

11. Withdrawing Child Benefit from better-off families: are there better options?

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Summary

- From January 2013, the government plans effectively to withdraw all Child Benefit from any family containing a higher-rate income taxpayer. The Treasury expects this to save it about £2.4 billion in 2013–14. Around 1.5 million families will effectively lose their Child Benefit as a result: about 600,000 one-child families will lose £1,056 per year; about 700,000 two-child families will lose £1,752 per year; and about 200,000 families with three or more children will lose at least £2,449 per year.
- The ‘cliff-edge’ feature of this policy, whereby all of a family’s Child Benefit is removed completely as soon as pre-tax income passes a certain threshold (rather than being tapered away gradually as income rises), will create a bizarre and economically damaging set of incentives for people within certain income bands. About 170,000 families could increase their net income if an individual in that family managed to lower their pre-tax income to just below the higher-rate tax threshold, and about 200,000 families slightly below the higher-rate tax threshold could find themselves with a lower net income if their pre-tax income were to rise slightly.
- The Treasury has estimated that the resulting distortions to people’s behaviour will reduce the revenue raised by the reform by about £280 million per year due to ‘tax planning’ and another £60 million per year due to ‘non-compliance’. A further £90 million per year will go uncollected due to difficulties in correctly identifying the families who should be affected by this reform. The total economic costs of the distortions to people’s behaviour (such as reduced labour supply) are likely to be greater still; and one can clearly also question the fairness of effectively rewarding people for working less or arranging a pay cut with their employer.
- The fact that Child Benefit withdrawal would be based on individual income, rather than family income, will mean that Child Benefit will be removed from some couples whose joint pre-tax income is £43,000 per year but not removed from other couples whose joint pre-tax income is £84,000 per year.
- The Prime Minister has recently said that the government is reconsidering the way in which Child Benefit is removed from better-off families. This chapter presents alternative ways of removing Child Benefit from better-off families that address one or both of the issues outlined above. Withdrawing Child Benefit gradually through the income tax system would affect a similar set of families to the government’s proposal and could easily be tweaked so that it would raise the same amount of money. Gradual withdrawal would avoid the ‘cliff-edge’ feature of the current policy and hence the most severe economic distortions. More rational solutions would use the existing system of means-testing for families with children, which is subject to neither of the criticisms outlined above: Child Benefit could be combined with the Child Tax Credit (and, later, Universal Credit).

11.1 Introduction

Child Benefit is currently the only universal child-contingent benefit. It is worth £1,056 per year to a one-child family, plus £697 per year for each subsequent child.

In 2010–11, spending on Child Benefit was about £12 billion, or about 6% of the total spending on social security benefits and tax credits.¹ Child Benefit has been around in its current form since 1977 and has traditionally been seen as a way of recognising the additional costs of children.²

Having announced the policy at the Conservative Party conference in September 2010, the Chancellor confirmed in his October 2010 Spending Review that, subject to parliamentary approval in the 2012 Finance Bill, Child Benefit would be effectively removed from families containing anyone who pays income tax at the higher rate of 40% (or more³) from January 2013. At the time, the Treasury expected this to save it about £2.4 billion per year when implemented.⁴ Around 1.5 million families will effectively lose their Child Benefit as a result: about 600,000 one-child families will lose £1,056 per year; about 700,000 two-child families will lose £1,752 per year; and about 200,000 families with three or more children will lose at least £2,449 per year.⁵

Some families affected by the proposed Child Benefit withdrawal will also have seen their Child Tax Credit payments stop because of cuts to tax credits announced by this government and implemented in April 2011 and April 2012. Due to the combined impact of these changes, a single-earner family with one/two/three children and a gross income of £50,000 per year was entitled to £1,601/£2,297/£2,994 per year in cash benefits in support for their children in 2010–11, but by January 2013 they will effectively receive nothing. This implies that from January 2013 the net income of such families will be about 4%/6%/8% lower than it would have been without these tax credit and Child Benefit reforms.⁶

The government's proposal will effectively make Child Benefit a means-tested benefit. We do not take a stand here on whether it is desirable to maintain a universal child-contingent benefit. There are good reasons for thinking that an equitable system should take less tax from (or pay more benefits to) those with children, even where incomes are high, to reflect their greater needs; on the other hand, it can look odd to pay money to the

¹ For Child Benefit spending, see HMRC's 2010–11 accounts (<http://www.official-documents.gov.uk/document/hc1012/hc09/0981/0981.pdf>). For total spending on social security benefits and tax credits, see page 142 of the Office for Budget Responsibility's *Economic and Fiscal Outlook* of November 2011 (http://cdn.budgetresponsibility.independent.gov.uk/Autumn2011EFO_web_version138469072346.pdf).

² For more on the history of Child Benefit, see F. Bennett, *Child Benefit: Fit for the Future*, Child Poverty Action Group, London, 2006. For more on how Child Benefit fits within the overall system of child-contingent support, see S. Adam, M. Brewer and H. Reed, *The Benefits of Parenting: Government Financial Support for Families with Children since 1975*, Commentary 91, IFS, London, 2002 (<http://www.ifs.org.uk/publications/1803>).

³ The 'higher' marginal rate of income tax is 40%. From April 2010, there has been an 'additional' marginal rate of income tax of 50% on gross income above £150,000. Both higher- and additional-rate taxpayers will be subject to Child Benefit withdrawal under the government's plan. For convenience, we simply refer to this group throughout the chapter as 'higher-rate taxpayers'.

⁴ See page 14 of HM Treasury, HM Revenue & Customs and Department for Work & Pensions, *Spending Review 2010 Policy Costings* (http://www.hm-treasury.gov.uk/spend_sr2010_policycostings.htm). The government had already announced, in the June 2010 Budget, that Child Benefit amounts would be frozen in cash terms for three years (i.e. cut in real terms year-on-year until April 2014).

⁵ These are our own estimates; see Box 11.1 for detailed discussion.

⁶ Ignoring any other benefits received and any council tax paid.

rich for what could be seen as a lifestyle choice.⁷ But the unusual way in which the government proposes to implement this means test looks rather ill-considered: it is likely to result in serious economic inefficiencies and inequities. Indeed, the Prime Minister has recently said that the government is reconsidering the way in which Child Benefit is removed from better-off families.⁸ So, this chapter takes as given the government's objective of withdrawing Child Benefit from some better-off families, but explores how this could be done while avoiding the most undesirable consequences of the current proposal.

Section 11.2 sets out the government's proposal for withdrawing Child Benefit from families where at least one adult is a higher-rate taxpayer, and explains the inefficiencies and inequities that are likely to result. Section 11.3 presents alternative ways of removing Child Benefit from better-off families and looks at their impact on the public finances and on the distribution of net income compared with the impact of the plan proposed by the government. Section 11.4 concludes.

