

## 7. Prospects for personal tax and benefit reforms

The present government has made many reforms to the UK's personal tax and benefit system in the three-and-a-half years since its election.<sup>1</sup> Among the most prominent changes have been the replacement of family credit with the working families' tax credit and the introduction of a 10p starting rate of income tax, the children's tax credit and the minimum income guarantee for pensioners. But it is clear that other radical reforms may be yet to come.

In this chapter, we first discuss the reforms that will already be in place by April 2001 – the children's tax credit and the working families' tax credit. We then describe the reforms that have yet to be implemented – the integrated child credit, the employment tax credit and the pension credit – and where many details still remain to be decided. We analyse the government's objectives for the future reforms and show how the reforms relate to those in place already. We then discuss what the trends in reform might mean for the forthcoming Budget, and for the future, should Labour win the next general election. In particular, we ask 'to what extent is the tax and benefit system becoming more integrated?', 'is means testing being extended?' and 'has there been a move back towards joint taxation?'

### 7.1 The new transfers

#### **Reforms so far: the working families' tax credit and the children's tax credit**

The working families' tax credit (WFTC) was the first major tax and benefit reform of the parliament and was introduced in October 1999. The next reform will be the children's tax credit, which will be introduced in April 2001. These reforms have both replaced existing measures – family credit and the married couple's allowance respectively.

WFTC, a refundable tax credit,<sup>2</sup> is more generous than family credit and provides substantial help with registered childcare costs. It is available to low-income families with children where at least one adult is working 16 or more hours a week. The credit is reduced by 55p for every pound of family income (after tax and National Insurance) above £91.45 per week. Figure 7.1 shows the proportion of families with children in each income decile that are eligible for WFTC. Entitlement to WFTC is concentrated amongst families at the bottom of the income distribution: over 35% of families with children in the second and third income deciles are eligible for WFTC, compared with only

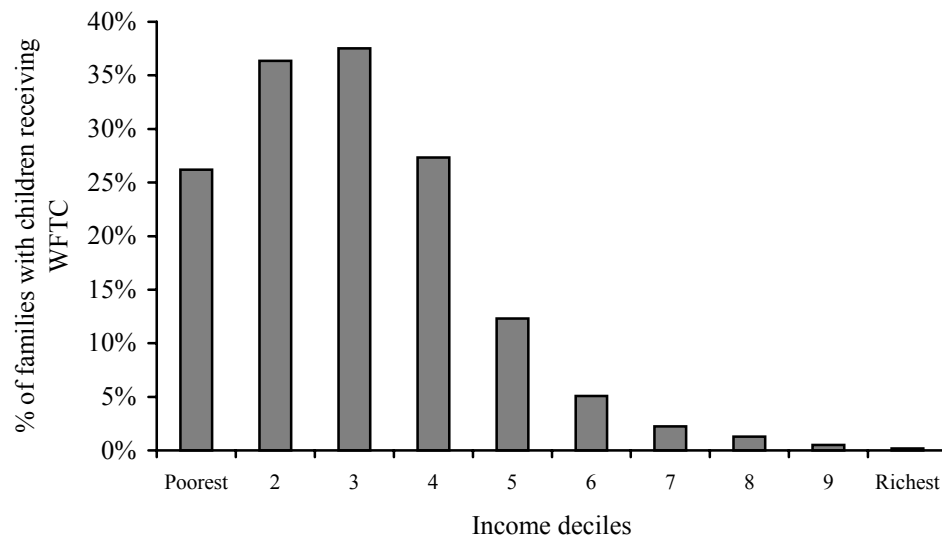
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<sup>1</sup> Complete descriptions of all reforms since 1997, together with summaries of their cost and distributional effects, can be found in M. Myck, *Fiscal Reforms Since 1997*, IFS Briefing Note no. 14, 2000 (<http://www.ifs.org.uk/publications/briefnotes.shtml>).

<sup>2</sup> See the Annex to Appendix B for definitions of elements of the tax system.

0.2% of families with children in the highest decile. Not all low-income families with children are eligible as not all are in work. Some high-income families with children are eligible as our deciles are constructed on household income, and there may be cases where a low-income family with children lives with other adults in a high-income household.

**Figure 7.1. Percentage of families with children eligible for the working families’ tax credit, by income decile**



Note: Income deciles are derived by dividing the total population into 10 equally sized groups according to household income adjusted for family size. Decile 1 contains the poorest tenth of the population, decile 2 the second poorest and so on, up to the top decile (decile 10), which contains the richest tenth. The childcare tax credit has not been modelled – this could extend eligibility up the income distribution.

Source: IFS tax and benefit model using Family Resources Survey 1998–99.

