briefing notes

FAMILY CREDIT AND THE WORKING FAMILIES' TAX CREDIT

Andrew Dilnot
Julian McCrae

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The Family Credit System and the Working Families’ Tax Credit in the United Kingdom

Andrew Dilnot and Julian McCrae
Institute for Fiscal Studies

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7 Ridgmount Street
London WC1E 7AE
Tel 020 7291 4800
Fax 020 7323 4780
mailbox@ifs.org.uk
www.ifs.org.uk

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1. Introduction

There has been a system of support for working families with dependent children in the UK for almost 30 years. In 1971, as a supposedly temporary measure while policies to address the problem of family, and especially single-parent, poverty were devised, family income supplement (FIS) was introduced. FIS was a means-tested benefit for families with an adult working at least 24 hours a week and with a dependent child. Initially, numbers were quite low, but they grew significantly through the 1970s and 1980s, as shown in Table 1. There were three reasons for this growth — increased generosity of the benefit, higher take-up, and a growth in the eligible population, in particular that of single parents. In 1988, FIS was renamed family credit (FC), with some structural change and an increase in generosity (Dilnot and Webb, 1988). Take-up continued to rise, as did the size of the eligible population and the generosity of the benefit, leading to further increases in numbers receiving. In the first half of the 1990s, the hours requirement was cut to 16 per week, and a childcare disregard was introduced to encourage higher participation especially amongst mothers of young children (Dilnot and Duncan, 1992). The take-up of the childcare disregard has been very small, but overall numbers have continued to rise, reaching more than three-quarters of a million before the introduction of another reform, the replacement of FC by the working families' tax credit (WFTC) in October 1999. The government estimates that, after the reform, nearly twice as many families will be in receipt of WFTC as received FC.

Table 1: Number of individuals receiving FIS/FC/WFTC

	Number of recipients
1971	71,000
1985	199,000
1990	317,000
1995	600,000
1999	780,000
Post-WFTC (government estimate)	1,500,000

The introduction of WFTC is one of the new Labour government's flagship policies, aimed at improving incentives to work. The cost of the policy change is large and the numbers covered substantial, although to a large extent WFTC is simply building on policies that have been in place for nearly 30 years. Our paper focuses on the effects of the WFTC reform, rather than the more difficult question of the overall impact of either FC or WFTC, although given the scale of the reform, we would expect the issues that arise to be much the same.

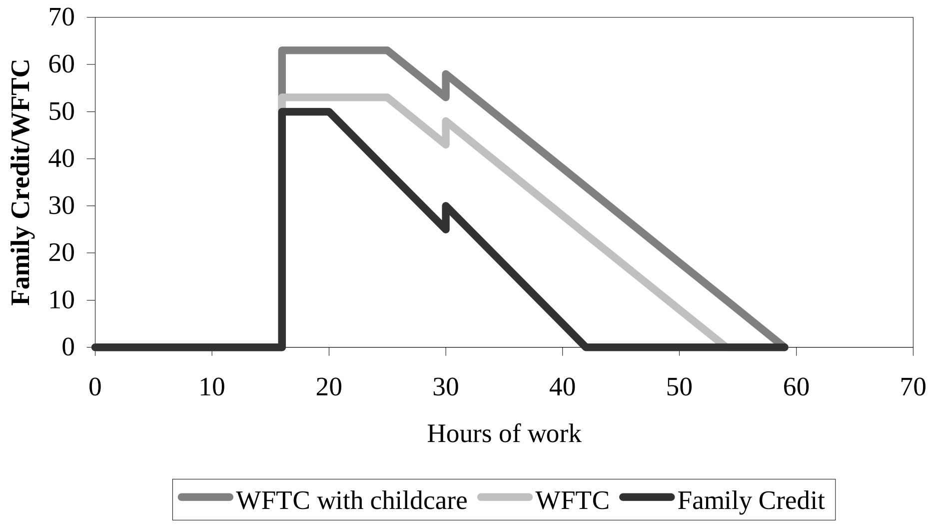
In Section 2 of this paper, we describe the structure of FC and the reform that will introduce WFTC, noting some characteristics of the population to be targeted. In Section 3, we discuss the ways in which the WFTC reform might affect incentives to work for different types of household. In Section 4, we discuss a series of issues that deserve attention and discussion in the context of the UK reform, and perhaps more generally in the consideration of policies of this type.

