DELIVERED TO THE INSTITUTE OF FISCAL STUDIES BIENNIAL RESIDENTIAL CONFERENCE IN CAMBRIDGE UK, APRIL 2005.

TAX CREDITS IN ANGLO-AMERICAN COUNTRIES: CONVERGENT IN DESIGN, DIVERGENT IN DETAIL

The Anglo-American countries rely upon large state run programs for their income security arrangements and to some degree have ‘planned’ systems of taxes and transfers. Consequently, tax credits are especially relevant for these countries. As well, the government institutions and cultural values of Anglo-American countries are similar enough to allow for meaningful comparisons to each other. Non-Anglo-American countries are often characterized by more highly regulated and usually more unionized labour markets, with corporatist structures and different cultural attitudes, as well as a more organically evolved, less planned system of taxes and transfers.

So, if tax credits have a unique application in the Anglo-American world, are they merely an administrative tool, or do tax credits demark a fundamental transformation in income security programs?

Tax credits address a problem that is at once both disarmingly simple, and alarmingly complex. Put simply, the problem is this: How can governments deliver non-stigmatizing benefits to low-income households without unduly interfering in their lives? This has been one of the central issues facing governments since they began developing modern income security programs in the 1940s. Appreciating the critical importance of this problem requires a review of the history of social policy – whence the complexity.

Much of the foundation of modern social policy in Anglo-American countries may be traced to the UK’s Beveridge report. Beveridge famously set out to slay the five so-called Giants: Idleness, Ignorance, Disease, Squalor and Want. Attacking the first four giants demanded health and social services, housing and town planning and, most of all, employment. All of this seemed achievable for post-war Britain, given the experience of wartime planning. The nation’s productive capacity and human resources had been instantly transformed from the despair of Great Depression waste into a country fully mobilized for war. What could not be achieved if there were but the will to achieve it?

Attacking the fifth giant, Want, required Beveridge to tackle head-on questions with which Britain and other countries had been struggling for centuries. Is the ‘whip of starvation’ a necessary evil in a labour market in which workers are free to come and go? Would lifting the threat of economic destitution result in a flood of work-shy labourers overwhelming the public purse and, not incidentally, fuelling demand for ever-higher wages? How could the state
guarantee adequate income for a family out of work when wages themselves could well be less than adequate?

One axiom of income security design appeared self-evident: Income acquired while working had to be more than income from not working. But family needs vary by family size, while wages do not. If income security programs for those outside the paid workforce were to be adequate, their benefits would have to reflect the needs of families. However, wages do not reflect family size, so benefits would then often be higher than the earnings of low-income families with children, contravening the axiom stated above. On the other side of the coin, if low-wage workers are to have the economic capacity to raise children, without being mired in poverty, how can the income of wage earners in a free labour market take into account the added needs of their dependent children?

In Beveridge’s initial draft, his solution to this dilemma was obvious: Pay sizable child benefits both to workers and to those not in the paid workforce. In short, create a universal family allowance, of an amount adequate to pay for the incremental cost of raising a child in a low-income household. Indeed, well before he began drafting his report, Beveridge (rather presumptuously) sent out a set of fundamental assumptions to his fellow commissioners, requiring that they all ‘sign on’ so that these assumptions could form the basis of the eventual report. The second of these assumptions was that “No satisfactory scheme for social security can be devised [without a] universal children’s allowance for all children...” [Timmins 1995 20]

As often happens in the pragmatic real world of government, this fundamental assumption turned out to be not quite so fundamental after all. In anticipation of Treasury’s doubtless horrified reaction to the cost of his proposals, Beveridge discussed alternatives with several confidants, including, we note in passing, his friend John Maynard Keynes. Following these discussions, Beveridge fortuitously discovered that wages in the UK were quite sufficient to pay for the cost of a first child. So universal family allowances did not after all have to be paid on behalf of every child in a family. Instead, family allowances could serve the second and each additional child. This was a most convenient finding, because it drastically reduced the cost of the family allowance proposal.