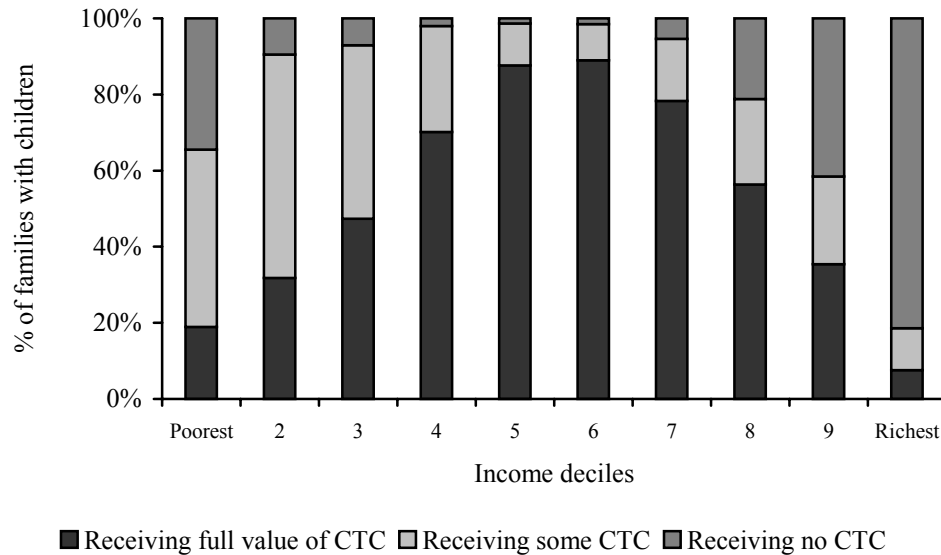
The children’s tax credit will be a non-refundable tax credit<sup>3</sup> for families with children, and therefore only assists families that pay income tax. On current plans, it will reduce the tax bill of a family by up to £442 per year (£8.50 per week).<sup>4</sup> Basic-rate taxpayers will have their tax bill reduced by the amount of the credit (but they will not see the full value of the credit if their tax bill is less than the value of the credit). Higher-rate taxpayers will gain by less, as the children’s tax credit will be withdrawn from families where either partner is a higher-rate taxpayer: £1 of the value of the credit will be withdrawn for every £15 of annual income taxed at the higher rate. Figure 7.2 shows the proportion of families with children in each decile that will be eligible for the credit. Families with children in deciles 5 and 6 are the most likely to benefit from the full amount of the credit. At the lower end of the income distribution, families pay little or no income tax, and so cannot benefit by the full amount

<sup>3</sup> See the Annex to Appendix B for definitions of elements of the tax system.

<sup>4</sup> Options for increasing the generosity of this credit are discussed in Chapter 4.

of the credit. Most families in the highest deciles have some or all of the credit withdrawn because there is a higher-rate taxpayer in the family.

**Figure 7.2. Percentage of families with children eligible for the children’s tax credit (CTC), by income decile**



Note: See note to Figure 7.1.

Source: IFS tax and benefit model using Family Resources Survey 1998–99.

### The integrated child credit

The government announced in March 2000 that it wanted to ‘... bring together the different strands of support for children in the WFTC, Income Support and the Children’s Tax Credit to create an integrated and seamless system of financial support for children’.<sup>5</sup> This integrated child credit is a radical reform of the tax and benefit system that will affect almost all of the 7 million families with children in the UK. A recent IFS publication, *Financial Support for Families with Children*, described the options for the reform in greater detail.<sup>6</sup>

From April 2001, there will be four ways that the government directs financial support to children:

- child benefit – a flat-rate, non-means-tested, non-taxable benefit for each child;
- means-tested benefits for families where no one works – income support and income-related jobseeker’s allowance – which contain extra child

<sup>5</sup> HM Treasury, *Tackling Poverty and Making Work Pay: Tax Credits for the 21<sup>st</sup> Century*, The Modernisation of Britain’s Tax and Benefit System no. 6, HM Treasury, London, 2000.

<sup>6</sup> M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, IFS, London, 2001.

allowances for children and a family premium for any family with children;

- in-work means-tested benefits for low-income working families – the working families' tax credit and the disabled person's tax credit – which contain credits for each child;
- the children's tax credit, which will not vary with the number of children and will be phased out where there is a higher-rate taxpayer in the family.

The government set out some broad objectives for an integrated child credit in the Pre-Budget Report in November 1999 and in the 2000 Budget,<sup>7</sup> but few practical details on how the credit will operate have yet been released. The information released so far has only shown how an integrated child credit would look if it mirrored the current structure of financial support for families with children. What is known is that the government proposes to combine the children's tax credit with the child credits in WFTC and the child-related elements of income support into one payment. On this basis, weekly child-related support for the first child will vary from £15.50 for the richest families, who only receive child benefit, to £45.95 for the poorest, who receive income support, but will reach £50 for some families on WFTC, who receive child benefit, the child credit in WFTC and the children's tax credit.<sup>8</sup>

Figure 7.3 shows how financial support for the first child will vary with income in April 2001, and how this could change under an integrated child credit. If the integrated child credit is to be a single system of support for out-of-work and low-paid families, then families currently on income support will gain, as support for these families needs to be raised to the level received by some families in low-paid work. On this basis, an integrated child credit could cost around £1 billion per year more than the current system and would represent around £10 billion of transfer payments.