11.2 The government's proposal for Child Benefit

Under the government's proposal, individuals who are higher rate taxpayers would be asked on income tax self-assessment forms whether they or their partner receives Child Benefit. If they do, then they will be liable for additional tax payments equal to the amount of Child Benefit that they or their partner receives.⁹

Most of this chapter analyses the economics of the government's proposal and of our suggested alternatives. But the government's proposed mechanism looks problematic administratively as well as economically. Below, we outline the key issues that arise from this proposal, taking the administration and the economics in turn.

Administrative issues with the government's proposal

Unless a claimant actively decides to stop claiming it, Child Benefit will continue to be paid to recipients even if they or their partner are higher-rate taxpayers. This means that the policy is, in effect, requiring the higher-income member of a couple to pay for the Child Benefit received by his or her partner. One implication of this is that the reform need not affect the state pension rights of Child Benefit recipients.¹⁰ But it raises a number of more serious administrative complexities.

⁷ For a discussion, see, for example, chapter 2 of S. Adam and M. Brewer, *Supporting Families: The Financial Costs and Benefits of Children since 1975*, Policy Press, Bristol, 2004.

⁸ For the text of the interview, see http://www.politicshome.com/uk/article/43591/david_cameron_interview.html. What he actually said was 'Some people say that's the unfairness of it, that you lose the child benefit if you have a higher rate taxpayer in the family. Two people below the level keep the benefit. So, there's a threshold, a cliff-edge issue. We always said we would look at the steepness of the curve, we always said we would look at the way it's implemented and that remains the case, but again I don't want to impinge on the Chancellor's Budget'. We are not able to infer from this whether he dislikes the inefficiencies of the cliff-edge, or the perceived unfairness in the treatment of single- and dual-earner couples.

⁹ Where both members of a couple with children are higher-rate taxpayers, presumably only one of them will in fact be liable for additional tax payments (although it is not yet clear exactly how the government will avoid 'double-counting' the Child Benefit income of such couples – see discussion below).

¹⁰ Since April 2010, adults receiving Child Benefit for a child under 12 receive credits towards the state pension equivalent to those they would have received had they paid National Insurance; between April 1978 and April 2010, all Child Benefit recipients qualified for Home Responsibilities Protection. See http://www.direct.gov.uk/en/MoneyTaxAndBenefits/ChildBenefitandChildTrustFund/Childbenefits/Paymentsandentitlements/Benefitsforparents/DG_173609 for the current system and A. Bozio, R. Crawford and G.

HM Revenue and Customs (HMRC) does not know for certain which families with children need to have Child Benefit withdrawn, and so the mechanism proposed relies on higher-rate taxpayers who are, or who live with, Child Benefit recipients – some of whom would not otherwise be completing income tax self-assessment forms – reporting to HMRC that they or their partner receives Child Benefit.¹¹ The government estimates that it will lose out on around £150 million of savings per year because of non-compliance and the government's inability to identify perfectly which higher-rate taxpayers are, or are the partners of, Child Benefit recipients.¹² In particular, it is not clear what would happen if a higher-rate taxpayer does not know (or claims not to know) whether his or her partner receives Child Benefit, unless it were to become a legal obligation for a Child Benefit claimant to tell their partner that they are claiming.

Various complexities also arise from the fact that entitlement to Child Benefit is assessed weekly, whereas income tax assessment is done on an annual basis. HMRC will need to determine what should happen to individuals whose family circumstances change within a year. For example, it is not clear at present how HMRC would treat the following cases:

- someone who received Child Benefit throughout a tax year who lived as a lone parent for part of the year and lived with a higher-rate income taxpayer for the other part of the tax year;
- someone who received Child Benefit throughout a tax year who lived (at different times) with two (or more) different higher-rate income taxpayers during a single tax year;
- a higher-rate income taxpayer who lived (at different times) with two (or more) different Child Benefit recipients during a single tax year.

In dealing with such complexities, there seem to be two broad options: either an entire year's history of cohabitation with Child Benefit recipients needs to be collected in an income tax self-assessment form, so that only the Child Benefit received by someone in the weeks when he or she was the partner of a higher-rate income taxpayer can be withdrawn; or Child Benefit could be withheld on the assumption that the family circumstances that applied on a certain date in fact applied for the entire tax year.

Finally, the government will need a way of ensuring that it does not 'double-count' the Child Benefit of couples who are *both* higher-rate income taxpayers when clawing it back through the income tax system. Presumably, this either requires members of a couple to be relied upon to share information about their pre-tax income with each other and to coordinate their responses on income tax self-assessment forms; or requires HMRC to implement some administrative mechanism for linking individuals who live together.

Any reform that could avoid these considerable administrative complexities would have very obvious advantages over the current proposal.

Tetlow, 'The history of state pensions in the UK: 1948 to 2010', IFS Briefing Note 105, 2010 (<http://www.ifs.org.uk/bns/bn105.pdf>).

¹¹ Although HMRC is responsible both for paying Child Benefit and for collecting income tax, the two systems are separate. HMRC may know which adults (usually mothers) have claimed Child Benefit, but it has no way of knowing whether these people (or, indeed, any two taxpayers) are married or living together with someone as husband and wife.

¹² See page 14 of HM Treasury, HM Revenue & Customs and Department for Work & Pensions, *Spending Review 2010 Policy Costings* (http://www.hm-treasury.gov.uk/spend_sr2010_policycostings.htm). This implies that approximately 6% of families who would, in principle, be subject to the withdrawal of Child Benefit are expected to escape that withdrawal because they cannot be identified.

Economic issues with the government's proposal

Economically, two features of the government's proposed means test stand out. First, Child Benefit will effectively be withdrawn entirely as soon as pre-tax income passes a particular threshold, rather than being tapered away gradually as pre-tax income rises (which, for good reasons, is the standard way of means-testing a benefit). Second, the withdrawal will be based on the individual pre-tax income of the higher-income adult in a family, rather than on joint income. We treat each of these issues separately below.

The 'cliff-edge'

It seems straightforwardly unfair to reward some people for arranging a pay cut with their employer or working less hard, and the potential economic inefficiencies that arise from such a situation are just as stark. But that is precisely the situation that the government's proposal will create.

A family will effectively lose all of its Child Benefit the instant that one adult becomes a higher-rate taxpayer. This cliff-edge has a number of consequences for people's economic incentives, depending on their pre-tax income and the number of children they have.