One cannot judge Beveridge harshly on this. He was only trying to square an obstinate circle: A rational income security system demands substantial family allowances to be paid to working as well as non-working families, but paying family allowances to everyone comes at a humongous cost. This is just the tyranny of price times quantity, which arithmetically equals total costs. If there is a limit on total costs— that is, if there is a budget constraint – something has to give. Either price has to reduced – i.e., the amount of benefits paid on behalf of each child has to be less; or quantity has to be decreased – i.e., the number of families who get the family allowance has to be reduced. Beveridge chose quantity.

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Of course, one could argue that the budget constraint is a fiction. Why not raise taxes and use the money to pay out universal family allowances? The result is a large amount of cash flowing through the Treasury, but very little actually ‘sticking’ there. So why worry about the
total cost, if taxpayers’ money is just being taken out of one pocket to be returned to another pocket? Aside from the consideration that the pockets may belong to different sets of trousers, it turns out that few taxpayers are impressed with this argument. They like to get the benefits, but are often nevertheless grumpy about paying the taxes.

Raising taxes to pay higher benefits is what British Conservatives have disparagingly described as ‘fiscal churning.’ Whether Conservative, Liberal or Labour, churning might be reasonable economic theory but it is not realistic political practice. The practical reality is that there is a budget constraint. When the time comes to allocate funding among government’s many competing priorities, there are always more priorities than can possibly be financed. For any given level of financing for child benefits, the question arises, is there a better way to spend the money? Choices must be made. Price or quantity? Reducing price means less than adequate benefits for those with the lowest incomes; reducing quantity means that benefits will not be paid on behalf of some children. Beveridge came up with a rationale for reducing the quantity of child benefits paid out, by arguing that benefits did not have to be paid on behalf of the first child. This was a reasonable compromise, yet in the end it meant that the system he devised could not do the job it was meant to do for low-income families.

Was there another choice?

An alternative way to reduce quantity – an alternative that Beveridge did not recommend – was to implement an income test to allow low-income families to collect the new family allowance, while paying little or nothing to higher income families. Beveridge did not recommend this alternative, because, such an alternative was unimaginable to him. The only mechanism in 1945 for relating a measure of family income to a benefit was the much reviled and deeply stigmatizing means test. Even if he had wanted to do so, there was no way that Beveridge would have suggested that the means test could be a mechanism for delivering benefits to the working poor. Aside from the political unacceptability of such a mechanism, it was administratively impossible. As it was, just getting out the universal family allowance was a minor administrative miracle. Even if it could have somehow been arranged administratively, the take-up rate would have been negligible. Low-income working families do not apply for benefits that lump them in with the non-working poor. Much of these families’ pride resides in making their own way, and it would take more than a few pence or even a few pounds to surrender this hard won virtue.

In 1945 Beveridge was quite correct in seeing no mechanism to better target child benefits. But changes were under way in public administration, not only in the UK, but also throughout the world. A parallel system of income testing was continuing to evolve along side the income security system: the income tax. Unlike odious and much detested means testing, income tax is very much a mainstream system. There is nothing demeaning about being required to report income through an income tax system. There seemed to be an obvious fit here between the needs of the income security system and an acceptable pre-existing mechanism for income testing. In the early 1950s, not all that much of the population was part of the income tax system, but as the decades passed this efficient revenue tool was capturing an ever-larger portion
of the population. Moreover, administrative capacity was exploding. The earliest stirrings of modern information technology were emerging, and processing capacity was expanding rapidly.

