

# 12. Supporting couples with children through the tax system

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## Summary

- The tax and tax credit system treats some married or cohabiting couples with children less generously than if the parents live (or claim to live) apart. Some 'couple penalty' or 'couple premium' is inevitable if you want to be proportionately more generous to people on lower incomes and if you assess entitlement to help according to family rather than individual circumstances.
- But critics variously argue that the current system is inefficient in lifting couples with children out of poverty, that it encourages parents to live apart to the detriment of their children and that it gives insufficient support to couples where one partner gives up work to care for young children.
- We assess three recent proposals to alter the tax treatment of couples with children in order to ameliorate one or more of these perceived problems. Reflecting the different objectives that motivate them, these proposals would have different effects on family incomes and financial work incentives.
- Increasing the working tax credit for all couples with children would particularly help low-income one-earner couples, but would discourage them from increasing their income, for example through adding an earner or working longer hours.
- Increasing the working tax credit only for two-earner couples would reverse a recent trend by strengthening the incentive for low- to middle-income couples to have both adults in work, but would also discourage such families from seeking increases in income through other means.
- A transferable personal allowance for families with a child under 6 would benefit the majority of one-earner couples with a young child, regardless of income, but would act to discourage such families from having both adults in work.
- All three proposals would reduce the 'couple penalty' in the tax credit system because they give extra support to couples with children but not to lone-parent families.

## 12.1 Introduction

Deciding how personal taxes, tax credits and means-tested benefits should treat parents in different family structures is an extremely difficult policy design issue. As usual, the difficulty arises because governments often face conflicting objectives.

At present, the tax and benefit system treats some married or cohabiting couples with children less generously than if the parents live (or claim to live) apart. As we discuss in Section 12.2, some ‘couple penalty’ (or ‘couple premium’) is inevitable if you want to be proportionately more generous to people on lower incomes and if you assess entitlement to financial help through benefits and tax credits (or liability to income tax) according to household rather than individual circumstances.

The purpose of this chapter is to compare some specific suggestions that have been made recently for changing the way that couples with children are treated by the tax and benefit system. The suggestions are:

- increasing the value of the working tax credit for couples with children;
- strengthening the financial incentive to work of a second earner in a couple by changing some aspect of the working tax credit; and
- a transferable personal income tax allowance, perhaps restricted to those with young children or couples with children who are married (or in a civil partnership) rather than cohabiting.

Although none of these proposals is yet advocated by any political party, all have been at least discussed at a high level. The Liberal Democrats have criticised the current tax credit system for providing apparent penalties for adults who decide to cohabit. In a report commissioned by the government, Lisa Harker recommended reforms similar to the second proposal. The Conservative Party has in the past proposed a transferable personal income tax allowance, and certainly seems sympathetic to the idea of supporting one-earner couples with children.

Section 12.2 discusses in general terms why designing a tax and benefit system for couples is more complicated than designing one for single people. Section 12.3 outlines the current system and the various criticisms made by the proponents of these reforms. Section 12.4 sets out the reforms and analyses their impact on family incomes, the ‘couple penalty’ and measures of financial work incentives.<sup>1</sup>

## **12.2 What should governments think about when designing taxes and benefits for couples?**

When considering how to structure a tax and benefit system for single people (meaning how generous to make benefits and tax allowances, how quickly to withdraw benefits and what rate to set for income tax), the key issues for a government to decide are how much support to give to those with low incomes, how quickly to reduce that support and then what rate of income tax to set, and how much money to raise overall (revenue from taxes less spending on benefits). In other words, there will generally be a three-way trade-off between:<sup>2</sup>

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<sup>1</sup> The Family Resources Survey is used with permission of the Department for Work and Pensions (DWP), and is also available at the UK Data Archive.

<sup>2</sup> S. Adam, M. Brewer and A. Shephard, *The Poverty Trade-Off: Work Incentives and Income Redistribution in Britain*, Policy Press, Bristol, 2006, explores these issues empirically.

- redistribution to the poor (generally achieved with high levels of benefits for the poor, low levels of benefit withdrawal and high rates of income tax);
- keeping work incentives strong (generally achieved with low levels of benefits for the poor, low rates of benefit withdrawal and low rates of income tax); and
- raising money for public spending elsewhere (generally achieved with low levels of benefits for the poor, high rates of benefit withdrawal and high rates of income tax).

One way to design a tax and benefit system for couples is not to treat them differently at all: in other words, to have a tax and benefit system that only ever depends upon an individual's circumstances. In this case, the tax and benefit treatment of a couple will be identical to the tax and benefit treatment of the two adults in the couple if they had been living apart. This can be thought of as a fully individualised tax and benefit system. This would be an appropriate way to design a tax and benefit system if it were thought that people's well-being (and ability to pay) depends upon their own income, and not the income of any partner who may be present, or if an overriding concern about individual autonomy ruled out a jointly assessed tax and benefit system.<sup>3</sup>

At the extreme, a fully individualised tax and benefit system would involve paying benefits or tax credits to a non-working or poorly-paid individual regardless of whether they were living alone or married to a millionaire. Although it is possible to argue that low-individual-income partners of millionaires are in need of state support – and such individuals in the UK would be entitled to child benefit (if they had children), a state pension (if they had made contributions before retiring) and certain disability benefits (if they were long-term sick or disabled) – most governments in developed countries have a tax and benefit system that redistributes income to couples who have a low combined income, rather than to individuals who have a low individual income. They achieve this by having a system where social security or means-tested benefits at least, and often income tax too, depend in some way upon the combined circumstances of the couple. Such a system makes sense if it is thought that couples in the same household share their income to some extent, and if it costs couples in the same household less to maintain the same level of living standards than two individuals living separately (e.g. because accommodation suitable for two people living together is less than twice the cost of suitable accommodation for one person).

If a government decides that it wants the tax and benefit system to take some account of couples' circumstances, then there are more factors to take into consideration.

- First, the government will need to consider the extent to which the tax and benefit system creates financial penalties or bonuses for adults who choose to live as a couple rather than as single adults. Such penalties or bonuses, even if not intentional, are almost inevitable: the only two ways to design a tax and benefit system for couples that does not give financial penalties or bonuses for adults who choose to live as a couple are either to have a fully individualised tax and benefit system or to have a purely proportional joint tax system with no tax-free allowance.

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<sup>3</sup> One feature of an individualised income tax system is that the net income available to a couple can depend on which partner earns it: for example, in a tax system where the average rate of tax rises with income, a two-earner couple would have a higher net income than a single-earner family with the same gross income as the two adults combined.

- Second, when considering the impact on work incentives, the government will need to think about how any tax and benefit system affects the work incentives of both first and second earners in a couple. This is because a tax and benefit system that is based on family income will tend to have different impacts on the financial work incentives of the first potential earner in a couple from those of the second potential earner. (Box 12.1 outlines a recent paper that uses economic principles to examine this issue, but which abstracts from the other two factors listed here.)
- Third, the government will also have to decide when two individuals should count as a couple and when they should be treated as two single individuals, and then be prepared to police this definition. For example, a government may decide to distinguish between married couples (which would now probably include those in civil partnerships) and all other living arrangements. Alternatively, it may decide that the legal state of marriage (or civil partnership) is not relevant, in which case the distinction is between single individuals on the one hand and all couples on the other; in this situation, a government will need to decide whether to treat same-sex cohabiting couples differently from other cohabiting couples. In current social security and tax credit legislation in the UK, the legal state of marriage (or civil partnership) is not relevant: both define a couple as a married couple (who are not separated) or an unmarried couple who are ‘living together as husband and wife’. Other parts of the tax system, though, maintain a distinction between married couples and all other arrangements.<sup>4</sup> Whatever the definition, a government will have to deal with the fact that family circumstances are not fixed over time, and in the real world there may not be an obvious divide between being a single adult and living as a couple.<sup>5</sup>

To conclude, there are at least four considerations affecting how a government would design a tax and benefit system that treats couples and single people differently:

- how much to redistribute to single adults with a low income and couples with a low joint income;
- to what degree to keep work incentives strong for both first and second earners in a couple (by having low rates of benefit withdrawal and low rates of income tax);
- how to define a couple, and whether to have financial penalties or bonuses for adults who live in couples; and
- how much money should be raised in taxes net of benefits for other public spending.