In 2013–14, the higher-rate income tax threshold is expected to be £42,735 per year.¹³ Hence, for an individual living with a Child Benefit recipient who is not a higher-rate taxpayer, a rise in earnings (or other taxable income) from £42,734 to £42,736 per year would be sufficient to trigger a loss of Child Benefit worth at least a thousand pounds per year. We estimate that around 200,000 families in which the pre-tax income of the adult with the higher income lies slightly below the higher-rate tax threshold could therefore find themselves in this situation.¹⁴

Equivalently, a family with children with an adult whose earnings lie a little above the higher-rate income tax threshold would increase their net income if this adult found a way to reduce his or her earnings to a point just below that threshold. As Table 11.1 reports, there are around 170,000 families in which the pre-tax income of the adult with the higher income lies slightly above the higher-rate tax threshold who, in principle, could increase their net income by finding a way to reduce their taxable income to just below the higher-rate tax threshold.¹⁵ Whether a family will be in this position depends on the number of children for whom they receive Child Benefit. Table 11.1 shows, for a given number of children, the band of gross annual income of the adult with the higher income within which such families must fall; it also splits the estimate of how many families with children will find themselves in this situation by the number of children in the family. Although we do not yet have precise details of how the Child Benefit withdrawal will operate, it seems likely that one easy way for such families to reorganise their finances in response would be to make additional contributions to a private pension until taxable income falls below the higher-rate threshold, as contributions to a private pension are

¹³ This is the figure implied by current government policies reflected in public finance forecasts, and the Office for Budget Responsibility's forecast of 3.1% RPI inflation in the year to September 2012 – the figure that will determine the default uprating of tax thresholds in April 2013 (see page 109 of the Office for Budget Responsibility's *Economic and Fiscal Outlook* of November 2011 (http://cdn.budgetresponsibility.independent.gov.uk/Autumn2011EFO_web_version138469072346.pdf)).

¹⁴ Some of these families would see their net income fall only if their pre-tax income rose by a very small amount: we estimate that approximately 100,000 families would find themselves with a lower net income if the pre-tax income of an adult in that family were to rise by 5%.

¹⁵ There will also be a small number of families where both adults' income falls into these bands; these families have not been included in our estimates.

deducted from taxable income.¹⁶ But the withdrawal of Child Benefit would also give them very strong incentives to work less – for example, by undertaking less paid overtime (or trying less hard for a bonus) – leading to a real reduction in economic activity.

Table 11.1. Families who could increase their net income by reducing their gross income under the current proposal for withdrawing Child Benefit

Number of children	Gross annual income	Estimated number of families in this situation
One child	£42,735 – £44,555	60,000
Two children	£42,735 – £45,756	80,000
Three children	£42,735 – £46,958	20,000
Four children	£42,735 – £48,159	10,000
Total	n/a	170,000

Note: Estimates ignore those individuals who have a partner who is also a higher-rate taxpayer.

Source: Authors' calculations using Family Resources Survey 2008–09 and TAXBEN, the IFS tax and benefit microsimulation model.

The Child Benefit withdrawal will mean that some families in which the pre-tax income of the adult with the higher income lies some way above the higher-rate tax threshold (to be precise: above the ranges of income shown in Table 11.1) would lose significantly less net income if their pre-tax income fell than they would do without this policy (even though their net income would still fall). This situation would arise if the fall in pre-tax income took them below the higher-rate tax threshold, leading to the reinstatement of their Child Benefit, which would partially offset the impact of the fall in pre-tax income. The implication is that, for this group, reductions in labour supply would be more attractive than they would otherwise have been. For example, a working individual in a one-earner couple with two children with gross earnings of £50,000 (and no other taxable income) could cut his or her salary by 20% (£10,000) but see the family's net income fall by only 12% or £4,320 (compared with 16% or £6,073 if Child Benefit remained universal).

Finally, an equivalent argument applies to families in which the pre-tax income of the adult with the higher income lies some way below the higher-rate tax threshold but who have the option of moving some way above it: even ignoring the starkest cases where the increase in earnings would result in a reduction in net income, the incentive to increase earnings slightly is far weaker than it would be without the proposed Child Benefit withdrawal. To reverse the previous example, a working individual in a one-earner couple with two children with gross earnings of £40,000 would see a rise in net income of just £4,320 (compared with £6,073 if Child Benefit remained universal) if his or her earnings rose by £10,000, an effective tax rate on the additional income of 57%.

Of course, all situations in which tax liability rises or benefit entitlements fall as income rises will distort behaviour by making increases in earnings less financially attractive than they would otherwise be. But by creating a cliff-edge, this policy will introduce an

¹⁶ We describe this as 'easy' because it need not require the cooperation of their employer. In effect, the policy increases the return to saving in a private pension for all those who are, or who live with, Child Benefit recipients and whose income exceeds the higher-rate income tax threshold but whose pension saving could reasonably reduce their taxable income below that threshold. For the same reason, the policy increases the incentive for these individuals to make charitable donations, since they can also be deducted from taxable income.

effective tax rate on additional income which will often be considerably higher than those caused by most taxes or means-tested benefits (and will exceed 100% for many people). This policy will, therefore, introduce an extremely sharp economic inefficiency. The government is fully aware of this damaging distortion: its costing of the policy assumes that it will lose approximately £280 million per year through what it describes as 'tax planning'.¹⁷

Assessment of Child Benefit eligibility against individual income

Because Child Benefit withdrawal is to depend on the pre-tax income of the higher-income individual in a family (rather than joint income), some couples with children with the same pre-tax income would be treated very differently by this policy, since Child Benefit entitlement would depend crucially on how pre-tax income is shared between them. For example, with a higher-rate tax threshold at its expected 2013–14 level of £42,735 per year, a couple where each adult has an income of £42,000 per year (and thus neither is a higher-rate taxpayer) would not lose any Child Benefit, whereas a couple with one individual with an income of £43,000 (who is therefore a higher-rate taxpayer) would lose all of their Child Benefit.

One could argue that, for families with children, there are extra costs associated with having two members of a couple in paid work rather than one, due to the need for childcare provision, and therefore it might be desirable for the tax and benefit system to account for this in some way. However, it is difficult to believe that this way of means-testing Child Benefit is an appropriate response to this concern (not least because it is not only being withdrawn from one-earner couples): it would surely be preferable to target the problem directly by designing state financial support for childcare accordingly.

The proposed withdrawal mechanism would also increase the so-called 'couple penalty' for a lone parent who was considering cohabiting with a higher-rate taxpayer, or for adults in a couple who were considering breaking up where one was a higher-rate taxpayer. When in opposition, the Conservative Party claimed it would seek to reduce, rather than increase this penalty, and the coalition agreement made in June 2010 says 'we will bring forward plans to reduce the couple penalty in the tax credit system'.¹⁸ However, *any* mechanism for withdrawing Child Benefit would either increase the couple penalty in the tax and benefit system, or introduce so-called couple premiums for some.¹⁹

11.3 Alternative ways of removing Child Benefit from better-off families with children

This section presents alternative ways of removing Child Benefit from better-off families and compares their impact on families with that of the plan proposed by the government.

The previous section outlined the inefficiencies and inequities that would result from the government's proposal for Child Benefit. These mostly stem from three key features of the proposal:

¹⁷ See page 14 of HM Treasury, HM Revenue & Customs and Department for Work & Pensions, *Spending Review 2010 Policy Costings* (http://www.hm-treasury.gov.uk/spend_sr2010_policycostings.htm).

¹⁸ See HM Government, *The Coalition: Our Programme for Government*, 2010 (http://www.cabinetoffice.gov.uk/sites/default/files/resources/coalition_programme_for_government.pdf).

¹⁹ For further discussion, see S. Adam and M. Brewer, 'Couple penalties and premiums in the UK tax and benefit system', IFS Briefing Note 102, 2010 (<http://www.ifs.org.uk/publications/4856>).