By the 1960s an increasing number of schemes were being discussed to use the income tax system as the testing mechanism for social benefits. These formed part of both Labour and Conservative thinking in the UK. In 1961 a young Geoffrey Howe advocated a somewhat vague idea of a tax-based income security system as an alternative to the current system. As paraphrased by Nicholas Timmins in his Biography of the Welfare State [Timmins 1995], “The use of tax codes, [Howe] argued, would remove the stigma traditionally attached to means-testing while at the same time making possible more generous payments, because those who no longer needed them would no longer get them.” In the US, both the right and the left talked about concepts of negative income tax as a way to deliver a ‘guaranteed annual income’. In Canada, one of the first tax-based income benefits was introduced in 1966; the Guaranteed Income Supplement paid a benefit to low-income Canadians 65 and over based on their previous year’s income. The Guaranteed Income Supplement worked well from the day it was first introduced. It worked so well that the administrative innovation it represented went virtually unnoticed. No one paid any special notice to Canada’s having successfully created a non-stigmatizing income test for the elderly, the very population for whom social insurance and universal benefits were developed in an attempt to avoid means testing.

With the invention of the semi-conductor, information technology took off on an asymptotic growth curve, which is continuing to this day. Government capacity to process complex information grew exponentially. Over the next two decades Australia and Canada both ‘cashed out,’ to use an Australian phrase, their regressive tax preferences for families with children and added the savings to help finance an income-related child benefit, with income testing accomplished through the tax system. Canada also abolished its family allowance program, a demogrant that had been converted to an income-tested program, and reallocated its spending to the tax-delivered child benefit. The UK also cashed out its regressive tax allowance for families with children, but used the money to set up a universal child benefit, rather than moving to a tax credit. The US remained alone in never removing or even recognizing its tax preferences for families with children, as is discussed further below. However, in 1975 the US did set up what was then a modest refundable tax credit program – the Earned Income Tax Credit – to offset Social Security payroll taxes on low-income workers. By ‘refundable tax credit’ we mean that the value of the tax credit is paid even where the positive tax liability is nil (in the form of a cheque from the government rather than an income tax reduction). Australia and Canada also made their child tax credits refundable.

Thirty years later, an elaborate system of tax credits is in place in Australia, Canada, the UK and the US. Australia and Canada’s child tax credits provide substantial payments to families with children, and have now entirely replaced both universal benefits and tax allowances for families with children. When Canada initiated its version of a value-added tax in 1990, the Goods and Services Tax, it also introduced a refundable tax credit to help compensate those with low incomes for the increased burden of this regressive tax. In the US, the Earned Income Tax Credit grew to become its largest income security program of assistance for working households,
mainly with children. A new non-refundable child tax credit has also recently been added to the 
US tax system. The UK, since the late 1990s, although retaining its universal child benefit, has 
implemented the most extensive and complex system of tax credits, not just for children but for 
working adults as well.

Figure 1 shows the system of tax credits, tax allowances or preferences, and universal 
benefits for children, as it existed in 2003 in Australia, Canada, the UK and the US. The US 
represents a special case, as already noted and which we shall discuss further, but what we wish 
to note now is the similarity in structure of benefits among Australia, Canada and the UK. 
Australia and Canada had very little knowledge of each other’s programs. While the UK did 
consciously review Australian and Canadian designs, they went on to adapt these to best fit their 
own circumstances. We can demonstrate that the designs for child benefits in the UK and 
Canada are in fact morphologically identical with regard to their benefit structure. Figure 2 
shows child benefits in the UK and Canada with a few simple adjustments to Canada’s benefit 
and marginal tax rates, and no other changes.

This represents a remarkable convergence in the evolution of social programs. To 
various degrees all four countries have shifted their systems radically towards tax credits, or 
more precisely, towards income-related benefits that use the tax system as a basis for income 
testing.
This convergence is a result of the self-evident logic at the heart of tax credits: if it is possible to use the tax system to income test, benefits can be better targeted without the stigma of a means test. It is the same logic driving all four countries. As the UK Treasury put it in 2002:

… the income tax system provides a light touch and non-stigmatising way of measuring income. … The advent of the new tax credits offers the opportunity to introduce a new system based on the principle of progressive universalism. This means supporting all families with children, but offering greatest help to those who need it most through a light touch income test. (HM Treasury, 2002, p. 4)

Geoffrey Howe himself could not have said it better! The point here is not that Labour had adopted Conservative ideas, or that Canada and Australia have done so; rather the point is that convergence towards a system of tax credits is a logical consequence of opportunity, no matter the party or the country. In all the Anglo-American countries, parties of all stripes have supported the movement towards tax credits.