Furthermore, the nature of the trade-offs is more complicated than it is when considering tax and benefit design for single adults. The following sections, which look at specific reforms affecting couples, will help illuminate some of these trade-offs.

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<sup>4</sup> See R. Sax, ‘The interaction of tax and family law in England and Wales’, paper presented at IFS conference Tax and the Family, New Hall College, University of Cambridge, April 2005 (<http://www.ifs.org.uk/conferences/sax.pdf>).

<sup>5</sup> This is reflected in the detailed guidance used by DWP and HMRC officials when deciding whether two adults should count as living together as husband and wife (LTAHAW); ultimately, the issue is one of an official’s judgement. Although this may be a reflection of how people live their lives, such imprecision will cause difficulties in the operation of the tax and benefit system if people are not clear whether they are a single person or LTAHAW, or if HMRC or DWP finds it hard to enforce a particular definition. For further discussion, see M. Brewer and J. Shaw, *How Many Lone Parents Are Receiving Tax Credits?*, IFS Briefing Note 70, 2006 (<http://www.ifs.org.uk/bns/bn70.pdf>).

### Box 12.1. Applying the optimal income tax problem to couples

Optimal tax theory is an area of economic research that attempts to determine how generous benefits and tax allowances should be, and what rates of benefit withdrawal and income tax to set, given information on how labour supply depends on financial incentives to work at all or earn more, and given to what extent a government wants to equalise incomes. Most theoretical and empirical applications have considered economies with only single individuals. A recent working paper has considered what happens if the economy has only individuals living in couples.<sup>a</sup>

One result of that paper is that it is not sensible to have fully individualised tax and benefit schedules if the government considers that an individual's well-being depends on family (rather than individual) income. Another result suggests that the optimal tax treatment for the second earner in a couple is to have relatively high marginal effective tax rates (these are defined in Box 12.3) for a second earner with a low-earning partner, and relatively low marginal effective tax rates for a second earner with a high-earning partner. The authors argue that this tends to be found in tax and benefit systems that combine individual-level income tax with jointly assessed benefits or tax credits for low-income families, such as that found in the UK.

But the analysis abstracts from much real-world complexity. It assumes that each individual's well-being depends upon family income, not individual income. And it assumes that every adult lives in a couple and does so permanently, which means that it does not need to consider the extent to which the optimal tax system creates penalties or bonuses for couples.

<sup>a</sup> H. Kleven, C. Kreiner and E. Saez, 'The optimal income taxation of couples', NBER Working Paper 12685, 2006.

## 12.3 The current system and its perceived drawbacks

This section first explains how the current tax and benefit system provides support to couples with children and then sets out some of the criticisms made of the current system. The following section then describes the reforms modelled in this chapter and how they would address these various criticisms.

### The current system

Since April 2003, support to families with children has been provided through two main programmes: child benefit and the combination of child and working tax credits.

Child benefit is a universal benefit payable to all families with children, regardless of income and family structure; reforms to this are not considered in this chapter.

The child tax credit (CTC) and working tax credit (WTC) together provide income-related support to the majority of families with children. The CTC consists of a small amount payable to each family with children (the family element), and much larger payments per child (the per-child element). The WTC provides support to families with at least one adult in work of at least 16 hours a week.

A combined means-test against a couple's joint annual income applies to CTC and WTC together: families with gross family income of £5,220 or less per year are entitled to the full CTC and WTC payments appropriate for their circumstances. Once family income exceeds this level, the tax credit award is reduced by 37p for every £1 of family income above this level. Formally, entitlement to WTC is withdrawn first, then the child elements of the CTC. In practice, this means that the WTC and CTC interact: increases in the generosity of the WTC automatically increase the point at which the CTC starts to be withdrawn as income rises, and so increases in the WTC (such as those considered in Section 12.4) benefit not only all families receiving the WTC, but also those families on the first taper of the CTC and those families who are brought onto the taper after any increase in WTC.

## Perceived drawbacks of the current tax and benefit system for couples with children

Between them, the proponents of the three reforms analysed in this chapter identify a number of drawbacks of the current tax and benefit system and the way that it affects couples with children.<sup>6</sup> The criticisms are:

- that tax credits do not do enough to ensure that couples with children with at least one worker can escape relative poverty, according to the way it is measured by this government;
- that the financial incentive to work for potential second earners is too weak;
- that insufficient support is given to one-earner couples with children; and
- that the means-tested benefit and tax credit systems treat some married or cohabiting couples with children less generously than if the parents live (or claim to live) apart.

Below, we discuss these in more detail.

### *Too many working couples with children remain in relative poverty*

One criticism made of the government's policies for tax credits is that, in order to be better targeted at reducing child poverty, they need to do more to reduce the risk of working poverty amongst couple families. Forty-two per cent of children in relative poverty in 2004–05 were living in couple families with at least one working parent and only 8% were in working lone-parent families, and so the extent to which tax credits can reduce working poverty amongst couple families will be crucial in determining future levels of child poverty.<sup>7</sup> The government's official analysis of low-income households states that 9% of children living with lone parents working full-time and 14% of those living with couples with one full-time worker were in poverty in 2004–05. For children living with lone parents working part-time,

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<sup>6</sup> The reforms are not intended by their proponents to address all four criticisms.

<sup>7</sup> The numbers are from table 4.7 of Department for Work and Pensions, *Households Below Average Income 1994/95–2004/05*, Corporate Document Services, Leeds, 2006. Being in poverty is defined as living in a household with an equivalised income less than 60% of the median, measured before housing costs (BHC) and using the McClements equivalence scale. Prospects for child poverty in 2010 are discussed in D. Hirsch, *What Will It Take to End Child Poverty? Firing on All Cylinders*, Joseph Rowntree Foundation, York, 2006, and M. Brewer, J. Browne and H. Sutherland, *Micro-Simulating Child Poverty in 2010 and 2020*, Joseph Rowntree Foundation, York, 2006 (<http://www.jrf.org.uk/bookshop/eBooks/9781859355091.pdf>). The same pattern is evident if incomes are measured after housing costs (AHC).



the poverty rate in 2004–05 was 15%; for children living with couples with one or two part-time workers (and no full-time workers), it was 40%.<sup>8</sup>

These results are driven by the fact that, when calculating poverty rates for households of different compositions, the government's official statistics assume that larger households need more income to achieve a given standard of living than smaller households.<sup>9</sup> In particular, the methodology implies that a couple with two children needs 30% more income than a lone-parent family with the same number of children. In 2004–05, this led to an implicit poverty line of £225 a week for a lone parent with two children, but £294 a week for a couple with two children. However, the tax credit system is designed so that couples with children and lone-parent families with the same number of children and the same gross incomes receive the same amount of tax credits. This implies that the level of earnings required by a couple with children to escape poverty using the government's current definition is significantly higher than that for a lone-parent family with the same number of children. For example, in 2004–05, a couple with two children would have needed a full-time job paying a gross wage of £240 to have a net income of £295, just above the poverty line for that family in that year. But a lone parent with two children working just 16 hours a week at the minimum wage (weekly gross earnings of £76) would have had a weekly net income of £222, £10 higher than the poverty line in that year for such a family of £212.<sup>10</sup>

This mismatch between the principles used when calculating poverty rates and the structure of tax credits is what leads to the situation that couples need to earn more than otherwise-equivalent lone parents to be considered as well off in official statistics on low-income households. It is possible to dispute the implication in the modified OECD equivalence scale that a couple with children necessarily has lower living standards than a lone-parent family with the same income: although the couple family will presumably need to spend more on most goods and services, they will probably benefit (compared with the lone-parent family) from having less need to find and pay for childcare, and from having one adult able to engage in home production – factors not considered when calculating official poverty rates.<sup>11</sup> Indeed, some research has suggested that couples with children enjoy a higher standard of living on average than lone parents with the same disposable income, a finding that could be used to justify significant increases in tax credits for lone parents rather than couples with children.<sup>12</sup> On the other hand, the government chose the modified OECD scale to equivalise incomes when calculating poverty rates for its 2010–11 target after a comprehensive consultation and review on how child poverty should be measured, so presumably it is happy with the

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<sup>8</sup> Again, the numbers come from table 4.7 of Department for Work and Pensions, *Households Below Average Income 1994/95–2004/05*, Corporate Document Services, Leeds, 2006.