- The government has proposed using the income tax system to withdraw Child Benefit, which raises a number of administrative problems and complexities.
- The proposal involves a *cliff-edge* – where £1 of additional income a year could lead to a family losing over a thousand pounds of Child Benefit – rather than a *gradual withdrawal* – where each £1 of additional income a year leads to a reduction in Child Benefit of some amount between £0 and £1.
- The government has proposed withdrawing Child Benefit against the income of the higher-income adult in couples, rather than against their joint income.

We propose three alternatives to fix some or all of these defects:

- a) Withdrawing Child Benefit through the income tax system, but gradually.
- b) Integrating Child Benefit with the Child Tax Credit, but withdrawing it in the same way as the family element of the Child Tax Credit was formerly withdrawn.
- c) Integrating Child Benefit with the Child Tax Credit.

We first describe these proposals in turn and then present estimates of their impact on the government's finances and the distribution of income. In an annex, we also consider variants of options b and c under the assumption that tax credits are replaced with Universal Credit.²⁰

Detail of proposals

Withdrawing Child Benefit through the income tax system (option a)

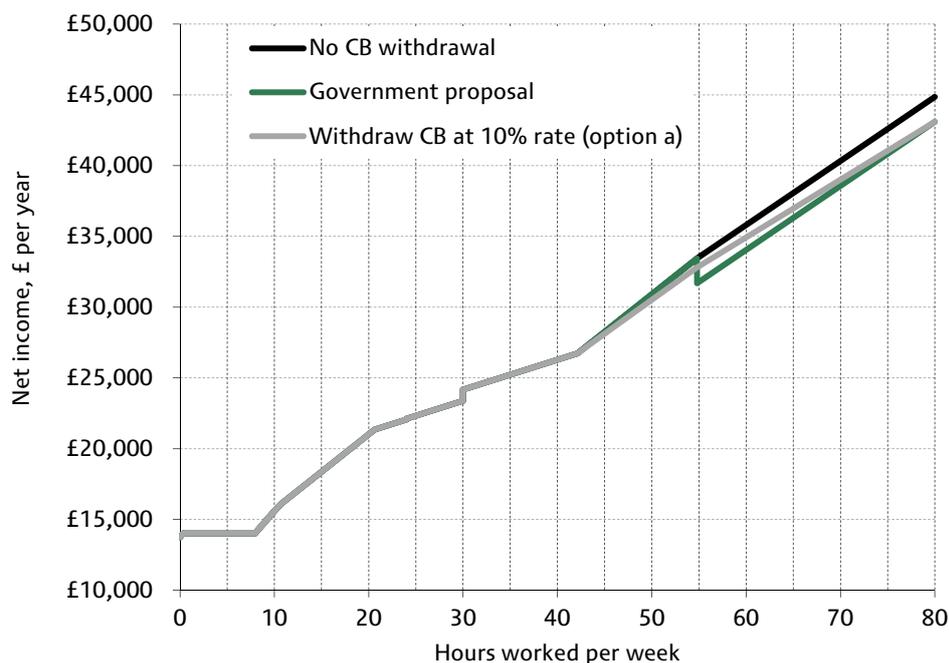
Our first option withdraws Child Benefit from families with children that contain a higher-rate taxpayer, as the government's proposal does, but at a gradual rate rather than in a cliff-edge. We use illustrative withdrawal rates of 10% and 20%. As far as we can see, implementing such a scheme is entirely possible using the mechanism that the government has set out for implementing its own proposal.

The impact on the budget constraint of a two-child family is shown in Figure 11.1. Essentially, the effect is to spread the loss of Child Benefit over a range of gross income. Adults directly affected would face an effective marginal tax rate of 52% or 62% (with withdrawal rates of 10% and 20% respectively) over this range, rather than the current 42% (or the proposed cliff-edge, which involves an infinite marginal tax rate at the higher-rate threshold). Such higher effective marginal tax rates would still weaken families' incentives to increase their income (which is completely unavoidable if the aim is to withdraw Child Benefit from better-off families) relative to maintaining the current system of universality, but this option avoids the extremely high effective marginal tax rates for some people affected by the government's proposal. In particular, it would mean that no family would face the situation where a drop in income would increase their net income or a rise in income would make them worse off.

These policies raise less than the government's proposal, but could be tweaked so as to raise the same amount by beginning Child Benefit withdrawal at gross income levels slightly below the higher-rate threshold (although this would require extending self-assessment to more families); we calculate that this would involve beginning the withdrawal at £35,235 or £38,835 for withdrawal rates of 10% or 20% respectively.

²⁰ At the time of writing, Parliament is still debating the Welfare Reform Bill which proposed to replace all means-tested benefits and tax credits for people of working age with a single programme to be known as Universal Credit. See <http://www.publications.parliament.uk/pa/cm201011/cmbills/154/11154.pdf> for more information.

Figure 11.1. Budget constraints in 2013–14 for an example one-earner couple with two children: option a compared with government proposal and current situation



Notes: Assumes that the earner can choose how many hours to work at a given wage rate of £15 per hour, and ignores the impact of any rent, council tax or disabilities. Budget constraints shown are for a family who remain within the current system of tax credits and means-tested benefits, rather than the new Universal Credit system which will begin to be phased in from October 2013.

Source: Authors' calculations using TAXBEN, the IFS tax and benefit microsimulation model.

Integrating Child Benefit with Child Tax Credit (options b and c)

The government has defended some of the inequities implied by its proposed mechanism for withdrawing Child Benefit on the grounds that it did not want to create a new means test.²¹ It is not entirely clear whether it considered integrating Child Benefit with the Child Tax Credit (or, later, Universal Credit).²² There are problems with the way that tax credits were designed and are administered, but the tax credit system is a good one for removing child-related support from better-off families, as it already captures the joint income of families with children who apply for it and it does so by means of a gradual withdrawal.

We offer two alternatives that integrate Child Benefit with the Child Tax Credit:²³

- The first (option b) proposes that Child Benefit be integrated with the Child Tax Credit, but withdrawn using a separate taper so that the withdrawal rate is 6.66%

²¹ See the Chancellor's response in Parliament to a petition on the withdrawal of Child Benefit (<http://www.publications.parliament.uk/pa/cm201011/cmhansrd/cm110519/petntext/110519p0001.htm>).

²² In fact, a statement by the Secretary of State for Work and Pensions, Iain Duncan Smith, implied that not only had the government considered integrating Child Benefit with Universal Credit, but also it actually intended to do so (<http://www.guardian.co.uk/politics/2010/oct/06/ids-means-test-child-benefit>); however, the current proposal for Universal Credit assumes that Child Benefit will remain separate.

