

Tax Credits:
Do they add up?

David Willetts and Nicholas Hillman

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22 Charing Cross Road
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Tel: 0207 240 5070 Fax: 0207 240 5095
e-mail: info@politeia.co.uk
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THE AUTHORS

David Willetts is Shadow Work and Pensions Secretary and Member of Parliament for Havant. He has served as Paymaster General in the last Conservative Government. His book *Modern Conservatism* was published by Penguin in 1992. He is a Visiting Fellow at Nuffield College, Oxford, and a member of Politeia's Advisory Council.

Nicholas Hillman is a Research Officer on social security, employment and pension policies at the House of Commons. He is currently working with David Willetts. As an historian he taught at St Paul's School in London. His recent published work includes *A Raw Deal for Lone Parents: Evaluating the Evidence* (with David Willetts).

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Preface

Gordon Brown's devotion to tax credits may seem to be an uncontentious way of tackling unemployment and low income. But it should not be taken at face value. It is not an innocent attempt to help the less well off. Its immediate consequences, already evident, have been to muddy the distinction between genuine earned income and state handouts. Its wider consequences in social corrosion will be felt long after the Chancellor leaves office.

This pamphlet by David Willetts and Nicholas Hillman considers, against the wider framework of the Chancellor's approach, the flaws and weaknesses which have emerged in the tax credit system and its fundamental problems. It examines the evolution of the tax credit, which either replaced a simpler 'top-up' benefit to supplement low income, or extended the category of those eligible for support. As with many of the Government's initiatives, the intention behind the policy 'to make work pay' has been well advertised. But its problematic nature has escaped popular scrutiny, partly because of the difficulty of having to find a way through the maze of tax and benefits, partly because the weight of official propaganda, though failing to endear the system to the public, has succeeded in making it boring.

The overlapping of the tax and benefit systems and the confusion between two different activities are wrong both in principle and practice. The problem in principle is that they muddle two distinct activities and the institutions responsible for each. Income tax, collected by the Treasury's Inland Revenue department, is determined on an annual basis according to total income, whereas benefits are given each month or week, and they are often subject to means testing, conditionality and intrusion. In practice, the amalgamation of the systems makes for greater bureaucratic hurdles for all concerned and introduces intrusiveness, further costs and greater levels of state bureaucracy.

In particular: -

Tax credits bring the state into an ever growing number of individuals' lives, employees and employers, those individuals who hitherto simply paid their tax and avoided being caught up in the tentacles of officialdom. Moreover employers are very often faced with the expense of operating the system.

The tax credit system operates in the main as a means-tested system. Historically, parties on all sides have recognised the iniquitous consequences for the short and long term of the means-tested handouts. As Beveridge pointed out they undermine incentive, inhibit saving and are, rightly, anathema to the British people. Means testing encourages people to lower their sights to the levels of income that would qualify them for free support.

The tax credit system itself fraudulently prevents government spending on what has been, and still is in reality, a benefit, as showing up as such in the figures. Dishonesty at the top is very bad for democracy.

Given that people can only qualify for such 'credits' or 'benefits' by meeting a raft of conditions set out by the officials and bureaucrats, there is a temptation for potential beneficiaries to make fraudulent claims or to cheat, and in some cases for the state to change policy to legitimise fraudulent activities that have been commonplace. Society as a whole is the loser from such a state of affairs, and the increasingly commonplace reports of individuals playing the system augur ill for the future.

Sheila Lawlor, Director, Politeia

I

A guide to Gordon Brown's tax benefits

Gordon Brown's big idea is the integration of tax and benefits. It dominates the Treasury now just as monetarism dominated it in the 1980s. And the effects are the same – restless innovation. In the 1980s the Treasury believed in monetarism so passionately that we had a different monetary rule every year, which was deeply damaging to the credibility of monetarism. Now we see the same intellectual energy applied to tax credits. The result is a whirlwind of activity that leaves experts, let alone real families, utterly bemused. The rest of this chapter gives a short summary of the changes that have already been introduced and which are due in 2003.

