a single, coherent system of financial support for 16-19 year olds, radically simplifying the complexity of the current benefits system and building on the principle of a household based income test where that is appropriate.

**7.17** As a significant step towards this long-term vision, from April 2006 the Government will extend Child Benefit, Child Tax Credit and Income Support to unwaged trainees on specific work-based learning schemes arranged by the Government<sup>3</sup>. In England, EMAs will also be extended to these trainees. The aim of these reforms is to deliver parity in financial support for education and unwaged training, enabling individuals to choose the learning route most appropriate for their talents and aspirations, rather than basing their decision on the amount of money available.

**7.18** Furthermore, from April 2006 the Government will extend Child Benefit, Child Tax Credit and Income Support to 19 year olds completing a course of non-advanced education or training which they started before their 19th birthday, up to a limit of age 20. This will ensure that most of these young people are supported until the end of their course. The Child Benefit Bill currently being considered by Parliament is the first step in implementing these two important reforms.

## Tackling Poverty

**7.19** The third principle guiding the Government's reforms of the tax and benefit system is: *to tackle poverty, minimum levels of income should be guaranteed for the most vulnerable in society – the elderly, families and those who cannot work because of illness or disability.* The Government has set itself ambitious targets to halve child poverty by 2010 on its way to eradicating child poverty by 2020.

<sup>3</sup> These programmes are set out in the draft Child Benefit regulations published by HM Treasury on 10 January, available from [www.hm-treasury.gov.uk/media/5C6/D9/draft\\_child\\_benefit\\_regulations\\_10\\_january.pdf](http://www.hm-treasury.gov.uk/media/5C6/D9/draft_child_benefit_regulations_10_january.pdf)

**7.20** The first milestone on the way to its long-term goal of eradicating child poverty is a reduction in the number of children in relative low-income households of one quarter by 2004-05. As set out in Chapter six, the Government is on track to meet this target. From 1998-99 to 2002-03, the proportion of children in households with equivalised incomes below 60 per cent of the contemporary median fell from 24 per cent to 21 per cent measured on a before housing costs basis and from 33 per cent to 28 per cent on an after housing costs basis.

**7.21** The next milestone on the way to the eradication of child poverty is halving the number of children in relative low-income households between 1998-99 and 2010-11<sup>4</sup>. To capture those aspects of poverty not covered by income alone, the Government will set an additional target in the next Spending Review to halve by 2010-11 the number of children suffering from both material deprivation and relative low-income. Child Benefit and Child Tax Credit have a key role to play in achieving these ambitious goals.

**Tax Credits 7.22** Almost 6 million families benefit from tax credits. Their introduction has changed the way that many families interact with government. Families can now contact the tax credits office, and be contacted, by telephone and through the internet. The Government recognises that customer service could be further improved which is why it is reviewing the content and clarity of the award notices received by tax credit claimants, and also improving the information on finalisation notices.

**7.23** The Government also continues to focus resources on the poorest pensioners. Key to this has been the Pension Credit, which further extends support to the poorest pensioners and rewards those who have built up small savings for retirement. To ensure that Pension Credit continues to take and keep pensioners out of poverty, at the time of the 2004 Pre-Budget Report the Government committed to increasing the guarantee element of Pension Credit by earnings in 2005-06 and in the period up to 2007-08.

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<sup>4</sup> In line with international practice, low income will be measured on a before housing costs basis. The Government continues to monitor progress against a range of other indicators, including income measured on an after housing costs basis and data on regional variations in child poverty.



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