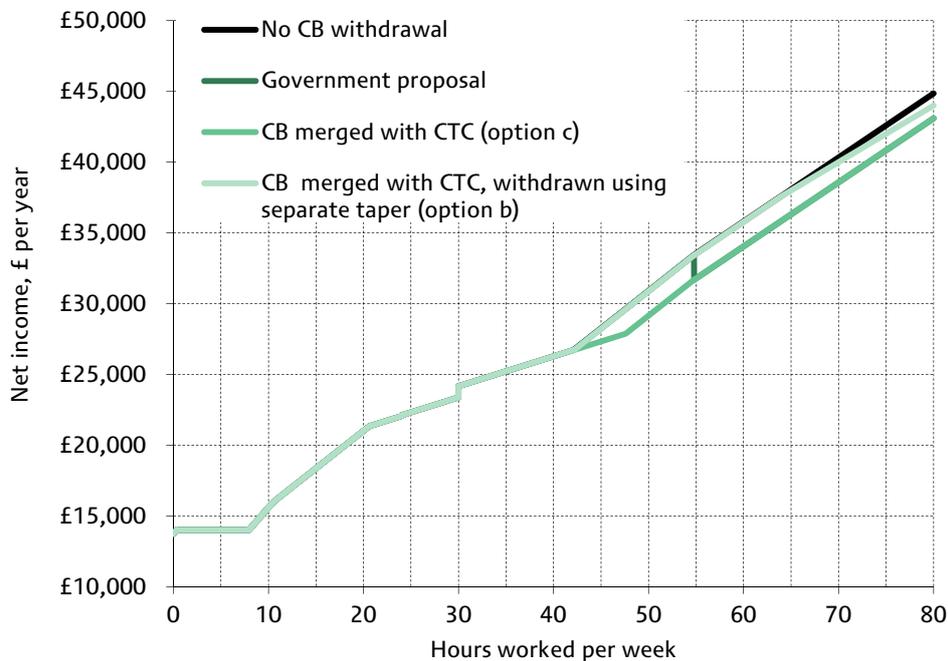
²³ These hypothetical policies could be achieved either by scrapping Child Benefit and increasing the value of the Child Tax Credit by an offsetting amount (with similar adjustments to child allowances in Housing Benefit and Council Tax Benefit), or by retaining Child Benefit as a separate benefit but requiring its recipients to claim the Child Tax Credit alongside it.

(rather than 41%, as for the rest of the tax credit system) and withdrawal begins at £50,000 of joint pre-tax income (rather than £6,420,²⁴ as for the rest of the tax credit system). This means that Child Benefit would be withdrawn in exactly the same way as the family element of the Child Tax Credit used to be withdrawn.²⁵

- The second alternative (option c) proposes that the withdrawal of Child Benefit be fully integrated with the withdrawal of Child Tax Credit. In effect, this means that Child Benefit would begin to be withdrawn as soon as joint gross income reaches the level where Child Tax Credit entitlement has been exhausted (for a family containing a full-time worker and two children,²⁶ this is expected to be £32,554 per year in 2013–14) and it would be withdrawn at the same 41% rate as tax credits.

The impact of these two proposals on the budget constraint of a one-earner couple with two children is illustrated in Figure 11.2.

Figure 11.2. Budget constraints in 2013–14 for an example one-earner couple with two children: options b and c compared with government proposal and current situation



Notes and Source: As Figure 11.1.

The proposal that straightforwardly integrates Child Benefit with the Child Tax Credit would see Child Benefit effectively removed from families at much lower levels of income than under the government's proposal. For a single-earner family, integrating Child Benefit with the Child Tax Credit but withdrawing it in a separate taper starting at £50,000 per year at the lower withdrawal rate of 1 in 15 (as was formerly done for the family element of the Child Tax Credit) would be quite similar to withdrawing it through the income tax system (option a). But the advantage of using the tax credit system is that

²⁴ £15,860 for families not entitled to Working Tax Credit.

²⁵ From April 2011, the family element began to be withdrawn at £40,000 rather than £50,000. From April 2012, it will be withdrawn immediately after the other tax credit elements.

²⁶ Assuming no disabilities or formal childcare costs.

it would reduce the inequities between single- and dual-income couples inherent in the government's proposal (and other proposals that effectively withdraw Child Benefit through the income tax system, such as option a). Under the government's proposal, a dual-income couple could, in principle, have a joint income of £84,000 and still keep all of their Child Benefit, whereas that limit would be £50,000 under option b for single-income and dual-income couples alike.

One disadvantage of integrating Child Benefit with the Child Tax Credit is that take-up of the Child Tax Credit is somewhat lower than that for Child Benefit.²⁷ If this were to continue, it would mean that some low-income families with children who do not claim the Child Tax Credit that they are entitled to would be worse off after the integration of Child Benefit with the Child Tax Credit (because not claiming Child Tax Credit would effectively mean not claiming Child Benefit either). But once the Child Tax Credit is subsumed within Universal Credit, which begins to be phased in from October 2013, the government expects non-take-up to be reduced, which would lessen this as an issue (see the annex for analysis of the integration of Child Benefit with Universal Credit). Another disadvantage of this proposal is that a new way might need to be found to give non-working parents of children under 12 credits towards their state pension, as currently happens for Child Benefit recipients.

All of the options that we have explored withdraw Child Benefit gradually, rather than all-at-once, avoiding the cliff-edge inherent in the government's proposal, which is arguably its most economically damaging aspect. Options b and c withdraw Child Benefit against the joint income of a couple – we consider that the joint income of a couple is likely to be a better guide to their ability to cope without Child Benefit than the income of the higher-income individual is.²⁸ Options b and c make use of the existing system of means-testing, which already collects information on the income of families with children: the Child Tax Credit (and its proposed replacement, Universal Credit).

Impact on government finances

Table 11.2 shows the impact of our three alternative proposals (and their variants) on government finances (Box 11.1 discusses some of the inevitable limitations and inaccuracies that apply to such estimates).

As we said earlier, withdrawing Child Benefit through the income tax system but at a finite rate (rather than the government's cliff-edge) would raise less money unless the threshold for withdrawing Child Benefit were also lowered. Adding Child Benefit to the Child Tax Credit system but withdrawing it using a separate taper would raise an amount of money similar to the government's proposal; this is because the use of a higher threshold (which reduces the yield) is roughly offset by the use of joint income rather than the higher income in a couple (which increases the yield). Straightforwardly integrating Child Benefit with the Child Tax Credit would raise substantially more money than the government's proposal.

²⁷ See HMRC's latest estimates of take-up of Child Benefit and Child Tax Credit at <http://www.hmrc.gov.uk/stats/personal-tax-credits/cwtc-take-up2008-09.pdf>.

²⁸ We do not consider a variant where Child Benefit is withdrawn through the income tax system but against the joint income of a couple. This would be introducing a form of joint income taxation, and would thus be a much more radical departure from the present system than an integration of Child Benefit with the existing Child Tax Credit system (or, later, Universal Credit), which would also see Child Benefit entitlement effectively assessed against joint income (and hence would have extremely similar impacts).

Box 11.1. Estimating cost and distributional impact of reforms to Child Benefit

The estimates of the cost and distributional impact of our proposals are derived from our own analysis of the Family Resources Survey using the IFS tax and benefit microsimulation model, TAXBEN. They are therefore subject to a number of inevitable limitations and inaccuracies.