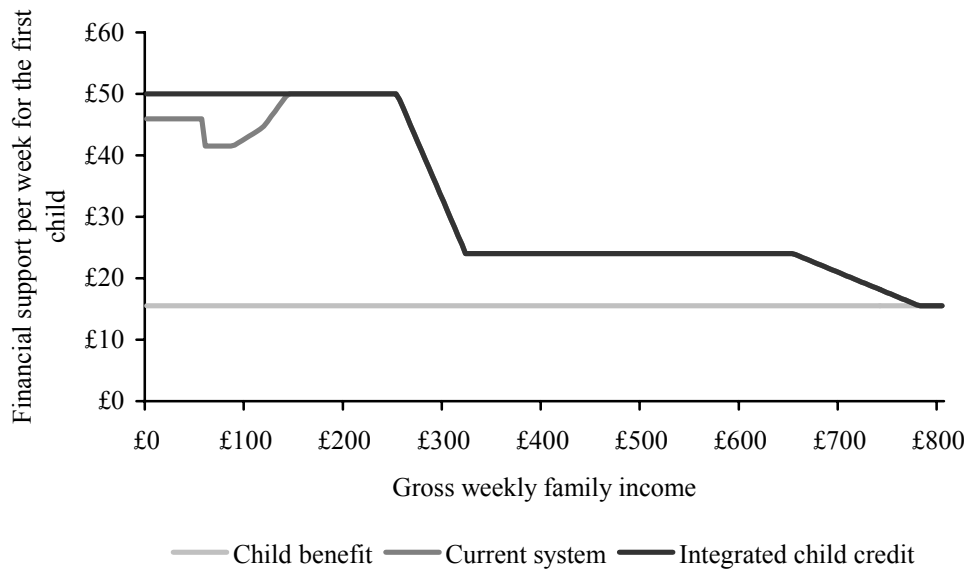
The integrated child credit will be assessed on the joint income of a family, and so will extend joint assessment to around 3 million taxpaying families who have, since 1990, managed their financial dealings with governments as individuals. Families on means-tested benefits already experience some form of joint assessment. The estimate of cost in the previous paragraph assumes

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<sup>7</sup> HM Treasury, *Tackling Poverty and Making Work Pay: Tax Credits for the 21<sup>st</sup> Century*, The Modernisation of Britain's Tax and Benefit System no. 6, HM Treasury, London, 2000; HM Treasury, *Supporting Children through the Tax and Benefit System*, HM Treasury, London, 1999.

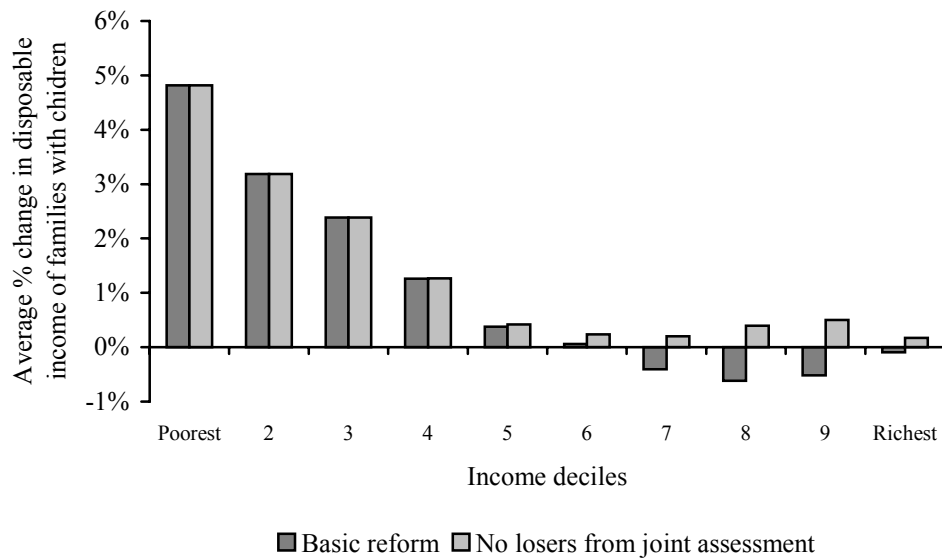
<sup>8</sup> Families on WFTC receive more per child than those on income support to compensate them for not being entitled to free school meals. In addition, families will be unable to benefit from the full value of the children's tax credit if their annual tax bill before the credit is less than £442, which is why support increases as gross weekly income rises from £59 to £144 in Figure 7.3. There is some controversy about whether the values shown in Figure 7.3 represents child-related support in the current tax and benefit system. Government documents treat the basic credit of WFTC as an adult-related payment because, from 2003, all adults will be able to claim an employment tax credit. But, until that time, the amount of extra financial support that a low-income couple without children could receive if they then had a child and claimed WFTC could be substantially greater than £50 per week. These rather technical issues are discussed further in M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, IFS, London, 2001.

**Figure 7.3. Financial support for children from April 2001 and under an integrated system**



Note: The figure is drawn for a family with one child. It assumes that the family qualifies for WFTC at a weekly wage of £59.20, or 16 hours of work at the national minimum wage.  
Source: IFS tax and benefit model.