However, while there are remarkable similarities between the Anglo-American countries, if we dig deeper, substantial differences become apparent. The tax system, it turns out, is an imperfect vehicle for delivering income security benefits. It lacks what is usually called ‘responsiveness,’ referring broadly to the timeliness and precision of adjustments in benefits to changes in income. The capacity of the income tax system to deliver responsive benefits depends upon the system’s design, but the tax system is usually organized on a retrospective annual basis. The beauty of using the tax system is its simplicity and non-interference in recipient’s lives, but the more responsive the benefits, necessarily the more they must interfere – requiring more frequent income information, reporting of family composition and so on. The
The trick is to find a way to balance the need for responsiveness with the desire for simplicity. Each of the countries has attempted to achieve this balance in its own way.

Both Australia and Canada pay their tax credits in monthly instalments. But, these two countries represent opposite poles in the balance of simplicity versus responsiveness.

In Australia, the major child tax credit is based on a family’s prospective estimate of its income, with reconciliation at the end of the year to actual income as reported for income tax. Australia permits mid-year adjustments for income increases or decreases, so that a family experiencing a mid-year change in income can report its latest guess as to what its income will be and so have its credits proportionately adjusted. Thus Australia’s system is highly responsive to change in income, but at the cost of a difficult reconciliation period. In the first few years of operation, huge repayments were demanded from relatively poor families who, not surprisingly, had underestimated their prospective income. This made for many entertaining newspaper headlines and administrator angst. After a costly decision to forgive the first A$1,000 of overpayments, and other measures to get families to realize overpayments may not be in their best interest, the problem seems to have quietened down for the time being.

Canada has taken the opposite tack to Australia. The Canada Child Tax Benefit pays a pre-determined monthly amount on the basis of net income and number of children as reported through the income tax system for the previous year. There are no changes permitted during the year, excepting only a few circumstances such as change in family structure due to marriage breakup or formation or birth of a child. But whether current income goes up or down, the child tax credit continues to pay according to the previous tax year’s income. For example, by April 30th of 2005, income from the calendar year 2004 has to be reported on income tax forms. This is then used to calculate automatically tax credit entitlements and the new tax credit rate begins in July 2005, remaining in pay until July 2006. So tax credits in pay on June 2006 reflect, in part, income as long ago as January 2004.

Figure 3 shows accounting periods for the Canadian system. The Canadian system is extremely simple, with almost no special forms, overpayments or underpayments. The administrative burden on recipients is negligible. But the trade-off is that the Canadian system of tax credits is also almost entirely unresponsive.

The explanation for the evolution of different approaches in Australia and Canada is to be found in the roots of their respective systems. Australia’s tax credits have long been the main source of child benefit for those with no other source of income, so it was considered critically important to be able to ensure maximum payments go to those most in need when the need it. Australia has tried various ways to make its system more responsive, for some time permitting adjustments for declines in income but not capturing increases in income. Paying for increased benefits due to decreased income but not reducing benefits when income increases is an expensive proposition for governments. In any case, once there are adjustments for current income a second accounting period has been introduced: current year accounting. These considerations have lead to the current prospective based system.
In contrast, Canada’s refundable child tax credit was initially a kind of add-on bonus for those with low incomes, building on the (then) universal family allowance that was delivered outside the tax system. The shape of the child tax credit system in Canada reflects its national character as one of the OECD’s most decentralized federations. The federal child benefit system is not responsive to changes in income and other family circumstances. However, the provinces operate a parallel and independent system of social assistance that (until the ongoing National Child Benefit reform) included benefits on behalf of children. The social assistance system is a highly responsive (albeit intrusive) program that frequently tests for changes in income and other circumstances. Canada’s child benefit system is evolving towards a fully integrated child benefit wherein the tax credit is the main benefit and social assistance child benefits are being replaced by federal and provincial income-tested benefits. However, the emerging system of child benefits has retained its non-responsive design origins. Interestingly, no one is complaining about Canada’s system. Non-responsiveness remains a non-issue in Canada, except for a handful of experts, despite the increasing importance of tax credits in its income security system.