First, our own estimates do not allow for behavioural responses to reforms (for example, people changing how many hours they work), or for revenue lost to the government through non-compliance or difficulties in identifying those who should be affected. We have ignored these as we have no credible means of quantifying the importance of these effects. Note that this means our proposals may raise more revenue (or cost less) relative to the government's than our estimates imply if, as we would expect, they result in less lost revenue due to administrative difficulties and behavioural responses. However, our estimate of the revenue raised from the government's proposal, which ignores these effects, is identical – £2.4 billion in 2013–14 – to the government's estimate, which incorporated £430 million of lost revenue from 'tax planning', 'non-compliance' and difficulties in identifying the appropriate families. This implies that the Treasury's estimate of the money saved from its proposal that also ignored these effects would be about £430 million higher than ours. One reason for this discrepancy is that the Treasury's estimate was produced in late 2010, whereas our figures use the economic forecast produced by the Office for Budget Responsibility on 29 November 2011. The more pessimistic earnings growth forecasts in November 2011 will have lowered the expected number of higher-rate taxpayers and hence the estimated revenue raised from the government's proposal.

Second, for the reforms in which we integrate Child Benefit with the Child Tax Credit system (options b and c), we initially base our revenue estimates on estimated entitlements to tax credits, but we adjust these to account both for non-take-up of tax credits and the fact that the Family Resources Survey (FRS) data underlying the analysis yield an underestimate of the number of people eligible for tax credits (this is most likely because it over-records the incomes of some families with children compared with the income assessed by HMRC when computing tax credits). To make this adjustment, we compute a scaling factor which we apply to the increase in tax credit entitlements that we simulate under our proposal. For the proposal that integrates Child Benefit with the Child Tax Credit but withdraws it using a second taper, we scale the estimated increase in entitlement to tax credits down by 10% because the number of families receiving Child Tax Credit in 2008–09 was 90% of the number of families who we estimate were eligible using the FRS data from that year. For the proposal that integrates Child Benefit with the Child Tax Credit, we scale the increase in tax credit spending down by 2% because the number of families receiving more than the family element of the Child Tax Credit in 2008–09 according to HMRC was 98% of the number of families who we estimate were eligible using the FRS data from that year. We apply the same scaling factors to the corresponding Universal Credit analysis in the annex: effectively, this assumes that take-up of Universal Credit is the same as take-up of tax credits. If take-up of Universal Credit is higher, which we might expect because it is intended to be simpler to claim, then the actual revenue raised by the Universal Credit variants of options b and c will be lower relative to their tax credit analogues. Our distributional analysis of the same reforms, however, does not make any such adjustments, because that would require detailed knowledge of which eligible tax credit recipients do not take up tax credits. Note that, in general, this means that actual losses from options b and c will be larger than those shown in our distributional analysis.

Table 11.2. Estimated revenue implications of alternative ways of withdrawing Child Benefit from better-off families

Policy	Revenue raised in 2013–14, compared with no Child Benefit withdrawal (£ billion)	Revenue raised in 2013–14, compared with government’s proposal (£ billion)
Government proposal	+2.4	n/a
Withdraw from higher-rate threshold at 10%	+1.7	–0.6
Withdraw from higher-rate threshold at 20%	+2.0	–0.3
Withdraw from £35,235 at 10%	+2.4	0.0
Withdraw from £38,835 at 20%	+2.4	0.0
Integrate with Child Tax Credit	+5.0	+2.7
Integrate with Child Tax Credit, withdraw using separate taper	+3.0	+0.6

Notes: Revenue estimates assume no non-compliance issues or behavioural responses. Estimated increases in tax credit expenditure are scaled up to account for discrepancies between the underlying survey data and administrative data on tax credit expenditure from HMRC (see Box 11.1).

Source: Authors’ calculations using Family Resources Survey 2008–09, TAXBEN (the IFS tax and benefit microsimulation model) and HMRC estimates of tax credit expenditure (<http://www.hmrc.gov.uk/stats/personal-tax-credits/cwtc-take-up2008-09.pdf>).

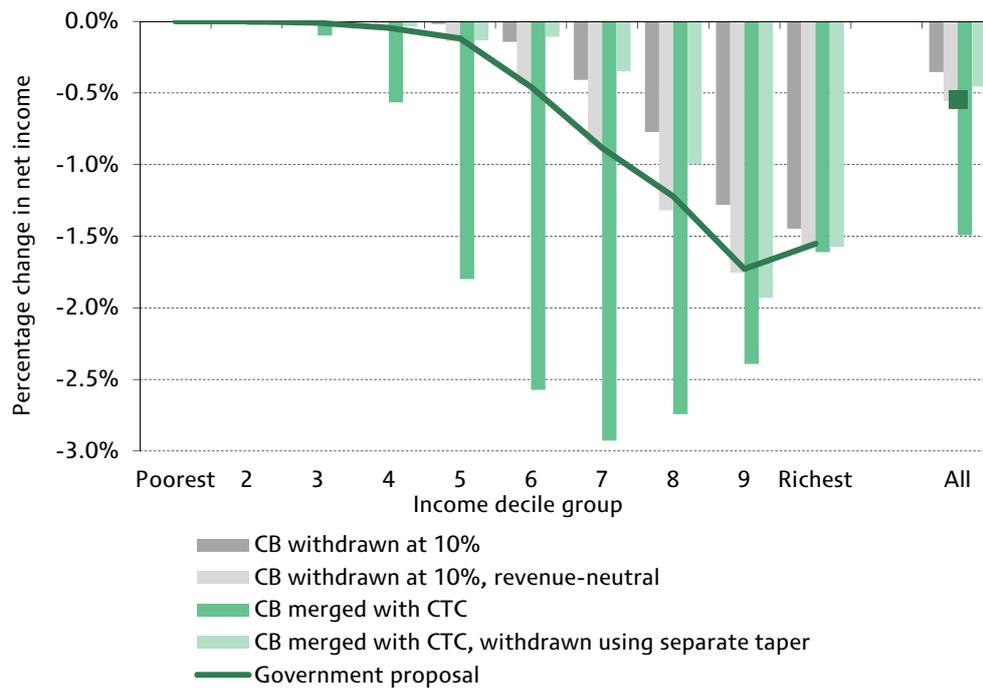
Distributional impact

Figure 11.3 shows the impacts of proposals on family incomes according to their position in the income distribution (again, subject to the inevitable limitations and inaccuracies that apply to such estimates set out in Box 11.1). The estimated impact of the government’s proposal is shown as a green line. The graph shows the following:

- All policies have very similar impacts on families in the top income decile group. This is because almost all families with children in the top income decile group would see their Child Benefit removed under all policies discussed in this chapter.
- Withdrawing Child Benefit gradually from the higher-rate threshold results in a similar distributional pattern to the government’s proposal, but the losses are generally smaller (because the policy raises less revenue). Withdrawing Child Benefit gradually but in such a way as to raise the same amount of money as the government’s proposal (by lowering the threshold at which it begins to be withdrawn) has a very similar distributional impact to the government’s proposal.²⁹
- Integrating Child Benefit with the Child Tax Credit but withdrawing using our second taper would have a similar distributional impact to withdrawing it gradually from families containing a higher-rate taxpayer.
- Straightforwardly integrating Child Benefit with the Child Tax Credit would lead to much larger losses lower down the income distribution (unsurprisingly, given the substantial amount of revenue this option would raise), with the losses as a share of income peaking in decile group 7.