**Figure 7.4. Distributional impact of the introduction of the integrated child credit**



Note: See note to Figure 7.1.  
Source: IFS tax and benefit model, and taken from M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, IFS, London, 2001.

that the integrated child credit would start to be withdrawn from richer families at the same point at which the children's tax credit will be withdrawn.<sup>9</sup> But the integrated child credit will be based on joint family income, rather than on the income of the highest earner as is the case for the children's tax credit. This means that families that do not contain a higher-rate taxpayer but do have a combined net income of over £483 per week could lose. The government could, though, design an integrated child credit so that no family would lose from this move to joint assessment: this would cost an additional £650 million per year.

Figure 7.4 shows the distributional impact of the introduction of the integrated child credit both in its basic form and in the more expensive form that ensures that no family is left worse off from the move to joint assessment. In the latter case, some families in higher deciles gain, because the threshold at which the integrated child credit is withdrawn is higher for some families than that at which the children's tax credit will be withdrawn.

The integrated child credit represents a significant reform of the tax and benefit system for families with children, and almost all the parameters of the current system could be changed. The government will have to decide how the credit should relate to family size and family income and how it will be administered. The three elements of support for families with children that will be combined in the integrated child credit are currently governed by different rules and administered on different bases. Decisions will have to be made on:

- how to treat different sorts of income and capital;
- the period of assessment and length of award;
- the responsiveness of the credit to changes in family structure or income;
- whether eligibility for and payment of the integrated child credit will be cumulative – like income tax – or non-cumulative – like National Insurance.

Table 7.1 summarises the major differences in administration in the current system that will have to be resolved if the government is to achieve an integrated and seamless system.

### **The employment tax credit**

The government has announced that the principle of the working families' tax credit will be extended to families without children when the integrated child credit is introduced. This means that all low-income working families, whether or not they have children, could claim an employment tax credit based upon joint family income, and that families with children would also receive support through an integrated child credit. This is being presented in part as an inevitable consequence of the move to an integrated child credit, but this need not be the case. After the introduction of the integrated child credit, it will be necessary to have an in-work tax credit for adults with children to ensure that

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<sup>9</sup> The children's tax credit is withdrawn from higher-rate taxpayers, i.e. when weekly gross income reaches £653 per week (as shown in Figure 7.3). This corresponds to a net income of £483 per week.

those currently on WFTC are no worse off, but there is no necessity to extend this in-work credit to those without children. The introduction of an employment tax credit for those without children must therefore be seen as a deliberate policy choice by the government.

**Table 7.1. Administration of the current system of financial support for families with children**

	<b>Income support</b>	<b>WFTC</b>	<b>Children's tax credit</b>
<b>Payment based on:</b>	Recent net family income	Net family income in last seven weeks	Annual gross individual income
<b>Award period</b>	Week Backward adjustments to award possible	Six months No adjustments to award	Annual through PAYE system
<b>Paid to:</b>	Claimant Paid directly	Parent elected by the couple Paid through pay-packet or directly	Taxpayer Paid through pay-packet
<b>Frequency of payments</b>	Weekly	As wages or monthly	Through PAYE
<b>Capital limits</b>	Apply	Apply	Do not apply
<b>Administered by:</b>	DSS	Inland Revenue	Inland Revenue

Note: For more details, see M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, IFS, London, 2001.

The government has said that 'a benchmark level of support provided by the employment tax credit for families with children and working people without children will be the adult credits in the working families' tax credit'.<sup>10</sup> The adult credit is worth £54 per week from April 2001, with an extra credit of £11.45 if people work 30 hours or more. IFS's January 2000 Green Budget showed that an employment tax credit for all working individuals without children would cost the government around £4.5 billion per year.<sup>11</sup> Young single adults, most of whom live with their parents, would be the main beneficiaries. In the 2000 Budget, the government argued that low pay for the young is likely to be transitory and less likely to be associated with poverty. It also argued that part-time employment – as well as low wages – influenced poverty amongst working families without children. It therefore suggested that it might be appropriate to target resources on older age-groups and to support only families with someone in full-time work. Table 7.2 shows the cost of different designs of the employment tax credit and the number of families affected in each case. The costs are shown with and without the capital limits that currently restrict WFTC entitlement to those with savings below £8,000.

<sup>10</sup> HM Treasury, *Tackling Poverty and Making Work Pay: Tax Credits for the 21<sup>st</sup> Century*, The Modernisation of Britain's Tax and Benefit System no. 6, HM Treasury, London, 2000.

<sup>11</sup> L. Chennells, A. Dilnot and C. Emmerson (eds), *The IFS Green Budget: January 2000*, Commentary no. 80, IFS, London, 2000.