<sup>9</sup> The jargon is that incomes are equivalised for household size and composition. The government is now using the modified OECD scale to adjust incomes (see appendix 3 of *Households Below Average Income 1994/95–2004/05* or appendix A of M. Brewer, A. Goodman, J. Shaw and L. Sibieta, *Poverty and Inequality in Britain: 2006*, IFS Commentary 101, 2006).

<sup>10</sup> Measuring incomes BHC and using the modified OECD equivalence scale.

<sup>11</sup> Spending on childcare is not deducted from the measure of disposable income, and the measure takes no account of leisure or home production (i.e. the amount of time spent not in paid work).

<sup>12</sup> Page 67 of R. Berthoud, M. Bryan and E. Bardasi, *The Dynamics of Deprivation: The Relationship between Income and Material Deprivation over Time*, DWP Research Report 219, Corporate Document Services, Leeds, 2004. This result may reflect the fact that having low income is a more permanent state for lone parents than it is for couples with children, and therefore that having a low income is a weaker indicator of long-run living standards for couples with children than it is for lone parents.

implications. If this is the case, then the mismatch between the principles used when calculating poverty rates and the structure of tax credits probably reflects that the government has multiple and competing objectives in mind when structuring tax credits, and is not solely concerned with reducing relative child poverty. One could also argue that when comparing poverty rates between couple and lone-parent families, families with the same number of non-workers (i.e. adults available to care for the children) – rather than the same number of workers – should be compared. If so, then the poverty rate of 9% amongst children living with lone parents working full-time should be compared with the poverty rate of 1% amongst children living with two-earner couples, and the poverty rate of 15% amongst children living with lone parents working part-time should be compared with the rate of 4% amongst children living with one full-time worker and one part-time worker. Using these comparisons, the tax credit system would seem to favour couple families at the expense of lone-parent families.

### ***Second earners in couples with children have weak incentives to work***

Another criticism that is made is that changes to tax credits since 1997 have weakened the financial incentive to work of second potential earners in couples with children.

Compared with a tax and benefit system without it, WTC strengthens the incentive for the first potential earner in a couple to work and weakens the incentive for the second potential earner to work. This is because WTC is available only if there is at least one adult in a couple in work, but it is then means-tested against the income of both adults. An evaluation of the impact of the former working families' tax credit (WFTC, which was structured very similarly to WTC) on employment patterns of couples with children estimated that it increased employment amongst parents whose partner did not work and reduced it amongst parents whose partner did work.<sup>13</sup> Analysis of how financial work incentives in the UK have changed under the current government shows that tax and benefit changes alone have tended to worsen both the incentive to work at all and the incentive to earn a little more for second potential earners in couples.<sup>14</sup> In fact, the same is also true (on some measures of financial work incentives) for first earners in couples, but what will be particularly relevant when considering the ability of tax credits to help reduce child poverty is that potential second earners in low- to middle-income families with children are more likely than those in high-income families to have seen their financial work incentives weaken thanks to tax and benefit reforms.<sup>15</sup> It remains the case that lone parents tend to face weaker work incentives than both first and second potential earners in couples.

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<sup>13</sup> See M. Brewer, A. Duncan, A. Shephard and M. José Suárez, 'Did working families' tax credit work? The impact of in-work support on labour supply in Great Britain', *Labour Economics*, 13(6), 699–720, 2006.

<sup>14</sup> See section 4 of M. Brewer and A. Shephard, *Employment and the Labour Market*, IFS Election Briefing Note 5, 2005 (<http://www.ifs.org.uk/bns/05ebn5.pdf>).

<sup>15</sup> Potential second earners in high-income families will have seen their financial work incentives hardly altered by the expansion of tax credits since 1999: the family element of the child tax credit is available to high-income families with children, but it has little impact on financial work incentives because it is not related to income until gross annual income reaches £50,000.



### ***The tax and benefit system gives insufficient support to single-earner couples with children***

A criticism that is made of the income tax system (but not the tax credit system) is that it is unfair to single-earner couples with children compared with two-earner couples with children because a two-earner couple can use two sets of personal allowances whereas a single-earner couple can only use one. For example, a two-earner couple where each earns £15,000 a year would pay a total of £74.40 (£37.20 each) a week in income tax, but a one-earner couple where the worker earned £30,000 a year would pay £100.66 a week.

This can be viewed as unfair, but only if the income tax system is viewed from the point of view of the couple: if it is believed that income tax should reflect only the individual's circumstances, then there is no unfairness in the current arrangement (indeed, if it is believed that income tax should reflect only the individual's circumstances, then it would be unfair that an individual's income tax bill depended on the work status of that individual's partner).

### ***The benefit and tax credit systems treat some couples with children less generously than if the parents live apart***

The final criticism relevant to the reforms considered in this chapter is that the current structure of tax credits and means-tested benefits treats some couples with children less generously than if the parents live apart (often described as reflecting a 'couple penalty' in tax credits, and this shorthand is used in this chapter).

The existence of a 'couple penalty' is usually shown by comparing how much state support a lone parent and a single adult without children would be entitled to if they lived apart with what they would be entitled to if they lived together; many (but not all) would be entitled to less if they were living together than if they were living apart.<sup>16</sup>

The existence of such 'couple penalties' is chiefly due to the fact that couples with children and lone-parent families are entitled to the same amount of tax credits if they have the same gross incomes (this criticism, therefore, is due to the same design feature of tax credits that motivated the first criticism above, that in order to be better targeted at reducing child poverty, tax credits should do more to reduce the risk of working poverty amongst couple families). Entitlement to both the WTC and the CTC does not take explicit account of the number of adults in the family, but does depend upon the joint income of the couple. This means that, if a lone parent who is already entitled to WTC and CTC starts to cohabit, that family's entitlement to tax credits will fall because of the extra income brought in by the new partner. Furthermore, the new partner will, in general, cease to be entitled to any means-tested support that he/she received when living alone.

In practice, the existence of a 'couple penalty' depends on the detailed circumstances of both the lone parent and the potential partner, and the assumptions made about how working and living arrangements might change when adults start or stop living together. It should also be stressed that some adults would experience a 'couple bonus' if they were to live together. But

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<sup>16</sup> See 'Tax credits leave couples worse-off living together', CARE press release dated 24 November 2006. Past work on this issue includes: Civitas, *The Lone Parent Trap*, London, 2002; J. Kirby, *The Price of Parenthood*, Centre for Policy Studies, London, 2005; and 'Government paying tax credits and benefits to 200,000 more lone parents than live in the UK', IFS press release dated 12 March 2006. An additional 'couple penalty' can arise from differential access to benefits in kind, notably social housing.

the design of tax credits does make it more likely that ‘couple penalties’ exist for families with children than for adults without children: this is because a couple without children is entitled to more WTC than a single adult without children with the same gross income.

It is difficult to find robust evidence that this situation genuinely affects how people make their living arrangements:

- By comparing the circumstances of women who live with a partner with those who do not, a recent paper estimated that a £100/week ‘couple penalty’ from the tax and benefit system reduces the probability of a woman having a partner by about 7 percentage points.<sup>17</sup>
- That same paper estimated that WFTC led to more couples with children (by financially encouraging lone parents to cohabit), but this result does not match that of an earlier paper, which estimated that the reverse had happened.<sup>18</sup>
- It has been reported in the media that some advice centres are asked to undertake ‘better off’ calculations for people considering cohabiting but who are concerned that they would be much worse off if they did so.