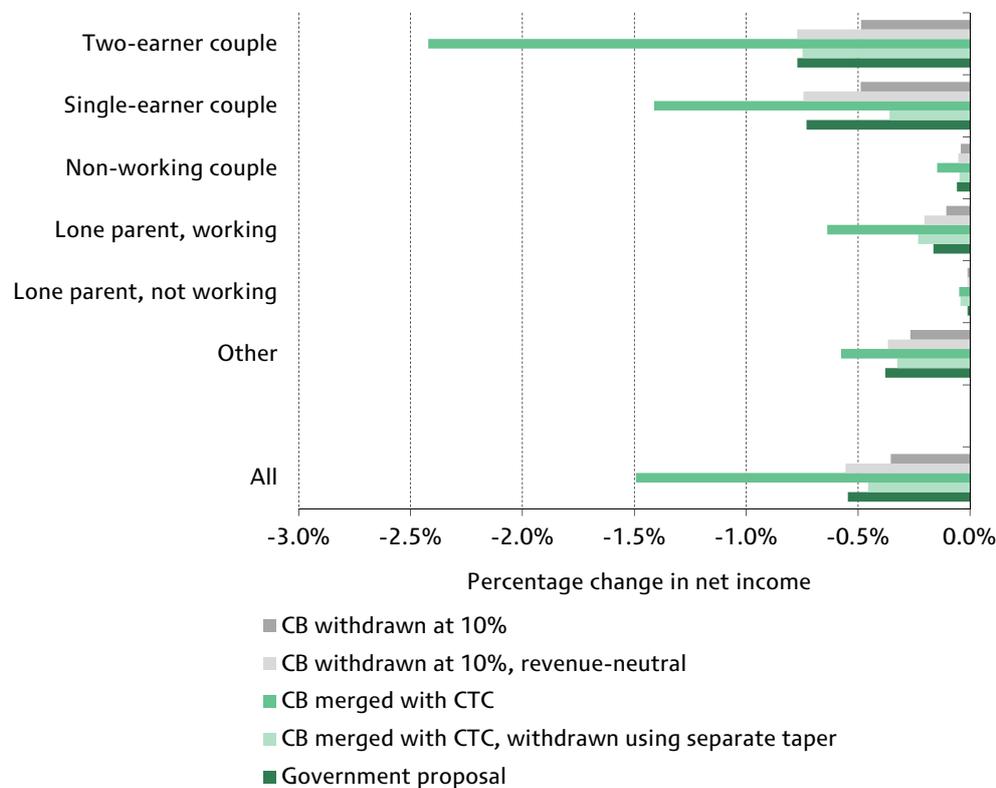
²⁹ Withdrawing it at a rate of 20% would have a similar impact to that shown here, at least at this level of aggregation.

Figure 11.3. Distributional impact by income decile group compared with a world where Child Benefit not withdrawn (families with children only)



Notes: Income decile groups derived by dividing all families into 10 equal-sized groups according to income adjusted for family size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of families, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth. Source: Authors' calculations using TAXBEN and Family Resources Survey 2008–09.

Figure 11.4. Distributional impact by family type compared with a world where Child Benefit not withdrawn (families with children only)



Source: As Figure 11.3.

Figure 11.4 shows the impact of proposals on family incomes for different family types. On average (and including the families who are entirely unaffected), the government's proposal leads to larger average losses among working couple families than among working lone parents, as the former are more likely to contain a higher-rate taxpayer. As before, the options that withdraw Child Benefit through the income tax system have similar impacts (at this level of aggregation) to the government's proposal. Integrating Child Benefit with the Child Tax Credit and withdrawing it using the separate taper would lead to smaller losses amongst families with one earner. Straightforwardly integrating Child Benefit with the Child Tax Credit would involve larger losses than the government's proposal across all family types.

11.4 Summary and conclusions

We do not take a stance on the government's current objective: to ensure that better-off families do not benefit from Child Benefit. But the way in which this ambition is pursued matters enormously to the working of the tax and benefit system. As we have shown, the government's current proposal will create real inefficiencies and inequities: about 170,000 families could increase their net income if an individual in that family managed to lower their pre-tax income; a further 200,000 families could find themselves with a lower net income if their pre-tax income were to rise slightly. It would mean removing Child Benefit from some couples whose joint earnings were £43,000 but not removing it from other couples whose joint earnings were £84,000. The sharp behavioural incentives that the proposal creates will lead to significant behavioural responses, mostly from families adjusting their taxable income to avoid the withdrawal, and there are a number of difficulties in identifying the families who should be subject to withdrawal. Together, these are expected to reduce the government's savings by around £430 million per year, or about 15% of the savings that would otherwise have been made by the reform.

The Prime Minister has recently said that the government is reconsidering the way in which Child Benefit is removed from better-off families, although it is not clear whether he dislikes the inefficiencies of the cliff-edge, or the perceived unfairness in the treatment of single- and dual-earner couples. We have offered some possible alternative solutions which achieve broadly what the government's own proposal does, whilst avoiding some or all of its undesirable consequences. Withdrawing Child Benefit gradually, rather than all in one go, could be implemented in much the same way as the government's proposal, but, without extending self-assessment to more families, would save slightly less money and affect a smaller set of families. It would still weaken affected families' incentives to increase their income but it would not give any individuals the unfair and inefficient incentive to reduce their taxable income in order to increase their net income. This alternative would, however, share the same administrative complexities as the government's proposal, and would be subject to the same possible concerns about inequities between single-income and dual-income couples. Combining Child Benefit with tax credits (or, from October 2013, with Universal Credit) would allow a more sensible withdrawal against the combined income of a couple, rather than against that of the higher-income individual. Consequently, it would lead smaller losses amongst one-earner couples and lone parents than the government's proposal. The precise design of this alternative, though, would need to depend upon the government's distributional objectives.

Annex. Variants where Child Benefit is combined with Universal Credit

This annex presents alternatives where Child Benefit is integrated with Universal Credit. These are near-equivalents to options b and c discussed in the main text.

The withdrawal of Universal Credit is to be assessed against net income, rather than gross income as under tax credits. To implement option b under Universal Credit, we withdraw the new element at a rate of 1 in 8.7 against net income which, for an adult who pays income tax at the 40% rate, is equivalent to the withdrawal rate of 1 in 15 against gross income that formerly existed for the family element of the Child Tax Credit. We begin the withdrawal at £36,000 of net income which, for a one-earner couple, is broadly equivalent to the £50,000 gross income threshold that existed for the family element of the Child Tax Credit. In other words, we have anchored option b under Universal Credit to option b under tax credits in the sense that the effective withdrawal of Child Benefit would operate in the same way for a one-earner couple (unless they have unearned income, which is to be treated differently under Universal Credit from under tax credits – see below).