**Table 7.2. Cost and caseload of the employment tax credit for families without children**

<b>Eligibility conditions</b>	<b>(As for WFTC)</b>				
Minimum age limit	18	25	25	40	40
Only available to full-time earners (i.e. at least 30 hours a week)?	No	No	Yes	No	Yes
<b>With capital limits</b>					
Cost	£4.4bn	£2.3bn	£1.0bn	£1.5bn	£0.5bn
No. of families affected	2.7m	1.5m	0.85m	0.84m	0.39m
% of single people among recipients	87%	80%	79%	69%	64%
<b>No capital limits</b>					
Cost	£4.6bn	£2.5bn	£1.1bn	£1.6bn	£0.6bn
No. of families affected	2.8m	1.6m	0.90m	0.94m	0.43m
% of single people among recipients	89%	81%	81%	72%	67%

Note: Calculations assume that singles and couples are eligible for the same amount of employment tax credit – £54 per week. For those options where part-time workers are eligible, full-time workers receive a premium of £11.45 per week for working 30 or more hours a week.

Source: IFS tax and benefit model.

The bench-mark scenario is shown in the first column and uses the same eligibility conditions as WFTC. The other columns restrict eligibility by setting minimum age or hours of work criteria. These restrictions reduce the cost and the caseload. For example, if the credit were limited to full-time workers aged over 25, it would cost around £1.1 billion and would affect around 900,000 families (with no capital limits). Raising the minimum age condition to 40 would lower the cost further to £600 million per year.

The government has considered introducing an employment tax credit with a reduced rate for single people.<sup>12</sup> In our models, single people represent around 80% of the predicted caseload and expenditure, so lowering the rate for single adults without children could reduce the cost substantially. For example, the government estimates that an employment tax credit for households with someone over 25 working at least 30 hours a week, with a lower rate for singles than for couples would cost around £300 million and benefit 300,000–400,000 families<sup>13</sup> – considerably lower than our estimate of around £1 billion with no discounted rate for single people.

### The pension credit

In the 2000 Budget, the government announced plans to introduce a ‘pension credit’ during the next parliament, ‘designed not only to lift the poorest out of poverty, but also to do more for those with modest occupational pensions and

<sup>12</sup> WFTC is paid at the same rate per family to lone parents and couples with children.

<sup>13</sup> HM Treasury, *Tackling Poverty and Making Work Pay: Tax Credits for the 21<sup>st</sup> Century*, The Modernisation of Britain’s Tax and Benefit System no. 6, HM Treasury, London, 2000.

savings who should not be penalised for having worked hard all their lives and saved for their retirement'.<sup>14</sup>

The current system of support for pensioners is twofold. Pensioners with sufficient past National Insurance contributions receive the flat-rate basic state pension, which is taxed but not means-tested. This is supplemented by a means-tested benefit known as the minimum income guarantee (MIG), which tops income up to £92.15 for single people over 60 and to £120.65 for couples over 60 from April 2001.

The MIG is a pure 'safety-net' benefit in that any income from the basic state pension or from other sources, such as savings, is withdrawn pound for pound from the MIG entitlement, meaning that net income for a pensioner with small amounts of savings is no greater than that for a pensioner with no savings. This system has been criticised because it gives no incentive for working-age people who expect to retire on a low income to save for their retirement. This, in turn, may increase the social security bill by increasing the number of pensioners with little or no savings, who will then require assistance from the MIG.

The pension credit was outlined in greater detail by the government in November 2000,<sup>15</sup> but is not scheduled for introduction until April 2003. It is designed to alleviate the incentive problem by allowing pensioners to benefit from modest amounts of savings. The pension credit will operate as follows:

- There will be a new guaranteed minimum income level (£100 per week for a single pensioner, £154 for a couple from April 2003). Pensioners with full basic state pension entitlement (£77 per week for a single pensioner, £123 for a couple from April 2003) and no other income will receive the difference (£23 or £31 respectively) through the pension credit.
- Pensioners with incomes below the guaranteed minimum level will receive a 60p pension credit 'top-up' for each pound of income received over and above that provided by a full state pension. So, for example, a single pensioner with full basic state pension entitlement and £10 per week of other income would have a net income of £106: the guaranteed income of £100 per week (£77 state pension, £10 other income, £13 income top-up) plus £6 in pension credit.
- For those with incomes above the guaranteed minimum level, each pound of income received reduces pension credit entitlement by 40p.

In practice, for anyone with income other than the basic state pension and claiming the pension credit, possession of an extra pound of private income leaves a pensioner 60p better off than they would have been without it, so the effective marginal tax rate implied by the pension credit will be 40% rather than the 100% rate that the MIG currently produces. Figure 7.5 shows how the budget constraint of a single pensioner will change under the proposed structure of the pension credit. The transfer will be completely withdrawn for