But there is good evidence that the situation at least affects how people *report* their living arrangements:

- During 2004–05, around 200,000 more lone parents were receiving tax credits (or the equivalent in means-tested benefits) than official surveys estimate to be living in the UK, in part, it was suspected, because some adults who were cohabiting were claiming state support as lone parents.<sup>19</sup>
- HMRC estimates that £305 million was paid out incorrectly in tax credit awards in 2003–04 because 90,000 couples incorrectly claimed tax credits as lone parents (whether through error or intentional fraud).<sup>20</sup>

Of course, even if the evidence that this aspect of the tax credit system distorts behaviour (and therefore leads to inefficiencies) is weak, it might be thought valid to criticise it purely on equity grounds – namely, that it is unfair to lone parents that they see such a considerable reduction in state support when they begin to cohabit.

## 12.4 Three proposals for reform

This section discusses the three proposals for reform, relates each back to some of the four criticisms of the current tax and benefit system outlined in the previous section, and then

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<sup>17</sup> Around 70% of women aged 20–55 live with their partner: see D. Anderberg, ‘Tax credits, income support and partnership decisions’, paper presented at RES conference, University of Nottingham, March 2006.

<sup>18</sup> M. Francesconi and W. Van der Klaauw, ‘The consequences of in-work benefit reform in Britain: new evidence from panel data’, ISER Working Paper 2004-13, found that the WFTC reform meant that lone mothers were less likely to start to cohabit (a reduction of 2 percentage points), but Anderberg (op. cit.) estimated that the WFTC reform created around 50,000 new couples by increasing the partnership rate by 0.5 percentage points.

<sup>19</sup> M. Brewer and J. Shaw, *How Many Lone Parents Are Receiving Tax Credits?*, IFS Briefing Note 70, 2006 (<http://www.ifs.org.uk/bns/bn70.pdf>).

<sup>20</sup> HM Revenue and Customs, *Child and Working Tax Credits: Error and Fraud Statistics 2003–04*, 2006 ([http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE\\_PROD1\\_025711](http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_025711)).

compares their impact on family incomes, financial work incentives and the ‘couple penalty’. The three proposals are:

- increasing the working tax credit for couples with children;
- changing features of the working tax credit to strengthen the financial incentives to work of a second (potential) earner in a couple; and
- introducing a transferable personal allowance restricted to couples with children.

To make fair comparisons, it is necessary to consider proposals for change that all cost the exchequer roughly the same amount. The cost of providing a transferable personal allowance for couples with a child under 6 is around £1 billion, and so the other reforms have been calibrated so that they cost around £1 billion. (The costs have been estimated assuming that families do not alter their work patterns or family structure. If they do, then the actual impact on net tax revenues may differ slightly from £1 billion. But as shown later, all three policies have mixed impacts on financial work incentives.)

Spending £1 billion can be achieved by:

- increasing the working tax credit for all couples with children by £15 a week (or £780 a year from its April 2006 level of £3,305);
- increasing the working tax credit for all couples with children where both adults work at least 16 hours a week by £40 a week (£2,080 a year); or
- making the income tax personal allowance transferable for couples with children under 6, restricted to the basic rate.

Below, we analyse the impact of these policies on families’ budget constraints, incomes and financial work incentives. All costs and financial values are in 2006–07 prices.<sup>21</sup>

## **What are the reforms intended to achieve?**

### ***Increase the working tax credit for couples with children***

This reform would give more support to low-income couples with children in order to:<sup>22</sup>

- target the working tax credit more efficiently on children in poverty; and
- reduce (or remove) possible financial penalties when a lone parent starts to cohabit, particularly amongst potential low-income couples with children.

These aims could be achieved by having a higher basic credit for couples with children than for lone parents, just as is currently the case for families without children (where a couple without children receives more WTC than a single adult without children with the same gross

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<sup>21</sup> The analysis of these policies assumes that they were introduced on the April 2006 tax and benefit system. No changes have been made to housing benefit or council tax benefit, broadly in line with the practice of the current government when altering the working tax credit, so the £1 billion net cost to the government will comprise an increased spend on tax credits of more than £1 billion (or reduced income tax revenue of more than £1 billion from the transferable personal allowance) but also savings on housing benefit and council tax benefit. This also means that couples with children receiving HB or CTB will in general gain by less from these proposals than otherwise-equivalent families not receiving those benefits.

<sup>22</sup> For example, the reform has been put forward by CARE in D. Draper and L. Beighton, *Restructuring Tax Credits*, CARE Policy Paper, 2006.

income).<sup>23</sup> An increase in the WTC for couples with children of £15 a week (or £780 a year from its April 2006 level of £3,305) would cost around £1 billion and benefit 1.5 million families with children.

The direct impact of giving couples with children more tax credits would be to increase the incomes of low-income working couples with children. Because lone parents are unaffected by this proposal, it would also reduce any ‘couple penalty’ (or increase any ‘couple bonus’) that can exist when a lone parent starts to cohabit by precisely the same amount. That means that the 1.5 million couples with children who would benefit from this policy would find that any ‘couple penalty’ had reduced by an average of £667 a year (or any ‘couple bonus’ had increased by the same amount).<sup>24</sup>

There would also be implications for financial work incentives. The policy would:

- increase the incentive for some low-income couples with children to have one earner compared with no earners;
- reduce the financial incentive for the working partner in a one-earner couple with children to earn more, whether through additional hours or being paid more per hour; and
- reduce the financial incentive for some second earners (or potential second earners) in low-income couples with children to work at all, or to work additional hours.

These impacts on financial work incentives are discussed in more detail later in this section.

The proposal would increase the financial incentive for some couples to have children (because it increases the support received by some couples with children, and not of couples without children). Whether this would actually affect childbearing decisions, though, is not clear.

### ***Encourage second earners through the working tax credit***

In Lisa Harker’s recent review for the Department for Work and Pensions (DWP) of what it would take for the government to meet its child poverty targets, she – like some of the proponents of the first reform – drew attention to the fact that ‘in-work poverty is primarily a problem that affects couple families’.<sup>25</sup> However, Harker’s proposed solution involved support and incentives for second earners to move into work – rather than increased financial support for one-earner families – with improved incentives coming about through ‘changes to the working tax credit or extending eligibility for the In-Work Credit to second earners with children’.<sup>26</sup>

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<sup>23</sup> They could also be achieved by having a higher income threshold for WTC for couples with children than for lone parents: this would allow couples with children to earn more (both more than the current system and more than lone parents) before higher earnings led to smaller tax credit awards. An increased threshold could be structured to have almost identical impacts on couples with children to one that increased the credit in the working tax credit, apart from those very few couples with children who are receiving WTC but have earnings of £5,220 or less: this group, disproportionately likely to include the self-employed, would not benefit from the increased disregard.

<sup>24</sup> It would be very interesting, but beyond the scope of this chapter, to estimate how this policy would affect the potential ‘couple penalty’ amongst existing lone-parent families, were they to cohabit.

<sup>25</sup> Page 47 of L. Harker, *Delivering on Child Poverty: What Would It Take? A Report for the Department for Work and Pensions*, Cm. 6951, Session 2006/7 (<http://www.dwp.gov.uk/publications/dwp/2006/harker/>).

<sup>26</sup> Page 49 of Harker (op. cit.). The In-Work Credit is a policy being piloted by DWP in various areas around Great Britain. It pays £40 a week to people who leave out-of-work benefits and move into work of at least 16 hours a week,

Harker did not specify how the WTC might be changed: her brief was to examine DWP's policies in detail, not those of the Treasury and HMRC. But an obvious change would be to introduce an extra credit conditional on a couple having two adults in work (16 or more hours a week), with this credit being tapered away as income rises, just as WTC is tapered away at present.<sup>27</sup> An increase by £40 a week (£2,080 a year) in working tax credit for all couples with children where both adults work at least 16 hours a week would cost around £1 billion and benefit around 600,000 couples with children.<sup>28</sup>

Given that this policy has been suggested as a response to the weak incentives to work facing second earners in couples with children, it is reassuring to know that it would indeed increase the financial incentive for the second earner to work at least 16 hours a week (these effects are shown in detail later in this chapter). However, it would also weaken the financial incentive for some second earners in couples with children already working 16 or more hours a week to increase their earnings, whether through working longer hours or seeking a better-paid job: this is because the proposal would extend the range of earnings over which any additional earnings by the second earner would lead to a reduction in the family's tax credit award. So although this proposal would encourage some second earners to work (rather than not work), the fact that the extra support is ultimately tapered away means that the proposal cannot be described as being unambiguously good for potential second earners' financial work incentives.