Table 11.A1 shows our estimates of the cost, and Figures 11.A1 and 11.A2 show the estimated distributional impact.

There are small differences between families entitled to tax credits and families who would be entitled to Universal Credit but, in general, the estimated cost and distributional impact of combining Child Benefit with the child additions of Universal Credit are fairly similar to the near-equivalent policies that integrate Child Benefit with the Child Tax Credit.

However, there is a substantial difference in the bottom income decile group. This arises because the government proposes that Universal Credit will feature a 100% withdrawal rate applying to all unearned income and a strict assets test, similar to that which currently applies in means-tested benefits. Both represent harsher means tests than currently operate in tax credits. This means that some families with unearned income or assets would be entitled to the Child Tax Credit but not to Universal Credit; they therefore do not lose when Child Benefit is integrated with tax credits, but would lose if it were integrated with Universal Credit.

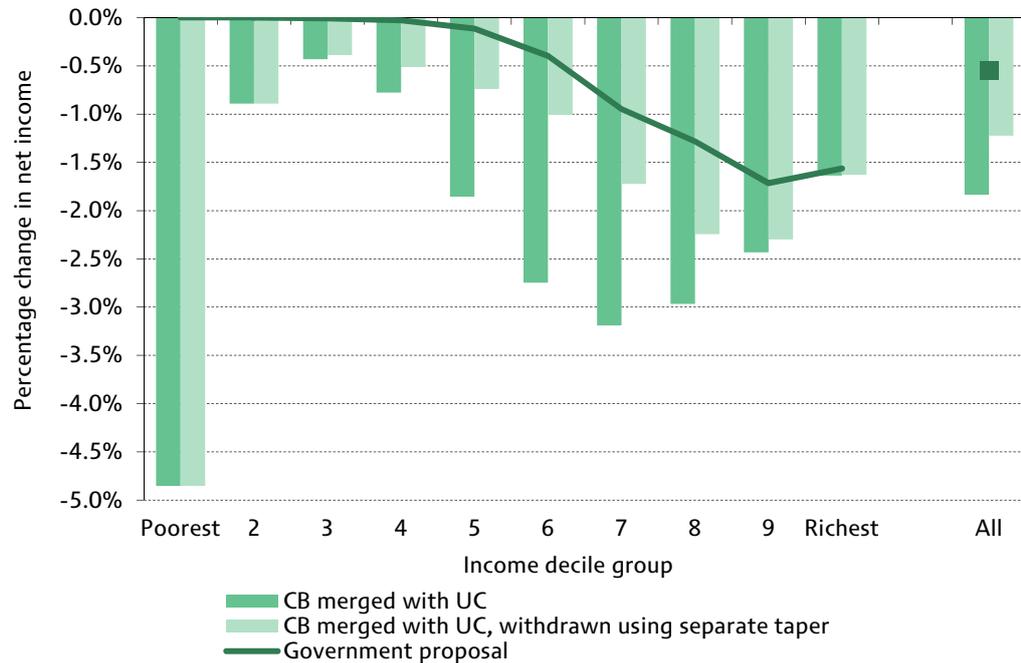
It is also the case that the policy that combines Child Benefit with Universal Credit but withdraws it using a second taper starting at £36,000 per year of net income raises considerably more money than a seemingly near-equivalent policy that combines Child Benefit with the Child Tax Credit but withdraws it using a second taper. Again, this is

Table 11.A1. Estimated revenue implications of integrating Child Benefit with Universal Credit

Policy	Revenue raised in 2013–14, compared with no Child Benefit withdrawal (£ billion)	Revenue raised in 2013–14, compared with government's proposal (£ billion)
Integrate with Universal Credit	+5.5	+3.1
Integrate with Universal Credit, withdraw using separate taper	+4.6	+2.2

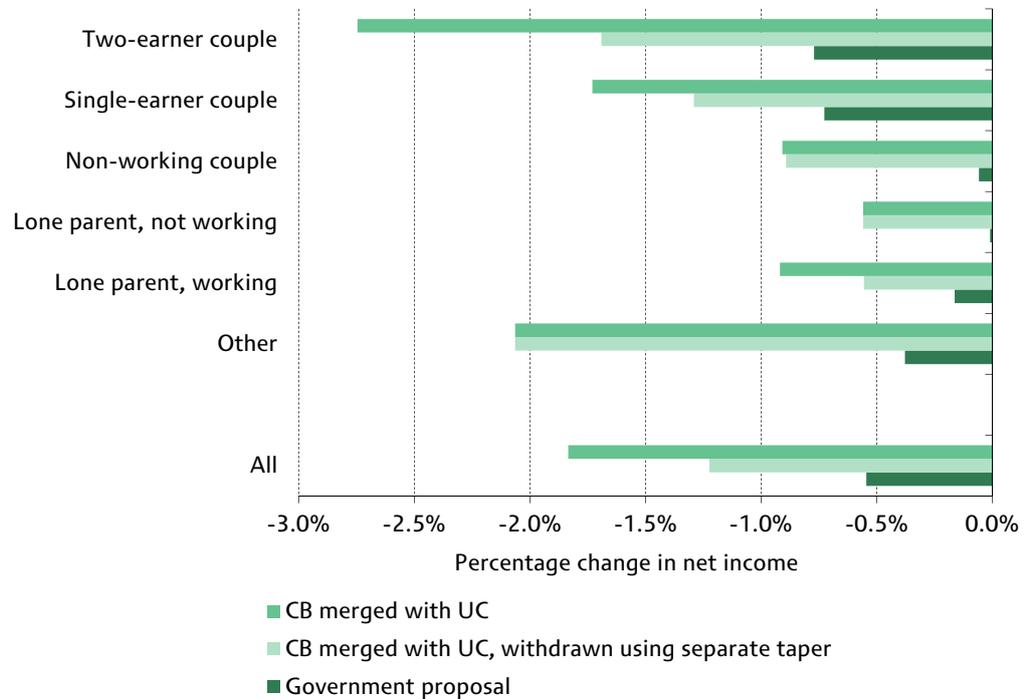
Notes and Source: As Table 11.2.

Figure 11.A1. Distributional impact by income decile group compared with a world where Child Benefit not withdrawn (families with children only)



Notes and Source: As Figure 11.3.

Figure 11.A2. Distributional impact by family type compared with a world where Child Benefit not withdrawn (families with children only)



Notes and Source: As Figure 11.3.

because of the harsher eligibility restrictions in Universal Credit relating to capital and unearned income. These different rules make a particularly big difference to the results for option b, where the earned income threshold above which Child Benefit is withdrawn is higher. This is because people with higher earnings are more likely to have capital and/or unearned income, and hence their entitlements are more likely to depend on eligibility rules relating to capital and/or unearned income – rules that differ substantially between tax credits and Universal Credit.