2. The structure of family credit and the WFTC reform

Family credit was the main UK in-work benefit from 1988 until October 1999. It was designed to provide support for low-wage families with children who are working. A family with children needed to have one adult working 16 hours or more per week to qualify for FC. Each family was potentially eligible for a maximum amount, depending on the number of children in the household and a small addition if they worked full-time. This maximum amount was payable if the family's net income (after income tax and National Insurance contributions) was lower than a threshold (£80.65 per week). Net income in excess of this threshold reduced entitlement to FC from the maximum by 70p for every £1 of excess income. The basic structure of FC is shown in Figure 1.

Family credit was payable for six months at a flat rate regardless of changes in the claimant's circumstances in order to minimise administrative and compliance costs and to remove the effects of the high withdrawal rate over the period of the fixed payment. It was paid to mothers even when the eligibility was in respect of the father's earnings. The average payment at the end of 1996 was £57 a week. Take-up of FC after its introduction in 1988 was initially low but has since increased. The latest estimated take-up rates are that 69% of eligible individuals take up 82% of the potential expenditure.

Figure 1: Increased generosity of in-work support



Starting in October 1999, family credit is to be replaced by the working families' tax credit. WFTC will be substantially more generous than FC. By the end of the century, the government expects to be spending £5 billion per year (1.5% of government budget, 0.6% of GDP) on WFTC, almost £2 billion more than was expected under FC. WFTC will increase the generosity of in-work support relative to the FC system in four ways:

- a credit for children of between £19.85 and £25.95 per week;
- an increase in the threshold from £80.65 to £90 per week;
- a reduction in the taper from 70% to 55%;
- a childcare credit of 70% of actual childcare costs up to £150 per week.

The effects of these changes relative to FC are shown in Figure 1. Those currently receiving the maximum payment see a small increase in the level of their payment if they have children under the age of 11. Those with net incomes between £80.65 and £90 move from being on the taper to receiving maximum support. The others on the taper see the taper rate fall from 70% to 55%. The largest cash gains go to those people who are currently just at the end of the taper. The increased generosity of in-work support also creates new entitlement to in-work support.

The final element of the increased generosity of the WFTC reform is the childcare credit. This replaces a childcare disregard in FC, which has suffered from very low levels of take-up. The credit increases the maximum amount of WFTC by 70% of childcare costs up to a maximum of £100 per week for those with one child or £150 per week for those with two or more children. The credit is available to lone parents and couples where both partners work more than 16 hours per week. The effect of the credit is also illustrated in Figure 1.

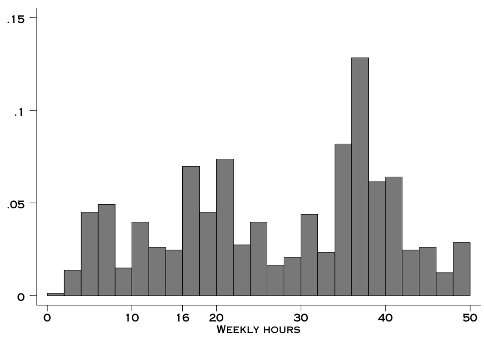
It should be noted that two further means-tested benefits — housing benefit and council tax benefit — may also be payable at the same time as FC/WFTC. In these cases, the increase in the disposable income of a family as a result of the WFTC reform may not be the same as the increase in the level of FC/WFTC payment, as entitlement to other benefits may be reduced. These interactions with other benefits are taken into account in the budget constraint examples that follow.

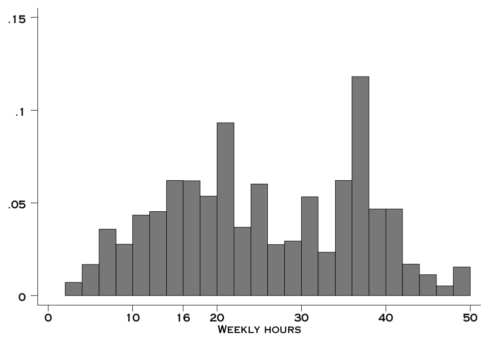
2.1 Population characteristics

There are two main groups targeted by WFTC and FC — lone parents and couples. The labour market participation rate for these groups is 40% for lone parents, 82% for men in couples and 57% for women in couples. Figure 2 shows the distribution of hours for these groups. For men, the basic decision is one of whether to participate or not — virtually no men work part-time. Women, on the other hand, work at a wide range of hours levels. There are also clear indications of the impact of the benefit system on female labour supply, with a spike in the distribution of hours for lone parents at the 16 hours point, the cut-off for eligibility for FC.