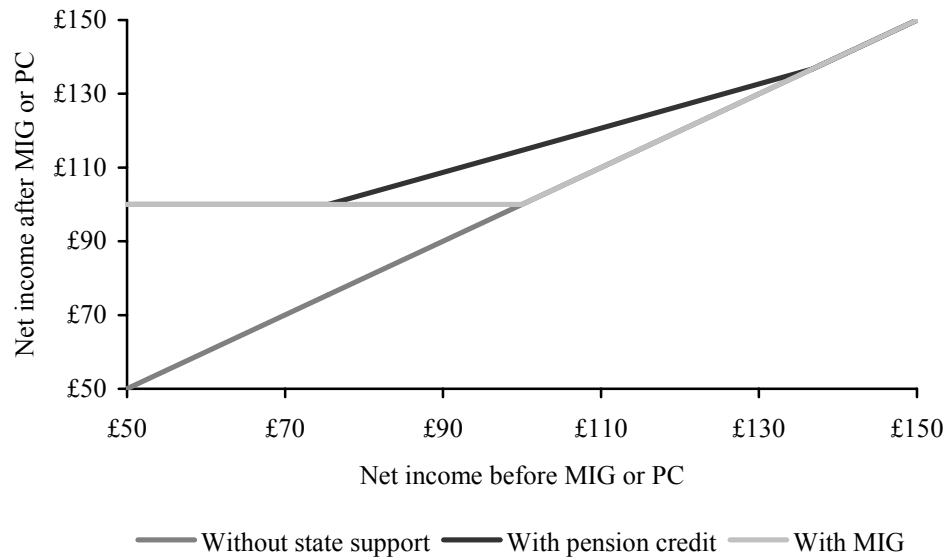
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<sup>14</sup> Chancellor of the Exchequer, Budget Speech, 21 March 2000.

<sup>15</sup> Department of Social Security, *The Pension Credit: A Consultation Paper*, DSS, London, November 2000.

a single pensioner when net income before the credit reaches about £135 per week.

**Figure 7.5. Budget constraint of a single pensioner before and after introduction of the pension credit (PC)**



The estimated cost of the reform – both the increase of the guaranteed minimum and the ‘top-up’ for extra income – will be in the region of £2 billion, although the final cost will depend on the specific details of the credit’s design.<sup>16</sup> Around half of all pensioner families will be entitled to some help through the pension credit, around 1.5 million more than will be entitled to the MIG in 2001–02.

There are a number of potential problems and important features of the pension credit that remain to be worked out. These include:

**Interaction of the pension credit with other benefits.** How should the pension credit interact with other benefits, which many pensioners are entitled to, such as housing benefit (HB) and council tax benefit (CTB)? If the HB and CTB tapers are applied in addition to the pension credit taper, then many pensioners would face marginal deduction rates of over 90%.<sup>17</sup> An alternative would be to ‘passport’ any pensioners with pension credit entitlement to full HB entitlement, as currently happens with income support. Without changing the HB rules, though, this could produce the anomaly that a pensioner with even a small pension credit entitlement would receive a higher income than a pensioner with slightly higher savings income and no pension credit entitlement.

<sup>16</sup> Estimate based on the IFS tax and benefit model. Details of the reform will be discussed in a forthcoming IFS Briefing Note.

<sup>17</sup> A marginal deduction rate is the proportion of income that is lost in extra taxes paid and benefits withdrawn as income rises by £1.

**Treatment of pensioners not entitled to full state pension.** Pensioners who have not paid enough National Insurance contributions to be entitled to the full basic state pension would see no benefit from the savings ‘top-up’ part of the pension credit unless their partial basic state pension entitlement plus other income was greater than the full state pension level. This feature of the system is open to the criticism that people anticipating retiring with less than the full state pension entitlement would still have little incentive to save; these people are likely to be among the poorest pensioners.

**Administrative and assessment issues.** The government has announced that it will end the weekly means test for pensioners currently on income support when it introduces the pension credit, although the details of how this would work remain to be revealed. The government also intends to abolish the capital limits for eligibility to all means-tested benefits for pensioners; instead, the means test for the pension credit, housing benefit and council tax benefit would include interest income from savings.

## **Conclusions**

April 2001 will see the introduction of the second major personal tax and benefit reform in this parliament. Following the implementation of the working families’ tax credit in October 1999, the children’s tax credit will replace the former married couple’s allowance, abolished in April 2000. We have shown that, while WFTC is received by a large proportion of families at the lower end of the income distribution, the children’s tax credit benefits mainly families in the middle deciles. This is because it is only received by families paying income tax and is withdrawn for families where the highest earner is a higher-rate taxpayer. Three more reforms are due to be implemented in April 2003: the integrated child credit, the employment tax credit and the pension credit. These are all most likely to benefit people at the lower end of the income distribution, but their distributional impact will depend on the precise details of implementation.

## **7.2 Common trends to the government’s tax and benefit reforms**

The most important common trends in the government’s tax and benefit reforms are:

- a blurring of the distinction between tax and benefit systems, with an extension of what might have been called means testing but in a form that is more like traditional income tax calculations; in some cases, this represents true integration of the tax and benefit system;
- a large increase in the generosity of government transfers, with a corresponding increase in the number of families receiving help from means-tested instruments;
- an increase in the use of the family rather than the individual as the unit of assessment.