Because the policy has no impact on lone parents, it would reduce the 'couple penalty' in tax credits (or increase any 'couple bonus'); because it would not be available to couples without children, it would increase the financial incentive to have children. Both effects, though, would be limited to relatively low-income two-earner couples.

### ***Transferable personal allowance for couples with young children***

This reform was recently proposed by the Tax Reform Commission established by the Conservative Party and headed by Lord Forsyth.<sup>29</sup> The proposal is that individuals in couples with children should be able to transfer their income tax personal allowance to their spouse if they are not making full use of it. The Forsyth Review proposed restricting this to couples with children aged under 6 and restricting the value of the transferred personal allowance

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but eligibility at present is limited to lone parents or partners of benefit claimants, and does not extend to non-working partners of working adults.

<sup>27</sup> Such a policy would have almost identical effects to introducing a higher income threshold (or earnings disregard) in the WTC for couples with children. At present, joint earnings in excess of £5,220 (from April 2007) reduce entitlement to WTC (and then to CTC). A proposal to achieve Harker's aims would be to increase this disregard in tax credits for two-earner couples (conditional on the second earner working 16 or more hours a week).

<sup>28</sup> This policy is similar to a policy in the Conservatives' 2005 election manifesto, and referred to since by David Cameron, which involved replacing the childcare element of the working tax credit with an extra credit in the working tax credit for working lone parents or for two-earner couples with children, perhaps targeted at parents with young children. That policy – like the alternative set out in this section – would improve the financial incentive for some second earners to work (particularly those who do not want to use formal childcare), but it would also make formal childcare more expensive: this could induce parents to use informal rather than formal childcare, or it could act as a financial disincentive to work for those parents who want to use formal childcare. (See M. Brewer, C. Crawford and L. Dearden, *Helping Families: Childcare, Early Education and the Work–Life Balance*, IFS Election Briefing Note 7, 2005 (<http://www.ifs.org.uk/bns/05ebn7.pdf>) for a more detailed analysis of the proposal in the Conservatives' 2005 election manifesto.)

<sup>29</sup> Tax Reform Commission, *Tax Matters: Reforming the Tax System*, 2006 (<http://www.taxreformcommission.com/downloads/Tax%20Reform%20Commission%20Report.pdf>).

(TPA) to the basic rate of income tax.<sup>30</sup> A similar proposal was included in the Conservative Party's 2001 election manifesto, but this proposed limiting the TPA to married couples: Box 12.2 discusses the implications of restricting a TPA to married couples.

### Box 12.2. Supporting all couples or just married couples?

Several variants of a TPA have been proposed in the past. Some have been limited to married couples – which would create a tax incentive to marry – while some would be available to all couples with children.

Government may take a moral stance on the merits of marriage per se, but whether a tax incentive to marry would lead to more marriages and/or better outcomes for children is unclear.

Around 1.4 million children in Britain live in unmarried couple families and 8.1 million with married couples, so around 15% of children in couple families have unmarried parents.<sup>a</sup> The proportion living in income poverty is higher for children with unmarried parents than for those with married parents, at 24% rather than 15%.<sup>b</sup>

<sup>a</sup> Author's calculations based on the 2004–05 Family Resources Survey. ONS estimates are that 1.4 million and 8.6 million children live in unmarried and married couple families respectively in the UK (<http://www.statistics.gov.uk/cci/nugget.asp?id=1163>).

<sup>b</sup> In 2004–05, measuring incomes BHC and using the modified OECD equivalence scale. Author's calculations using the Family Resources Survey. Measuring incomes after housing costs (AHC) and using the McClements equivalence scale, the equivalent proportions are 29% and 19%.

The Forsyth Review (page 61) said that

The financial disadvantages suffered by parents, usually women, who look after children while their partners are out at work, represent a major unfairness in the tax system ... This unfairness can be addressed by giving parents an option to transfer their personal allowance to their partner while they have young children. Restricting the transferable allowance so that relief is only available at the basic rate would ensure that this reform is appropriately targeted.

The stated aim of the policy is to provide more help for single-earner couples.<sup>31</sup> If introduced in April 2007 and taken up by eligible couples, this proposal would mean that one-earner couples with young children would be better off by up to £1,149.50 a year. Around 1.3 million couples with children would benefit, so the average (mean) gain is around £770 a year. The policy would also reduce the 'couple penalty' inherent in tax credits (or increase any 'couple bonus'), and increase the financial support conditional on having children, but both effects would be limited to one-earner couples with children.

But the policy would also have a number of effects on financial work incentives (shown later in this section). Compared with the current tax and benefit system, a transferable personal allowance would:

<sup>30</sup> The restriction to the basic rate means that the policy would be of no benefit to two-earner couples where one adult pays income tax at the higher rate and the other pays income tax at the basic rate: these sorts of families would benefit from an unrestricted TPA, and the restriction to the basic rate means that the beneficiaries of the TPA proposed here are almost all one-earner couples.

<sup>31</sup> The proposal to make allowances transferable is sometimes described as recognising the value of caring, but the extra support would be received by the main earner in the form of higher net pay, and so it would increase (not reduce) intra-household differences in income.



- increase the incentive for couples with young children to have one earner rather than none; and
- decrease the incentive for couples with young children to have two earners rather than one. This is because, once someone has elected to transfer a personal allowance, any increase in that person's earnings in the future will effectively be liable to income tax from the first pound (rather than only after the 5,225<sup>th</sup> pound, as is the case at present). Because this policy provides up to £1,149.50 a year extra help to one-earner couples and not to two-earner couples, it follows that it must reduce the incentive to move from being a one-earner couple to being a two-earner couple by that same amount.

The proposal would take the income tax system in the UK a little further away from a fully individualised system, and a little bit closer to a jointly-assessed system like tax credits.

### The impact of the proposals on budget constraints

Figures 12.1 to 12.3 show how the budget constraint – the relationship between gross earnings and family income after taxes, benefits and tax credits – would change for potential second earners under these three reforms. The impacts on the budget constraint vary with the earnings of each partner, so the budget constraints for three second earners are shown:

- a low-wage second earner with a low-earning partner (Figure 12.1);
- a high-wage second earner with a low-earning partner (Figure 12.2); and
- a low-wage second earner with a medium-earning partner (Figure 12.3).

The impact of the reforms is most dramatic for low-income couples with children (i.e. where both adults potentially earn low hourly wages).

Figure 12.1. The budget constraints for a low-wage second earner with a low-earning partner in a couple with children



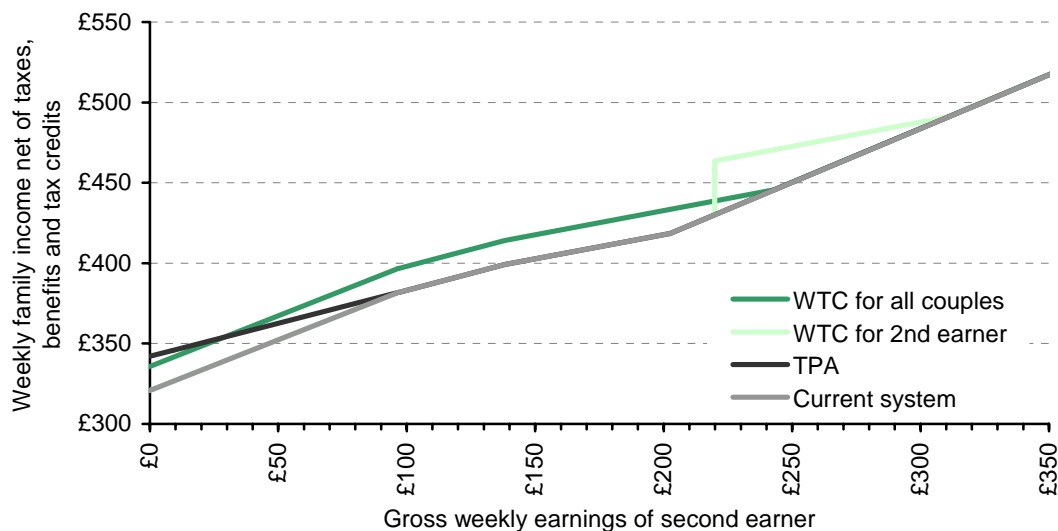
Notes: Assumes that first earner works at least 30 hours a week and has annual earnings of £15,000, that second earner earns £5.50 an hour and that the family has two children, both at least 1 year old. Both workers are contracted in to the state second pension. Ignores childcare costs.