The UK has landed somewhere in the middle of Australia and Canada. The UK’s tax credits are estimated and put in pay based on the past year’s income as verified by the tax record, but are reconciled against current year’s income. Income changes and changes in family circumstances are to be reported during the year, and tax credits in pay are adjusted reflecting a new estimate of income for the whole current year. At the end of the year, the amount of tax credits paid is then reconciled against the amount of income actually reported, and any overpayments or underpayments calculated. Because the UK credits are calculated based on what should have been in pay all along given a revised estimate of income, they are in essence revised on an ongoing basis. In the ideal world, neither an overpayment nor an underpayment will have resulted at the end of the year. In addition, taking a cue from Australia, the UK built in forgiveness for overpayments, exempting a £2,500 increase in income per year.

Like Australia, the UK’s system requires lots of special forms and administrative work for recipients and, at least until recently, for employers as well. The UK also had its share of negative publicity, although the headlines about administrative problems never quite reached the
fevered pitch of the Australian media. It remains to be seen whether these were just teething problems of a new system, or whether they are endemic to the complex arrangements and administrative demands of the UK system.

Part of the explanation for the UK’s approach to tax credits may be found in its tax system. Of the four countries discussed here, only the UK has a fully developed pay-as-you-earn system of income tax, wherein most people do not have to fill out an income tax form annually on their own behalf. In the other three countries, income tax liability is deducted on pay cheques, and the self-employed must make quarterly instalments -, but these are at best a rough approximation of the amount of tax that will actually be owed at the end of the year. In Australia, Canada and the US, there is no ongoing process of recalculation during the course of the year. In these three countries, an annual income tax reconciliation takes place after the end of the tax year wherein detailed tax liabilities are calculated with a resulting refund or payment due depending upon the amount paid in deductions during the year. In Australia, Canada and the US, almost every adult fills out their own income tax form. Employers are responsible for the tax deduction system and for sending out tax information slips to taxpayers, but are otherwise not involved in income tax filing on behalf of employees. In contrast, the PAYE system has accustomed the UK to the concept of ongoing recalculation of benefits during the year.

Not incidentally, the UK was also the last of the four countries discussed here to introduce an extensive tax credit system and so consciously attempted to get the best of all the others’ experience.

In contrast, the US was among the first countries to develop a significant tax credit – the Earned Income Tax Credit – and it has been influential in other countries as well. The UK’s early foray into the tax credit system, in ‘New Labour’s’ first Budget, was designed to emulate the US tax credit system. The US tax credit system is much like Canada’s except that the former is y paid mainly in a single lump sum, at the request of recipients, rather than monthly and there is no attempt to integrate it into a larger income security system – perhaps because there is little of a larger income security system within which to integrate. Other than lump sum payments, the US system is exceptional in two main respects: first it is unreformed in maintaining regressive tax allowances for families with children. These have not been converted into progressive tax credits. Second, the US system of tax credits pays nothing to those with no income.

The continued presence of a regressive tax allowance may be attributable at least in part to the US tax system. The US tax system is family-based, not individual-based. There are different tax forms with different rates for various structures of families. It requires a cross comparison to understand that there is a tax preference for families with children and that this tax preference is regressive in impact. Rarely is this aspect of the benefit structure for families recognized when the system of tax benefits for children in the US is described, even by academics and experts in child benefits. Despite this, as can be seen in Figure 4, tax allowances are actually the largest component of public support for children in the US. Australia, Canada and the UK all had much more transparent regressive tax allowances for children, and long ago
converted these into tax credits or, in the UK, into a universal child benefit, thereby shifting funding from upper-income to lower-income families. The US system looks much like the Canadian system before the latter was reformed in the mid-1980s.