## **Integration of the tax and benefit system**

The government has stated a desire ‘to take tax and benefit integration further, applying the same principles in reform of both the tax and benefit systems’.<sup>18</sup> Taxes and benefits have traditionally been seen as having different objectives – the funding of government expenditure and the relief of need – and have been administered by different government departments (the Inland Revenue and the Department of Social Security). A complete integration of taxes and benefits would integrate the structures of different taxes and benefits, merge the two systems of administration and move to a common method of means assessment so that families are assessed once and receive one single transfer (or one single tax demand). But if taxes and benefits do have the different objectives mentioned above, it may be an advantage to have a system where people could potentially both pay tax and receive benefits. This would enable governments to award benefits on a basis that discriminates more carefully between different types of households than is appropriate for taxes.

Some of the reforms announced by the government to date have blurred the traditional dichotomy between taxes and benefits outlined above, and others represent true integration. For example, the government’s view is that the working families’ tax credit is now part of the tax system, as it is administered by the Inland Revenue and most recipients are paid through the pay-packet. But it is assessed on the basis of a short-term ‘snapshot’ income measure and is reassessed every six months. In these respects, it looks identical to its predecessor – family credit, a means-tested benefit – and has different rules and a separate structure from income tax.

The pension credit has been announced as further contributing to the integration of taxes and benefits. In reality, it is more like an extension of a means-tested benefit, albeit with an infrequent means assessment, perhaps with a very different feel to the weekly means test that it replaces. The only aspect of true tax and benefit integration in the pension credit is the announcement that the age-related personal allowances in income tax will be increased to limit the number of individuals facing the pension credit withdrawal rate and also subject to income taxation.<sup>19</sup>

Despite these minor changes in design, WFTC and the pension credit therefore both look set to remain administratively separate from income tax, at least in the short term. In contrast, the integrated child credit represents a genuine integration of elements of the tax and benefit systems, as it will combine elements of means-tested benefits (income support), in-work benefits (WFTC) and the Pay-As-You-Earn income tax system (the children’s tax credit).

The government has stated that its programme of tax and benefit integration has been informed by several objectives:<sup>20</sup>

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<sup>18</sup> Department of Social Security, *The Pension Credit: A Consultation Paper*, DSS, London, November 2000.

<sup>19</sup> The proposals appear to make the overlap between the two systems very limited, at least for single people. The issue is complicated for couples because benefit assessment is on joint income but tax assessment is individual.

<sup>20</sup> Department of Social Security, *The Pension Credit: A Consultation Paper*, DSS, London, November 2000.

- to tackle poverty;
- to promote incentives to work and save;
- to maximise take-up;
- to ensure that support is targeted at those who need it most;
- to improve customer service and increase efficiency in administration.

But integration of taxes and benefits may not be the best way to achieve these objectives. Poverty is probably better tackled through increasing the generosity of transfer payments, regardless of their form. Ensuring support is targeted to those who need it most is achieved by accurate targeting of transfer payments, again regardless of the form of the transfer. The three elements that are most likely to be achieved by closer integration are improved service and efficiency, maximised take-up, and promotion of incentives to work and save. These points are outlined in Box 7.1.

### **Extending means testing up the income distribution**

The government's reforms have increased the number of families eligible for extra transfer payments, by introducing new transfers and making existing transfers more generous. For example, the working families' tax credit is worth more than its predecessor, family credit, because the awards are higher and because it is withdrawn at a lower rate; this has increased the number of families claiming it by around 300,000. The pension credit will be available to around half of all pensioner households, perhaps 1.5 million more than will be eligible for income support in 2001. Integrating financial support for families with children in the integrated child credit could mean that nearly all the 7 million families with children could be eligible for a means-tested payment, around 3 million more than are currently means-tested through income support or WFTC. Also, the government plans to introduce the employment tax credit for those without children, perhaps affecting 850,000 families.<sup>21</sup>

It is argued that this extension of means testing is undesirable for a number of reasons. Compared with universal benefits, means-tested benefits can be costly to administer and could increase opportunities for fraud. Certainly, one economic disadvantage of extending means-tested benefits is that it tends to increase marginal deduction rates for newly entitled families. Opponents of means testing also portray it as an infringement of personal liberty and argue that it places too much power in the hands of government agencies. But this viewpoint may rest on the particular form of means testing used in the UK, under which claimants have to fill in long questionnaires to claim support and may have to report any change in circumstances to the Benefits Agency every week. The abolition of the weekly means test and the capital limits for the pension credit might, therefore, reduce these objections to means-tested

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<sup>21</sup> Some families newly entitled to the means-tested benefits described above may already be receiving means-tested help through housing benefit or council tax benefit. Estimates from the House of Commons Library are that 29% of non-pensioner families and 56–59% of pensioner families will be receiving income-related benefits in 2003, compared with 21% and 37% respectively in 1998–99 (quoted in Nicholas Timmins, 'Means testing "a step backwards"', *Financial Times*, 4 December 2000).

benefits, by making the means-testing process seem more like the process of tax assessment. In addition, as we mentioned above, a greater coverage of means testing might reduce the stigma associated with claiming government support, and so increase take-up and public support.

### **Box 7.1. Possible advantages of integrating taxes and benefits**

#### **Increasing take-up**

*Reduction of 'hassle', improvement of customer service and increased efficiency in administration:* In a fully integrated tax and benefit system, there could be a single agency collecting information on individuals, both assessing tax liabilities and entitlement to receipt of transfer payments. This could significantly reduce the amount of information that individuals need to supply to the government and improve the service that the government can offer individuals.