Source: Author's calculations using the IFS tax and benefit model, TAXBEN.

Figure 12.1 shows that extra WTC for couples with children and a TPA both make this specimen family better off when the second earner does not work (i.e. has gross earnings of £0), but have no effect compared with the current system if the second earner earns more than £100 (for the TPA) or more than around £250 a week (for the extra WTC for all couples). For this relatively low-income family, though, extra WTC for two-earner couples would make a considerable difference to family income if the second earner worked 16 or more hours a week. But the WTC is means-tested, so there are no differences from the current tax and benefit system when the second earner earns over £300 a week (or a joint annual income of around £30,000).

Figure 12.2 shows the budget constraints when the second earner has a higher wage (and the first earner is still relatively low-paid). Compared with the low-waged second earner, the TPA and extra WTC for all couples have identical impacts, but the impact of extra WTC for two-earner couples is a little smaller: the fact that the extra credit for the second earner is means-tested means that it is worth less than £40 a week to the higher-waged second earner even when he/she is working 16 hours per week.

Figure 12.2. The budget constraints for a high-wage second earner with a low-earning partner in a couple with children



Notes: Assumes that first earner works at least 30 hours a week and has annual earnings of £15,000, that second earner earns £13.74 an hour (annual earnings of £25,000 at 35 hours a week) and that the family has two children, both at least 1 year old. Both workers are contracted in to the state second pension. Ignores childcare costs. Source: Author's calculations using the IFS tax and benefit model, TAXBEN.

Figure 12.3 shows the budget constraints when the second earner is low-paid (as in Figure 12.1) but the first earner has a moderate wage. The impact of the TPA is again unchanged; but the impact of the two proposals to increase WTC are worth much less to this family than to the first two families: this time, it is because the higher earnings of the first earner mean that much of the extra WTC has been means-tested away even when the second earner does not work (indeed, for second earners in couples with even higher-paid first earners – not shown here – the two proposals to increase WTC would have no impact at all on the budget constraint of the second earner).

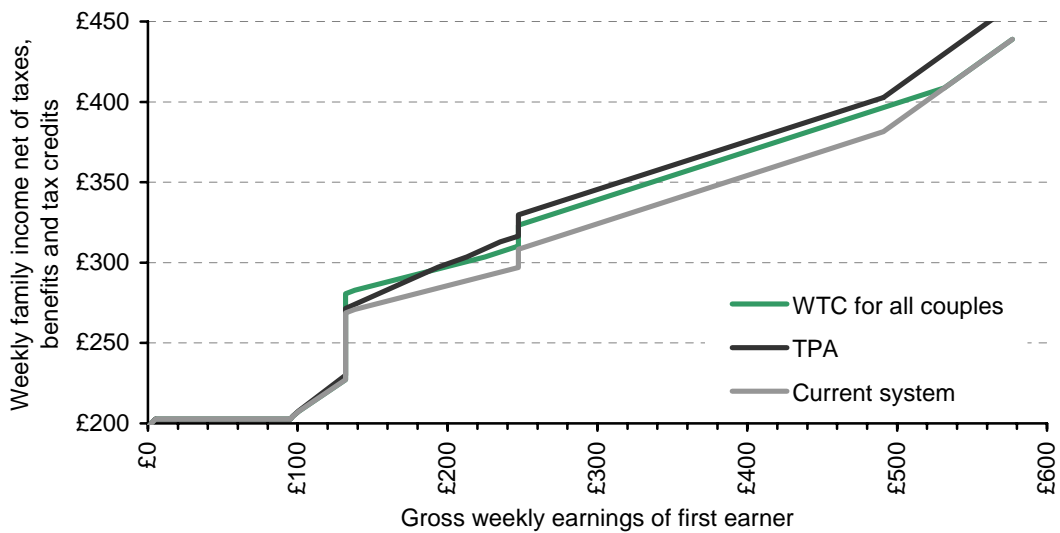
Figure 12.3. The budget constraints for a low-wage second earner with a medium-earning partner in a couple with children



Notes: Assumes that first earner works at least 30 hours a week and has annual earnings of £25,000, that second earner earns £5.50 an hour and that the family has two children, both at least 1 year old. Both workers are contracted in to the state second pension. Ignores childcare costs.

Source: Author's calculations using the IFS tax and benefit model, TAXBEN.

Figure 12.4. The budget constraints for a low-wage first earner in a couple with children



Notes: Assumes that first earner has hourly wage of £8.24 (annual earnings £15,000 at 35 hours a week) and that the family has two children, both at least 1 year old. Ignores childcare costs.

Source: Author's calculations using the IFS tax and benefit model, TAXBEN.

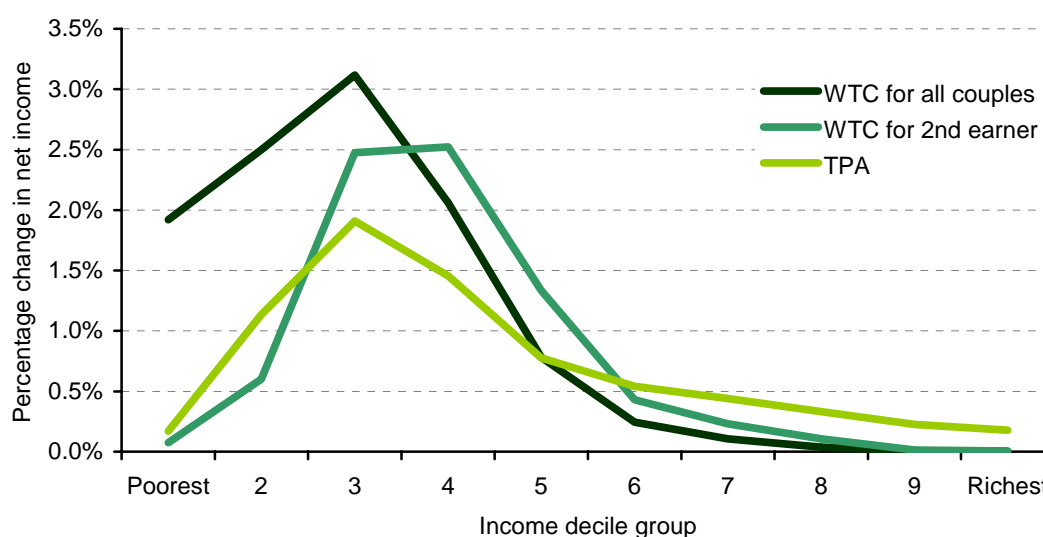
Figure 12.4 shows the budget constraints for the first earner in a couple with children. Extra WTC for two-earner couples would have no impact on this budget constraint and is not shown. Both the extra WTC for all couples and the TPA increase income for the family when the first earner is in work. For the extra WTC for all couples, this extra support is means-tested away completely when weekly earnings reach around £500, but this is not the case for

the TPA. (The budget constraints for a high-wage first earner would look very similar and so are not shown.)

## The impact on the incomes of couples with children

This section discusses how the policies would affect the incomes of couple families with children. Figure 12.5 shows the gains amongst couples with children as a fraction of net income, ranked by their position in the overall income distribution (so the values for the poorest decile, for example, show the average change in family income experienced by those couples with children in the poorest tenth of the entire income distribution).

