

Labour's tax credit changes encourage lone parents to work, but discourage many potential second earners

Changes to taxes and benefits since 1997 have increased the financial incentive to work for most lone parents. As a result, there are more lone parents in work and fewer children in poverty. However, for couples with children where one parent is already in work, the same changes have, on average, reduced the incentive for the other parent to find a job as well.

This contrast reflects the fact that, when increasing financial support for all parents on low incomes, the Government has been more generous to parents who work, but has then had to means-test that more generous support away as household income rises. Relative to the position in 1997, this encourages lone parents and one parent in a couple to work, but then discourages any effort to increase household income further.

These are the findings of new IFS research funded by the Joseph Rowntree Foundation and published today. It examines the success of the Government's "Make Work Pay" agenda, which seeks to improve financial incentives to work, and to reduce poverty amongst working families, mainly through changes to tax credits.

The Government can point to important successes:

- More parents, particularly lone parents, are working in 2004 than in 1997, and there are 350,000 fewer children in households where no adult works. This has contributed to the substantial fall in relative child poverty, which is on track to be at a level in 2004/5 last seen in the early 1990s. Academic studies agree that government policies were partially responsible for the growth in the rate of employment among lone parents.

But the impact of Labour's changes to personal taxes and benefits on the financial work incentives faced by parents is mixed. When considering whether to take a job:

- A majority of lone parents now have a larger financial reward to work than in 1997, but more parents in couples face a smaller financial reward to working than face a larger reward.
- The financial reward for a couple with children to have a second earner is now less, on average, than in 1997. This means that parents in couples now face a stronger financial incentive than in 1997 to organise their work patterns so that one of them works, and one of them cares for their children full-time.

Findings about effective marginal tax rates faced by working parents include:

- Changes to tax credits mean that low-earning lone parents now keep more of any increase in earnings they achieve than in 1997, but medium- and high-earning lone parents now keep less.
- However, over 40 per cent of working parents in couples have seen their effective marginal tax rate rise under Labour, with the average change being a rise of 5 percentage points.

Mike Brewer, a Programme Director at the Institute for Fiscal Studies, and one of the authors of the report, said: "The Government has been very successful in getting more lone parents into work, and substantially reducing child

poverty, largely through its tax credit reforms. But to limit the cost of the Government’s reforms, more working parents than in 1997 now face means-testing to withdraw benefits or tax credits as their earnings rise. This reduces their incentive to seek pay rises or work longer hours. Although fewer working parents face very high effective tax rates, Labour’s changes mean that almost 900,000 more working parents face an effective marginal tax rate of over 50 per cent than was the case in 1997.”

Looking forward, the authors argue that the Government’s recent policy towards tax credits – reducing the real value of the working tax credit while increasing the real value of the child tax credit for those who do not work – may eventually be unsustainable because of its negative impact on work incentives. They also argue that further progress in making work pay will ultimately require reform of Housing Benefit and Council Tax Benefit.

ENDS

Notes to editors:

1. *Has Labour made work pay?* by Mike Brewer and Andrew Shephard is published on 17 November by the Joseph Rowntree Foundation. It is available as a free download at www.jrf.org.uk. For details of embargoed copies, contact Emma Hyman on 020 7291 4850.
2. Mike Brewer will present a summary of the report's findings from 1pm - 2pm at the Institute for Fiscal Studies, London on Wednesday 17th November. To book a place, please contact Bonnie Brimstone on 020 7291 4818.
3. A separate press notice, “JRF reports show progress tackling poverty, but continuing problems with low pay“, issued by the Joseph Rowntree Foundation (JRF), contains details of two other reports funded by the JRF which are also released on 17 November. Contact David Utting, Associate Director (Public Affairs), 020-7278 9665 / 07930 313790 / david.utting@jrf.org.uk
4. An effective marginal tax rate measures what proportion of a small increase in gross (pre-tax) earnings is lost through income tax, employee national insurance contributions, and reduced awards of means-tested benefits and tax credits. In this report, effective marginal tax rates were calculated by increasing earnings by 5 per cent.
5. The table below (Table 4 in the report) shows the number of working parents facing different levels of effective marginal tax rates. This is the source behind the conclusion that nearly 900,000 (actually 875,000) working parents face effective marginal tax rates of over 50%, and that 225,000 (actually 224,000) fewer parents face effective marginal tax rates of over 80%.

<i>Marginal effective tax rate</i>	<i>Number of working parents facing marginal tax rates under tax and benefit systems(thousands)</i>		
	<i>April 1997</i>	<i>April 2004</i>	<i>Difference</i>
All	7,569	7,569	
More than 0%	7,415	7,395	- 21
More than 10%	7,187	7,167	- 19
More than 20%	7,056	7,062	6
More than 30%	5,878	6,423	545
More than 40%	1,802	2,947	1,146
More than 50%	875	1,749	875
More than 60%	841	1,515	674
More than 70%	793	899	106
More than 80%	488	264	- 224
More than 90%	307	116	- 191
More than 100%	34	8	- 26

Note: Authors’ calculations from Family Resources Survey 2002-3 and TAXBEN. Excludes parents aged over 55 and the self-employed. Numbers may not add because of rounding.