*Reduced stigma:* The name of a transfer and its form of payment may have consequences for take-up. The WFTC reform aimed to reduce the stigma associated with claiming it, to increase take-up and to strengthen the link between work and the transfer by paying WFTC through the pay-packet. On the other hand, having WFTC paid through the pay-packet could increase stigma as it is now more transparent to employers which of their employees are receiving in-work benefits. Stigma may also depend on the proportion of the population that are eligible for the transfer. Both the pension credit and the integrated child credit may therefore reduce stigma (and increase public support for means-tested benefits) as the majority of pensioners and families with children will be entitled to some payment.

#### **Promoting incentives to work and save**

In the current system, the effective marginal tax rates faced by some individuals on low incomes can be very high because of the interaction of income tax, National Insurance contributions and the withdrawal of means-tested benefits. Integrating taxes and benefits could make marginal tax rates more transparent and could help remove unwanted interactions between taxes and benefits. But it is not obvious that tax and benefit integration is necessary here: in principle, the government could remove unwanted interactions within a non-integrated system. Moreover, the government has had more impact upon marginal deduction rates in recent years by changing the parameters of WFTC than it has through any genuine tax and benefit integration. One area where integrating taxes and benefits could promote work incentives is if it could provide more certainty and security of cash flow to people leaving out-of-work benefits to enter work.

### **Extending joint taxation and joint assessment**

From 1990 until 2001, the UK tax system has been based on individual assessment: an individual's tax liability depended on his or her own income only; the financial position of his or her partner was immaterial. The system retained one distinction from that of purely independent tax – the married couple's allowance. This offered a tax discount to those who informed the

Inland Revenue that they were married. This was abolished from April 2000 (except for those couples where one person in the couple was born before 1935), seemingly completing the transition to a fully independent tax system.

In contrast to income tax, entitlement to means-tested benefits has always been assessed against joint family income. The main role of means-tested benefits is alleviation of poverty and responsiveness to needs. Entitlement to these benefits on the basis of family income reflects the recognition that members of a family share their income within the family to some extent. Prevention of poverty should thus focus on family rather than individual incomes.

There has therefore been a clear dichotomy in the UK tax and benefit system. Taxpaying individuals, usually at the middle or top of the income distribution, have been subject only to individual income assessment, but those claiming extra help from benefits have been subject to joint family assessment. Table 7.3 shows a range of possible tax systems, from fully independent progressing through to fully joint assessment.

**Table 7.3. A range of possible tax treatments of the family**

<b>Tax type</b>	<b>Information Revenue requires on taxpayer's partner</b>	<b>Example</b>
Fully independent	None	Post-2000/01 tax system for childless families
Independent with universally available transferable allowance	Whether married or have children	1990–99 married couple's allowance
Independent with selectively available transferable allowance	1. Marginal tax rate	Post-2001 children's tax credit
	2. Whether engaged in unpaid caring	Semi-transferable personal allowance (1997 Conservative Party manifesto)
Fully joint	Income	Pre-1988

Three developments in the last few years have shifted this balance between individual and joint assessment. First, as a result of the increased generosity of WFTC, more families with children are now subject to joint assessment. Second, the children's tax credit represents a move towards joint taxation, as it is withdrawn from couples where either partner is a higher-rate taxpayer. Third, the integrated child credit, the employment tax credit and the pension credit will extend the principle of joint assessment to even more families, just as they extend means testing.

The advantages and disadvantages of joint assessment partly rest on the implicit view about how couples share their income. Individual assessment would be more appropriate if governments were concerned with individuals' own income, but joint assessment would be more appropriate if governments believed that the combined income of a couple bore more relation to their standard of living. One concern with some forms of joint assessment is that

they can lead to poorer incentives to work for the second earner in a couple than for the first earner.<sup>22</sup> In addition, joint assessment means that families have to provide government agencies with details of their relationships and be prepared to have these investigated. It also means that individuals in a couple have to share information on their incomes with each other.

## **Conclusions**

The welfare reforms since 1997 have blurred the distinction between taxes and benefits. This trend has taken place alongside increases in generosity of means-tested transfers and an increasing use of the family as the unit of assessment. The increases in generosity have undoubtedly meant that extra resources have been targeted at the less well-off. The other reforms may improve the incentives to work and increase take-up of the transfers. But this could come at a cost of subjecting more individuals and families to a means test, the inconvenience of having to claim support and the need to provide detailed information to the authorities about their private lives.

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<sup>22</sup> This is the case if a transfer is assessed on joint income but there is some form of tax allowance: the first earner will typically use the allowance to reduce the amount of his or her income that reduces the transfer, whereas the second earner will have all of her or his income taken into account. This is one of the implications of the WFTC – see R. Blundell, A. Duncan, J. McCrae and C. Meghir, ‘The labour market impact of the working families’ tax credit’, *Fiscal Studies*, vol. 21, pp. 75–103, 2000.