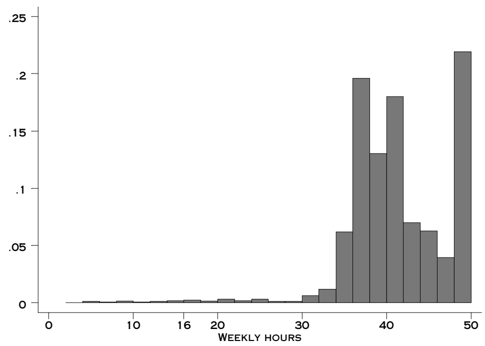
Figure 2: Hours of work by family types

Lone mothers *Women in couples*





Men in couples



Source: Family Resources Survey, 1994–95.

2.2 Childcare expenditure

One key element of the WFTC reform is the childcare credit. This could potentially have a large impact on labour supply decisions. Table 2 shows the type of childcare used by families where the youngest child is below school age. For couples, over one-third report that they use no childcare, while just over 25% use relatives and just under 25% use formal childminders or nursery care. For lone parents, the largest difference is in the numbers reporting no childcare, which are below 10%, and a corresponding increase in those depending on relatives.

Table 2: Type of childcare usage when youngest child aged under 5

Type of care	*Couples*	*Lone parents*	*All*
No care reported	35.4%	9.3%	32.9%
Relatives only	28.7%	44.0%	30.1%
Relatives and friends combined	1.1%	4.4%	1.4%
Friends only	3.0%	9.8%	3.6%
Childminders only	11.2%	11.1%	11.2%
Nursery care only	7.1%	6.7%	7.1%
Childminders and informal combined	2.5%	3.4%	2.6%
Nursery care and informal combined	4.3%	7.5%	4.6%
Multiple formal care	3.4%	1.0%	3.1%
Other forms of care	3.3%	2.6%	3.3%
Total	100.0%	100.0%	100.0%

Source: Family Resources Survey, 1994–95 and 1995–96.

3. Potential incentives of WFTC

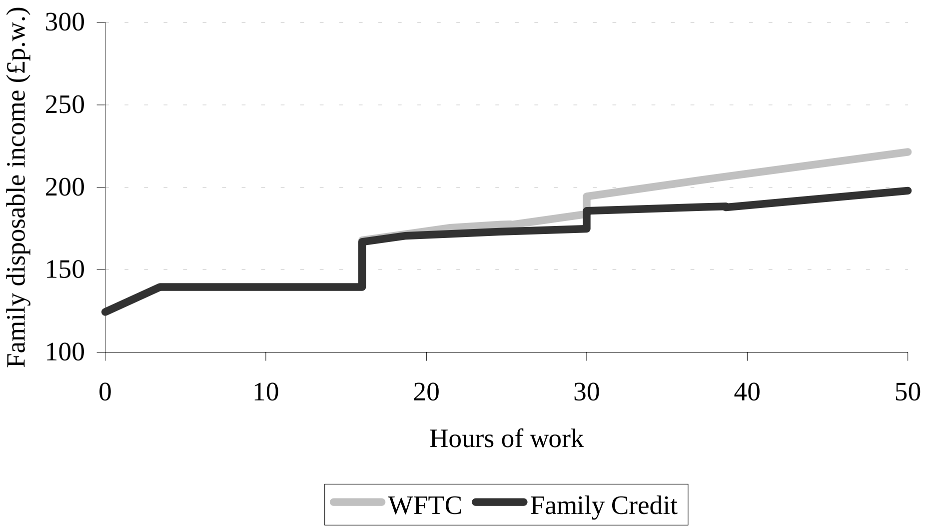
WFTC is designed to influence the work incentives of those with low potential returns in the labour market. It does this via the increased generosity of in-work payments, which are to be called tax credits rather than social security benefits from October 1999. This does indeed increase the work incentives for certain groups. However, in some cases, the incentives created by WFTC are likely to lead to *lower* participation in the labour market.