Figure 12.5. Distributional analysis across working-age couples with children



Notes: Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth. Source: Author's calculations using the Family Resources Survey 2004–05 and the IFS tax and benefit model, TAXBEN.

As mentioned earlier in this section, 1.5 million families with children would gain from the WTC for all couples with children, 0.6 million would gain from the WTC for two-earner couples with children and 1.3 million would gain from a TPA. Because all the policies cost the same, this means that the average (mean) gain among those benefiting is highest for the extra WTC for two-earner couples and lowest for the extra WTC for all couples.

Although these policies are intended to benefit couples with children, different families would gain under each. In general, the two proposals that involve changing the WTC are able to focus the gains on part of the income distribution, because the WTC has a relatively steep taper that ensures that high-income families do not benefit:

- The extra WTC for all couples is therefore targeted at low-income working couples with children, most of whom have only one earner.
- The extra WTC for two-earner couples is targeted at low-income two-earner couples with children.

- The TPA is less targeted by income, benefiting all one-earner couples with children of a certain age provided the main earner earns at least £5,225 a year, but is restricted to families with young children.

None of these reforms particularly helps very high-income couples with children: such couples tend to have both adults in work (and therefore cannot benefit from a TPA) and have too high an income to benefit from the working tax credit. And none of these reforms directly benefits couples with children with the lowest incomes: such couples tend to have both adults out of work (however, the TPA and extra WTC for all couples would increase the incentive for such families to have one adult in work).

For all the policies, the beneficiaries are concentrated in low- to middle-income couples with children: deciles 2, 3 and 4 (or 3, 4 and 5 in the case of extra WTC for two-earner couples) gain by the most on average as a proportion of net income. The policy that is most directly targeted at low-income couples with children is the extra WTC for all couples. The policy of most benefit to high-income couples with children is the TPA, but note that this policy is also of more benefit to couples with children in the bottom two income deciles, on average, than extra WTC for two-earner couples (but note that that policy would incentivise some of those couples to have two earners).

One complicating factor when comparing the distributional impact of these proposals is that the TPA is limited to families with young children but the other proposals are not.

Families with young children tend to have lower incomes than families with older children, partly because their parents are younger and therefore tend to have lower hourly wages, but more importantly because women are more likely to be taking time out of the labour market when they have young children.<sup>32</sup> The restriction of the TPA to families with young children probably reflects a desire by the Forsyth Commission to target help on families with young children (rather than those with older children) and a belief that it would be worse to encourage potential second earners not to work when they have older children than it is when they have young children.<sup>33</sup>

## The impact on financial work incentives

Although these policies are reasonably similar in their impact on the income distribution, they have very different effects on financial work incentives, reflecting their different objectives. Below, we analyse how these policies would change two measures of financial work incentives: the marginal effective tax rate (METR) and the participation tax rate (PTR). The METR is a measure of the disincentive provided by the tax and benefit system to earning a little more, whether through working more hours or earning more per hour. The PTR is a measure of the disincentive provided by the tax and benefit system to working at all. Box 12.3

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<sup>32</sup> For detailed analysis of how children affects women's labour market activity, see G. Paull, 'The impact of children on women's paid work', *Fiscal Studies*, 27(4), 473–512, 2006.

<sup>33</sup> Restricting the TPA to families with young children has more significance than, say, restricting child benefit to families with young children: in the long run, an increase in child benefit for the under-5s will benefit the same families and be worth the same amount of money to families as an equally expensive increase in child benefit for all children; but a family's eligibility to a TPA will in general vary as their children age, so a TPA available to all families with children will not benefit the same families (and will not be worth the same amount of money to families who do benefit) as an equally-expensive TPA restricted to families with young children, even in the long run.

explains how these numbers are calculated; higher numbers mean weaker incentives for both measures.

### Box 12.3. The marginal effective tax rate and the participation tax rate

The participation tax rate (PTR) measures the extent to which the tax and benefit system provides a disincentive for people to work at all. It is calculated as  $1 - (\text{increase in family income when a person works} / \text{that person's gross earnings})$ . It measures what fraction of an individual's earnings is lost to the government in taxes and forgone benefits or tax credits.

The marginal effective tax rate (METR) measures the extent to which the tax and benefit system provides a disincentive for people to increase their earnings. It is calculated as the proportion of a small rise in earnings that is lost to the government in taxes and forgone benefits or tax credits.

Both calculations ignore the temporary (one-year) disregard in tax credits that applies when gross earnings rise, so the short-run financial work incentives are, in practice, stronger than those shown here.

To calculate a measure of the incentive to work at all for those women in our data who are not working, it is necessary to impute the hourly wage that they would earn if they were to work. This was done by predicting what wage they would have earned, given the hourly wages earned by women who are working.<sup>a</sup> The PTR was then calculated for part-time and full-time work (16 and 37 hours a week respectively) at these wages.

Expenditure on childcare and entitlement to the childcare element of the working tax credit were ignored for these calculations.

<sup>a</sup> This was done using the customary log wage equation with a correction term to account for the selection into employment of those women with relatively high wages. The variables in the wage equation were age of women, region of residence, education level of women and number of children. The selection effects were identified using variables measuring age of youngest child and family income if the women did not work as instruments. Full details are available on request.

Below, we present some summary measures of the (dis)incentive to work at all. Table 12.1 shows various measures of the PTR for women in couples with dependent children calculated for part-time (top panel) and full-time work (bottom panel) (assumed to be 16 and 37 hours a week respectively).

Rather than showing how the mean (average) PTR changes, the panels show how PTRs at various points of the distribution change. In particular, they show the median (50<sup>th</sup> percentile) PTR, as well as the 25<sup>th</sup>, 75<sup>th</sup> and 90<sup>th</sup> percentiles of the PTR distribution, and how these values change under the three reforms. (The median PTR is the PTR such that half of working women in couples with dependent children have a PTR lower than that and half have a PTR higher than that; the 25<sup>th</sup> percentile (75<sup>th</sup> percentile) is the PTR such that a quarter of working women in couples with dependent children have a PTR lower (higher) than this and three-quarters have a PTR higher (lower) than this.)

Bearing in mind that lower PTRs correspond to stronger incentives to work, Table 12.1 shows that the extra WTC for two-earner couples tends to strengthen women's incentives to work



(according to these measures) and that the TPA tends to weaken them. The extra WTC for all couples is a little more complicated: it tends to weaken incentives to work for most women, but it strengthens incentives to work part-time for some women previously facing the weakest incentives. This is because it tends to strengthen incentives for those few women with children whose partner does not work and weaken them for the majority of women whose partner does work.

**Table 12.1. Estimated participation tax rates for women in couples with dependent children**

	<b>Percentile of the participation tax rate distribution</b>			
	<b>25<sup>th</sup></b> (stronger-than-average incentives to work)	<b>50<sup>th</sup></b> (average incentives to work)	<b>75<sup>th</sup></b> (weaker-than-average incentives to work)	<b>90<sup>th</sup></b> (very weak incentives to work)
<i>Part-time work</i>				
Current tax and benefit system	5.5	18.2	37.7	56.2
Extra WTC for all couples	6.4	22.0	38.2	51.5
Extra WTC for two-earner couples	0.0	7.1	19.2	49.7
TPA	14.0	24.3	46.3	59.0
<i>Full-time work</i>				
Current tax and benefit system	21.3	26.1	37.8	52.6
Extra WTC for all couples	22.3	27.4	41.3	53.7
Extra WTC for two-earner couples	20.8	25.6	34.0	46.0
TPA	23.7	28.8	40.1	54.7

Note: See Box 12.3 for details.

Source: Author's calculations using the Family Resources Survey 2004–05 and the IFS tax and benefit model, TAXBEN.