![Figure 4](image.png)

The other notable peculiarity of the US system is its lack of payments to those with no income at all. Explaining how and why this came to be would doubtless take a several hundred-page discourse. Likely it has much to do with American attitudes towards individual responsibility for success and failure, which are in turn to some extent based on a racialized perception of poverty. But this is to venture far from the topic of this paper: tax credits.

We can draw four main points from this brief survey of tax credits in Anglo-American countries:

First, all the countries have made increasing use of what they are calling tax credits, which feature to a greater or lesser extent reliance upon the tax system. Superficially, the systems in Australia, Canada and the UK are strikingly similar.

Second, Canada and US are the only tax credits fully integrated with their tax systems. Australia and the UK’s tax credits make use of tax information but are essentially independent systems with different accounting periods. Consequently, both the UK and Australia have lots of additional administrative requirements and complexities, but what they lose in simplicity they gain in responsiveness.
Third, tax credits are a flexible instrument that permits countries to adapt and use them in a way that reflects their differing institutions and history.

And fourth, to return to the question asked at the beginning of this paper – are tax credits merely an administrative tool, or do tax credits mark a fundamental transformation in income security programs? – Australia, Canada and the UK have deliberately set out to use tax credits as a vehicle for transformation of their income security systems, at least for children’s benefits and working income supplements. Tax credits have allowed these three countries to pay higher benefits to those with the least income and, in the case of Australia and the UK, to solve Beveridge’s dilemma. Canada is heading down this path as well, although it is not quite there yet. In contrast, these issues are nowhere on the public agenda at the present time in the US.

What is the future likely to bring? Are tax credits going to be used more extensively in the future? Or have they reached the end of their utility? In the UK context, one cannot but notice the anomaly of the continued universal child benefit. If the child tax credit works well and becomes a regularized and accepted part of the system, it is likely that future UK governments, under fiscal pressure, will begin rolling part or all of the universal benefit into the tax credit system – especially if advocacy groups begin to see that the old aversion to means testing is now out of date and that the tax system offers a way to combine the best of universality with a more progressive benefit structure, into a new kind of ‘progressive universality.’

More fundamentally, however, can the tax credit system be used to transform ‘adult benefits’ as it has been used to reform ‘child benefits’? The UK may be pioneering this strategy with its Family Tax Credit, but would it be possible to go further and replace the core assistance for those in need?

In the Canadian context, the Caledon Institute is now developing a proposal to use the tax system as the basis for delivery of a new adult benefit for those with a temporary requirement for income. What we are provisionally calling the ‘Temporary Income Program’ would provide a time-limited refundable tax credit to any adult of working age who requested it. The tax credit would then be retrospectively income tested through the tax system and any excess tax credits would be repaid, with a partial restoration of the entitlement period. For example, say that the entitlement was $500 a month for six months every three years, with repayment at 75 percent of income beyond $15,000 per year and restoration of 75 percent of entitlement for all periods repaid. This means that someone who collected benefits for six months and had a $19,000 income would repay all $3,000, but would be re-entitled to four and a half months tax credits in the new year. This benefit structure is meant to discourage anyone with higher income from using his or her entitlement, but at the same time it allows for unregulated on-demand citizen-initiated temporary income assistance. There is no problem with work incentives: partial restoration of entitlements effectively provides a big benefit for anyone who earns enough income during the year to catapult them into the high repayment zone.
Of course, a last resort social assistance system would still be needed for those who run out of temporary income after six months and have no job, but our data shows that in Canada about 40 percent of social assistance recipients are on assistance for six months or less. Use of tax credits retrospectively income tested through the tax system can provide a non-intrusive, non-stigmatizing, low administrative cost alternative so that this caseload would never come on to assistance at all. This fundamental reform would allow intensive resources to be used where they are needed most: with longer-term caseload.

It remains to be seen whether the Caledon proposal or other radical proposals for continued transformation of the income security system are ever brought into reality. But we can see even from the experience to date that continued development of information technology capability and increasing experience with tax credits have provided the basis for a new type of progressive income security system. This administrative tool can indeed provide a mechanism for a fundamental transformation in our income security programs.

Bibliography