The aim of this section is to examine how we would expect WFTC to influence work incentives by looking at the changes in typical budget constraints faced by individuals. It must be stressed that these examples are merely illustrative and it is dangerous to generalise too widely on the basis of them.

3.1 Incentives for lone parents

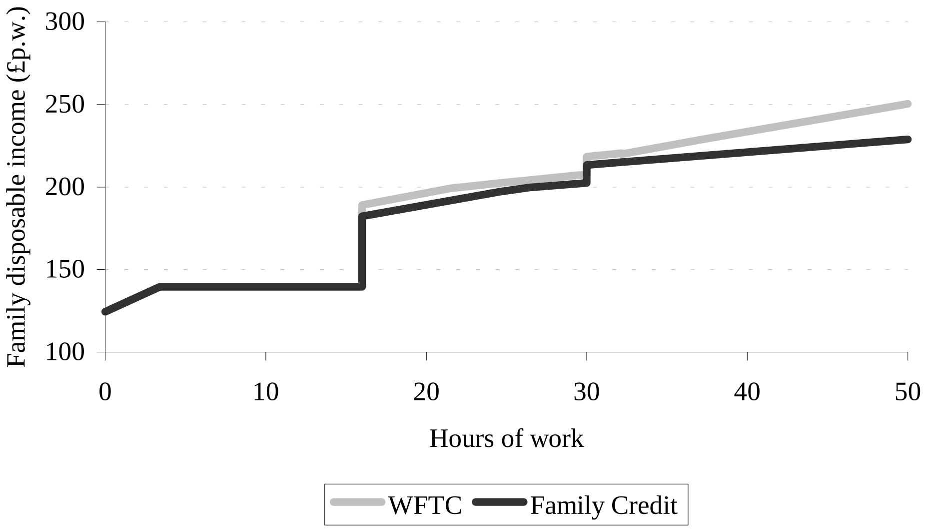
As an illustration of the likely impact of WFTC on the work incentives of lone parents, Figure 3 presents the change in the budget constraint of a lone parent with one child. It is clear that the reform unambiguously enhances the probability of participation. However, the increase in net income is small below 25 hours of work. Above this hours level, the reduction in the WFTC taper starts to increase the returns to working. In terms of hours of work for those already working, the direction of any change is ambiguous. In the example, the marginal tax rate remains at almost 70% even under the WFTC reform.

Figure 3: Budget constraint for example lone parent without childcare costs



Notes: 1 child aged under 11
Hourly wage £4.39 (median for lone parents)
Rent £41.10 p.w. (median for social renters with children)
No childcare costs

Figure 4: Budget constraint for example lone parent with childcare costs



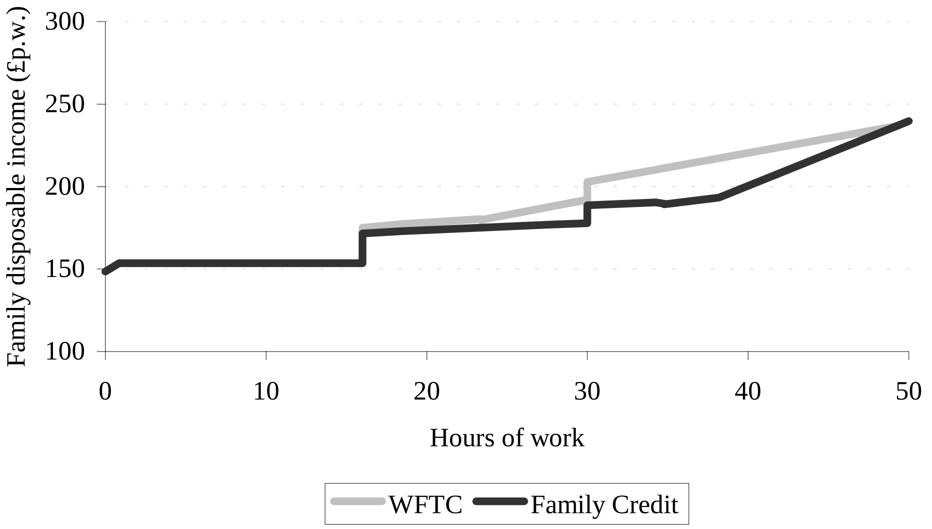
Notes: 1 child aged under 11
Hourly wage £4.39 (median for lone parents)
Rent £41.10 p.w. (median for social renters with children)
Childcare at £1.96 per hour