For men, the picture is slightly more complicated (and not shown here): the extra WTC for two-earner couples tends to lead to stronger work incentives for men, as it does for women. Extra WTC for all couples and TPAs, though, tend to strengthen incentives to work at all for men with relatively weak incentives to work, and to weaken incentives to work at all for men with relatively strong incentives to work (the PTR at the 75<sup>th</sup> percentile falls, but those at the median and 25<sup>th</sup> percentile rise). This is because both proposals would strengthen work incentives for people whose partner does not work (i.e. potential first earners) but weaken them for people whose partner does work (i.e. potential second earners), regardless of gender. Amongst women, the latter effect dominates, but for men, the former effect is evident in the fall in the PTR for those with relatively high PTRs (who tend to be one-earner couples with the man in work).

We now present some summary measures of the (dis)incentive to earn a little more, first for working adults (Table 12.2) and then for non-working adults (Table 12.3, where the table shows the effective tax paid on the first pound of earnings). Table 12.2 shows the median, 25<sup>th</sup>, 75<sup>th</sup> and 90<sup>th</sup> percentiles, and the mean METR for working women (top panel) and men (bottom panel) in couples with dependent children.

There is much less change in METRs than in PTRs. All three proposals would increase METRs for working women, on average. The two proposals that increase WTC would increase METRs for working men, on average, but the TPA would lower METRs for some

working men, who would see a lower METR if they benefited from a transferred personal allowance and as a result moved into a lower income tax band.

Both proposals that increase WTC tend to increase METRs because they increase the range of earnings over which individuals in working families with children are subject to a withdrawal of tax credits as their income rises. However, these two proposals would also lower some very high METRs, because increases in the WTC reduce the likelihood that families are subject to simultaneous withdrawals of tax credits and housing benefit (HB) or council tax benefit (CTB); this is not apparent in Table 12.2 because in practice this applies to very few couples with children.

**Table 12.2. METRs for working adults in couples with dependent children**

	Percentile of the METR distribution				Mean
	25 <sup>th</sup> (stronger-than-average incentives to earn more)	50 <sup>th</sup> (average incentives to earn more)	75 <sup>th</sup> (weaker-than-average incentives to earn more)	90 <sup>th</sup> (very weak incentives to earn more)	
<i>Women</i>					
Current tax–benefit system	31.4	33.0	38.1	66.4	34.1
Extra WTC for all couples	31.4	33.0	38.1	68.4	35.6
Extra WTC for two-earner couples	31.4	33.0	41.0	68.4	37.2
TPA	31.4	33.0	38.1	63.9	35.3
<i>Men</i>					
Current tax–benefit system	31.4	37.0	47.7	70.0	43.2
Extra WTC for all couples	31.4	41.0	68.4	70.0	44.6
Extra WTC for two-earner couples	31.4	41.0	68.4	70.0	45.5
TPA	31.4	37.0	47.7	70.0	42.9

Note: See Box 12.3 for details.

Source: Author's calculations using the Family Resources Survey 2004–05 and the IFS tax and benefit model, TAXBEN.

The TPA increases METRs for some working women who are earning less than the income tax personal allowance (and some who pay income tax at the 10% lower rate) and who elect to transfer their allowance to their partner. Such women would have previously paid no income tax on any extra earnings (or at the rate of 10%), but after transferring their allowance, they will effectively be paying 10% or 22%. On the other hand, the TPA will reduce METRs for a few working women who benefit from having their non-working partner's personal allowance transferred to them. The table shows that the former effect dominates.

The impact on METRs for those currently not working (this is the effective tax rate on the first pound of earnings) is shown in Table 12.3 for women (top panel) and men (bottom panel). Of course, many non-working adults have a METR of 0%: these are adults living in families with sufficiently high incomes not to be eligible to HB, CTB, WTC or the child element of the CTC.

The extra WTC for two-earner couples has absolutely no impact on METRs faced by non-workers, because the second earner in a family would need to work 16 hours a week before

becoming eligible to the extra credit. The TPA significantly increases METRs for non-working women (and slightly increases it for non-working men): this is because any non-working individual who does transfer their allowance to their partner then faces income tax from the first pound of earnings, as explained above.

The extra WTC for all couples increases METRs for some non-working adults and reduces it for others (this can be seen in the figures for women and men). As explained above, this is because an increase in WTC lengthens the range of earnings over which individuals in working families with children are subject to a withdrawal of tax credits as their income rises. However, it can also lower some very high METRs because increases in the WTC reduce the likelihood that families are subject to simultaneous withdrawals of tax credits and HB or CTB.

Table 12.3. METRs for non-working adults in couples with dependent children

	Percentile of the METR distribution				Mean
	25 <sup>th</sup> (stronger-than-average incentives to earn more)	50 <sup>th</sup> (average incentives to earn more)	75 <sup>th</sup> (weaker-than-average incentives to earn more)	90 <sup>th</sup> (very weak incentives to earn more)	
<i>Women</i>					
Current tax–benefit system	0.0	0.0	37.0	38.1	19.0
Extra WTC for all couples	0.0	6.7	37.0	37.0	19.4
Extra WTC for two-earner couples	0.0	0.0	37.0	38.1	19.0
TPA	0.0	22.0	49.6	59.0	30.0
<i>Men</i>					
Current tax–benefit system	0.0	0.0	28.7	49.6	17.3
Extra WTC for all couples	0.0	0.0	33.0	47.0	17.3
Extra WTC for two-earner couples	0.0	0.0	28.7	49.6	17.3
TPA	0.0	0.0	28.7	59.0	17.5

Note: See Box 12.3 for details.

Source: Author's calculations using the Family Resources Survey 2004–05 and the IFS tax and benefit model, TAXBEN.

In summary, then:

- The extra WTC for all couples strengthens the incentives for couples to have one person in work but reduces the incentive for the second earner to work. It also tends to lead to higher METRs, or weaker incentives to earn more, for both first and second earners in relatively low-income families.
- The TPA also strengthens the incentives for couples to have one person in work but reduces the incentive for the second earner to work. It slightly reduces the METRs faced by working men (who will make up the majority of beneficiaries of a transferred personal allowance) and slightly increases the METR faced by a few low-earning working women who elect to transfer their allowance. All effects, of course, are limited to couples with children aged under 6.

- The extra WTC for two-earner couples significantly improves the incentive for couples to have two earners in work, although this chapter has shown the impact only on women's incentives. But, by expanding the range of earnings over which tax credit withdrawal applies, it weakens the incentives for working adults in relatively low-income two-earner couples to earn more.

Of course, the very different impacts of these policies on financial work incentives directly reflect the differing motivations of the policies' proponents:

- The extra WTC for two-earner couples is intended to encourage second earners to work, and does just that.
- The extra WTC for all couples is intended to raise the incomes of low-income couples with children, who tend to have only one earner; but the fact that this extra help is means-tested inevitably means that incentives to earn more – whether through adding a second earner, increasing hours or earning more per hour – are weakened.
- The TPA is intended to recognise the value of caring and to support one-earner couples with young children. But the fact that such support is not of benefit to most two-earner couples inevitably means that financial incentives to have a second earner are reduced.

## 12.5 Conclusions

This chapter has compared three proposals for changing the way in which couples with children are treated in the tax credit and income tax systems, each of which has been proposed to address different perceived problems with the current system.

The impact on the distribution of income and the impact on financial work incentives are quite different. Of the three proposals:

- The proposal to increase WTC for all couples with children is the most targeted on the poorest working couples with children, but as a result does the most to weaken the financial work incentives for adults in such families.
- The proposal to increase WTC for two-earner couples is the best policy for encouraging second earners in relatively low-income families, but at the cost of extending the range of incomes over which adults in such families face high METRs.
- A transferable personal allowance for couples with young children is the least targeted, so it helps some on relatively high incomes as well as some on relatively low incomes. By recognising the value of unpaid work by adults in couples, it weakens financial incentives to do paid work for those same adults. Unlike the other proposals, though, these effects are restricted to families with children aged under 6.

All three proposals would reduce the extent to which the tax credit system treats some married or cohabiting couples with children less generously than if the parents live (or claim to live) apart – indeed, some families might find that these reforms lead to a 'couple bonus'. This would occur because lone-parent families would not gain anything from any of the changes.