Figure 4 shows the effect of the childcare credit. We assume that the childcare costs £1.96 per hour and predict childcare as in Blundell et al. (1999). Note that disposable income is gross of childcare expenditure. Again, it is unambiguous that the returns to entering the labour market increase. Additionally, for those at lower hours levels, there is a small but appreciable increase in income.

3.2 Incentives for men in couples

Figure 5 shows the effect of the WFTC reform on an example man in a single earner couple. Again, the incentives for those previously not participating are unambiguously to move into work. Indeed, the gains are far larger than for our lone parent example, as the largest cash gains from the WFTC reform accrue to those at the end of the current taper. The incentives to change hours of work are ambiguous. But one interesting point is the marked increase in the effective marginal tax rate for those who become eligible to WFTC as a result of the reform. They face an increase in their marginal tax rates from 33%, produced by income tax and National Insurance, to just under 70%, produced by the interaction of the 55% WFTC taper on post-tax income. In the example, the marginal tax rate rises from 33% to just under 70% above 40 hours of work.

Figure 5: Budget constraint for example man in couple without childcare costs

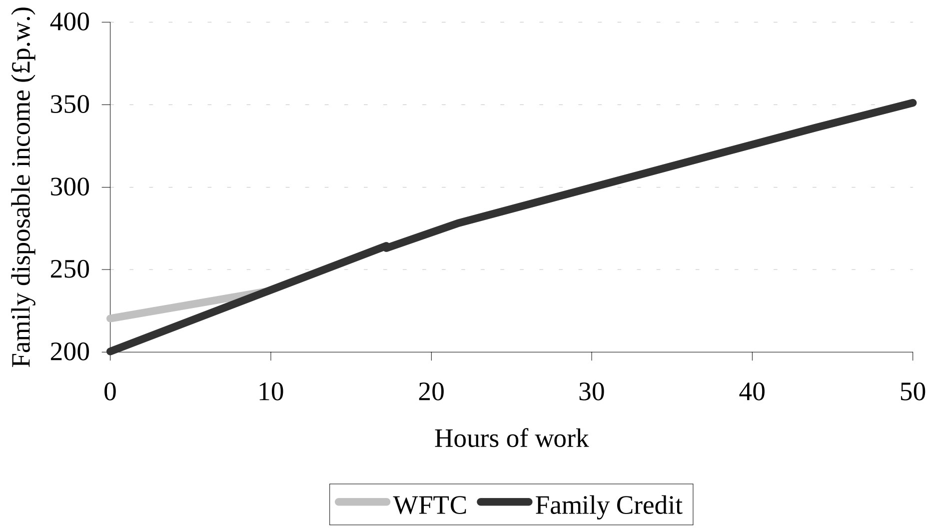


Notes: Spouse not working
1 child aged under 11
Hourly wage £5.87 (25th percentile for men in couples with children)
Rent £41.10 p.w. (median for social renters with children)
No childcare costs

3.3 Incentives for women in couples

One point that is often forgotten about increasing in-work means-tested benefits is that they can lead to incentives to move out of work altogether. Figure 6 shows the budget constraint for the partner of the man in Figure 5, which is conditional on the man working 40 hours a week. Thus the family income of the woman when she does not work is that shown at the 40 hours point in Figure 5. This means that the income at zero hours has increased through the WFTC reform. In the example, anyone working more than 10 hours has an increased incentive to reduce their hours or move out of work altogether.

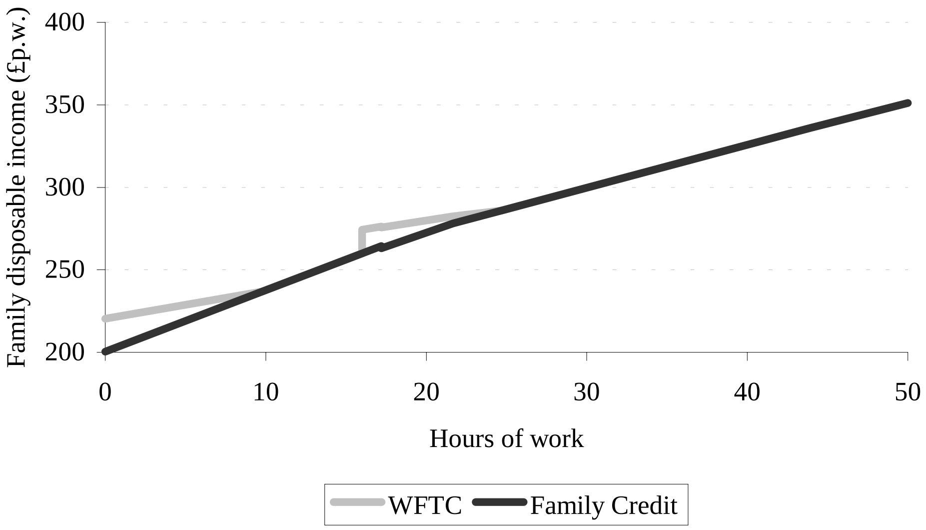
Figure 6: Budget constraint for example woman in couple without childcare costs



Notes: Spouse working 40 hours at £5.87 per hour
1 child aged under 11
Hourly wage £3.72 (25th percentile for women in couples with children)
Rent £41.10 p.w. (median for social renters with children)
No childcare costs

The situation changes when we allow for childcare costs. For couples, the childcare credit is only available when both partners work more than 16 hours per week. Figure 7 repeats Figure 6, but this time allows for the use of childcare at a cost of £1.96 per hour. Here, there is an additional incentive to work just over 16 hours to take advantage of the childcare credit.

Figure 7: Budget constraint for example woman in couple with childcare costs



Notes: Spouse working 40 hours at £5.87 per hour
1 child aged under 11
Hourly wage £3.72 (25th percentile for women in couples with children)
Rent £41.10 p.w. (median for social renters with children)
Childcare at £1.96 per hour

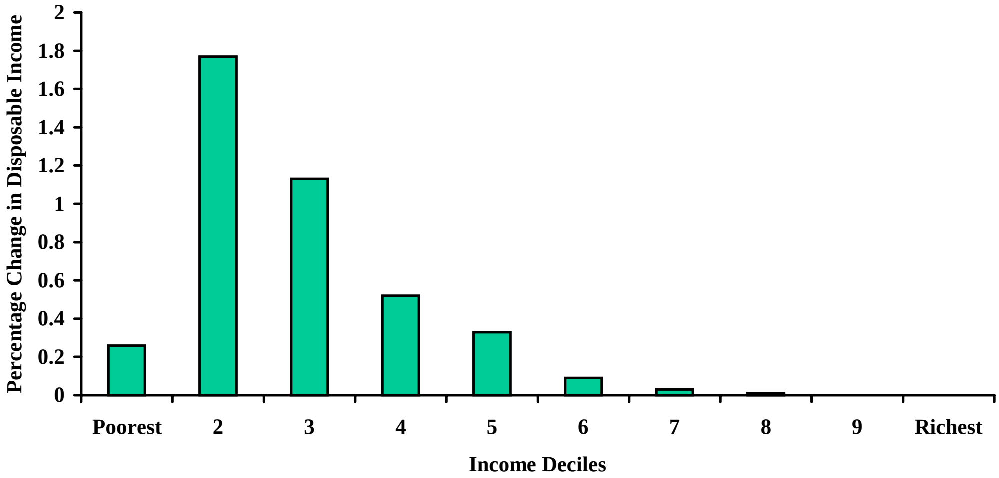
4. Outstanding issues

4.1 Redistribution or labour market effect?

As we noted at the beginning of the paper, the UK has had an in-work benefit for nearly 30 years, and over that period, both the costs and the numbers receiving have grown very substantially. There can be little doubt that such an instrument is a relatively well-targeted means of addressing the potential labour market problems caused by low wages/productivity, the need to care for children and the presence of an out-of-work benefit system. By the late 1990s, before the introduction of WFTC, FC was already a relatively generous payment and was received by 3% of the working population. It is therefore vital to recognise that a large part of the importance of WFTC is as a redistributive instrument. WFTC is an extremely well-targeted form of redistribution, directing extra money to low-paid families in work with children. The generosity of WFTC is a reflection of the political priorities of the new Labour government.

The distributional impact of the increased generosity of WFTC over FC is shown in Figure 8, drawn from Giles and McCrae (1998). This shows the average percentage change in disposable income by income decile generated by the introduction of WFTC. The deciles are based on family income equivalised using the McClements equivalence scales. The majority of the gains from this change are in the poorer deciles, with the second poorest decile gaining the most. Virtually none of the gains from this change go to households in the richest half of the income distribution. This pattern contrasts sharply with even the most progressive means of reducing the income tax burden, such as increases in income tax allowances, where the largest average gains tend to go to families in the sixth and seventh deciles.

Figure 8: Distributional impact of WFTC



Despite these very significant redistributional effects, much of the rhetoric surrounding WFTC has focused on the labour market effect of its introduction. The UK government, while ascribing great importance to this effect, has not made any estimates of its likely size. Such estimates are difficult to make, and greater clarity will be possible once micro-data are available for the post-WFTC period. Estimates for the family credit era (see, for example, Duncan and Giles (1996)) suggest a fairly small, albeit positive, effect for the increases in generosity of FC in the early 1990s. Colleagues at IFS were asked by the Monetary Policy Committee of the Bank of England to make an estimate of the likely effects of the introduction of WFTC, using cross-section micro-data, and found a likely increase in economy-wide participation of between 10,000 and 45,000 (Blundell et al., 1999; Bank of England, 1999). The participation rate for single parents was estimated to rise from 39.8% to 42% and for women with unemployed partners from 41.9% to 43.2%, while for women with employed partners the participation rate was estimated to fall from 67.6% to 67%.

A different approach, which used data from the UK Quarterly Labour Force Survey and sought to model the impact of reform on entry rates to the labour market, found a maximum increase in participation of around 90,000, although this effect was not robust to controlling for family type in modelling and assumed constant exit rates pre- and post-reform (Gregg et al., 1999).

Unless the labour market effect is much larger than this, which we can see little reason on past evidence to expect, the principal outcome of WFTC will be a redistributive one, and it is largely on the merits of that that the change in policy should be judged.

4.2 Marginal rate structure

Much political debate in the UK has failed to recognise the trade-off between improving the participation/non-participation choice and the hours of work choice conditional on participation. In particular, the negative effect on work incentives of high marginal withdrawal rates extending up the income distribution as taper rates are cut is often ignored. The WFTC reform increases marginal tax rates for many, as shown in Figures 5 and 6, without substantially increasing the returns to working relatively low hours.

Table 3, also drawn from Giles and McCrae (1998), shows the effect of the reform on marginal tax and benefit withdrawal rates for the UK population as a whole. The first set of columns show the number of individuals whose marginal tax rates are in each range before and after the introduction of WFTC. The second set of columns show the numbers with marginal tax rates in that range or above. There is a reduction of 450,000 in the number of people with marginal tax rates above 70%. Most of the people in these groups see their marginal tax rates fall to the 60–70% range. In addition, a large number of people are drawn into higher marginal tax rates through the increase in the number of recipients of in-work support. These two factors contribute to the sharp rise in the numbers with marginal tax rates between 60% and

70%. Overall, while the number with marginal tax rates above 70% falls by 450,000, the number with marginal tax rates above 50% increases by 460,000.

Table 3: Number of individuals with altered marginal tax rates (thousands)

Range	*Numbers in range*			*Numbers in range or above*		
	Before	*After*	*Change*	*Before*	*After*	*Change*
50–60%	0	207	207	810	1,274	464
60–70%	79	790	711	810	1,067	257
70–80%	266	17	–249	731	277	–454
80–90%	235	145	–90	465	260	–205
90–100%	222	115	–107	230	115	–115
> 100%	8	0	–8	8	0	–8

A greater participation effect might have been achieved by concentrating resources on increasing the reward to entering the labour market by increasing the starting level of WFTC, rather than by spreading the coverage further up the income distribution through cutting the taper rate and therefore increasing marginal rates for many individuals. The apparently common-sense assumption that lowering tapers must be good is far from obviously true; it may be better to have higher taper rates affecting a smaller group.

4.3 Childcare

Much work has shown that a major determinant of women's labour market behaviour is the presence of young children in the family, so an obvious policy response for those seeking to increase labour market participation is to subsidise childcare in some form. The WFTC reform might be important in this area, but its results are very uncertain. As shown earlier, much childcare in the UK is informal. Simply formalising informal arrangements would have a large revenue cost to the government with little other outcome. An alternative result would be a growth in the use of formal childcare with a large and beneficial impact on the lifetime welfare and productivity of the children of WFTC participants. But it is worth emphasising that if the most effective form of action is to change childcare arrangements, a whole range of more direct policies are available to government and might be more effective. Close monitoring of this area in the coming years is vital to adequate evaluation of the scheme.

4.4 Administration

Administration and implementation matter a great deal in this area. In the UK, the combination of an individual-based income tax system (since 1990) and a family-based benefit system creates particular difficulties. For the reformer, these are exacerbated by a cumulative income tax deduction system with fewer than one-quarter of all taxpayers required to file tax returns.

One of the most troublesome issues to arise out of the individual-tax/joint-benefit unit of assessment relates to getting money to caring parents. We have an individual income tax system but a strong desire to pay benefits (or tax credits where they are substitutes for benefits) to those on low family income. If the system of support is run within the social security system, as FC was, the natural way of directing resources to the caring parent is simply to pay the benefit to that parent, even where the adult in the family in paid work is not the caring parent. This was the way in which FC operated. Shifting to payment through the pay-packet, as with WFTC, automatically delivers the payment to the person in paid work, which in most cases will be the man in the couple. The UK government response is to make payment through the pay-packet optional, with the payment going to the mother if the couple agree. This may not be an entirely satisfactory compromise.

We see here again a potential tension between redistributive and labour market objectives. The redistributive objective is presumably to get money to families with children, but especially to the children. The labour market objective may be more effectively met if the person going to work sees a larger pay-packet, rather than the money going direct to the mother, but there is a clear risk that less money will, in these circumstances, flow to the mother and children.

A related implementation issue is compliance costs for employers, although in the UK these seem unlikely to be large where employment is stable, given that the receipt of claims and calculation of entitlement will be the responsibility of the government, which will send employers notification of how much to pay into the recipient's salary. But the process for ensuring that payment continues as an individual shifts from one employer to another may be more burdensome.

4.5 Presentation

This is an area of policy where presentation may be very important. It has been argued that the Labour government would have found it much more difficult to allocate nearly £2 billion per year to something called an increase in social security benefits than to something that can be presented as a tax cut. This may be true, but seems an argument over which to be at least a little wary.

A second aspect of presentation relates to the attitudes of potential recipients. Low take-up rates for means-tested benefits have often been partially explained by the stigma associated with claiming such benefits. Changing the feelings associated with this type of transfer into more positive ones is a worthy goal. One way of achieving this may be a change of name, although this has been tried before, in 1988, when family income supplement was renamed family credit. A more effective part of the WFTC reform in this context is perhaps the shift in payment to the pay-packet.

A third important aspect of presentation relates to information. Low-paid parents in work or potentially in work may simply not know that they may be entitled to some help. The publicity surrounding change may be a powerful form of advertising. In the UK in 1993, for example, when a childcare disregard for FC was announced with a large advertising campaign, few people took up the disregard, but the associated publicity did seem to lead to an increase in claims for FC by those without childcare expenses.

5. Conclusion

Working families' tax credit, like its precursors family credit and family income supplement, is an extremely effective redistributive tool, useful for governments concerned about low incomes among families with children. It is also a way of encouraging participation by increasing the financial rewards from working. But there can be negative as well as positive effects on labour supply, affecting the participation decisions of secondary earners and the hours decisions of participants. Given the level of FC in the UK in the late 1990s, it seems that the distributional effects of the WFTC reform are likely to be more dramatic than the behavioural effects, and it is to these that we must appeal to justify the very large cost of the reform. One area of genuine uncertainty is the likely effect of the childcare subsidy.

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