Labour talks as if no one had thought of boosting the incomes of families in low-paid jobs before it came along so, in the interests of historical accuracy, we should start with Family Credit. It was introduced in 1988 as a benefit paid to the caring parent in low-income working families and in turn replaced Family Income Supplement introduced by Keith Joseph in 1971. In October 1999, it was converted into the Working Families' Tax Credit (WFTC). At the same time a Disabled Person's Tax Credit (DPTC) was also introduced, replacing the Disability Working Allowance. Since April 2000, the WFTC and DPTC have been delivered through the payroll as a sort of negative tax payment from the Inland Revenue. Linked with them is a Childcare Tax Credit, designed to help with the childcare costs of lone parents and two-earner couples, though not one-earner couples.

The Employment Credit, a special payment under the New Deal to workers over 50 was introduced in November 1999 and extended across the country in April 2000.

The Married Couple's Allowance was abolished in April 2000. It was replaced a year later by a Children's Tax Credit. This credit is awarded through the tax system to families with children, but is withdrawn from couples in which either partner pays higher-rate tax. From April 2002, a baby tax credit worth twice the value of the Children's Tax Credit will be awarded to families with a child under one year old.

In April 2003 there will be a further set of changes. The WFTC will be broken up and replaced. The element covering the costs of children will be combined with the Family Premium in Income Support and Jobseeker's Allowance, which are currently paid to non-working families. The Children's Tax Credit will also be included. Putting the child element of the WFTC together with the Family Premium in Income Support and the Children's Tax Credit will create what was going to be called the Integrated Child Credit, but which is now going to be known as the Child Tax Credit.

At the same time, the adult elements of the WFTC and DPTC will be renamed. They were going to be called the Employment Tax Credit, but will now be known as the Working Tax Credit. By ending the link between in-work benefits and payments for children, the Government will lose any justification for not offering in-work benefits to people in low-paid work who do not have children. The Working Tax Credit will therefore be extended to childless people in low-paid jobs. It will also be merged with the Employment Credit that is part of the New Deal 50 plus.

To put it another way, within the space of four years, from 1999 to 2003, the Government will have:

- abolished Family Credit;
- introduced the Working Families' Tax Credit;
- introduced the Disabled Person's Tax Credit;
- introduced a Childcare Tax Credit;
- introduced an Employment Credit;
- abolished the Married Couple's Allowance;
- introduced the Children's Tax Credit;
- introduced a baby tax credit;
- abolished the Working Families' Tax Credit;
- abolished the Disabled Person's Tax Credit;
- abolished the Children's Tax Credit;
- abolished the baby tax credit;
- introduced a Child Tax Credit;
- abolished the Employment Credit;
- introduced a Working Tax Credit.

So, since October 1999, the Government will have introduced five new tax credits for families, scrapped four of them and then introduced two new ones in April 2003. That averages out as a new tax credit for families every six months.

II

Integration or complication?

When people complain about intricate and intrusive means tests, we are often told that the tax system is the biggest means test of the lot and that we should replace means-tested benefits with an improved tax regime. But income tax is not a big means test. It has a very different rationale.

There is a difference between paying in and taking out. The purpose of the tax system is not to fine-tune the income distribution but to pay for essential public services in a way that is socially acceptable and which does a minimum of economic damage. The purpose of the benefits system is to help poor people by boosting their incomes. These are different functions and trying to merge them causes a series of practical problems as we shall see in this chapter.

The temptation to merge the two, however, is that it flatters the public accounts. The public accounts have always recognised the difference between paying in and taking out. If you use the NHS one year it is not netted off against your income tax. But Gordon Brown treats his benefit increases, once they are credits, as tax cuts. For example, Family Credit was counted as part of social security expenditure, but the Treasury counts its replacement – the WFTC – as a £6 billion tax cut. If all benefits were replaced with tax credits in this way, all benefit expenditure would miraculously disappear from the Government's accounts.

The proposals for integrating means-tested benefits and taxes in tax credits rest on some serious misconceptions. For a start, people in receipt of means-tested benefits are not the same as those with significant income tax liabilities: only 20 per cent of WFTC expenditure offsets income tax¹ and just 24 per cent of means-tested benefit recipients pay tax².

The people who receive means-tested benefits are by and large not the same as the people who are paying income tax. So why do many pundits believe that there is a continuum of similar information being collected from

1 Institute for Fiscal Studies, *The IFS Green Budget*, January 2001, p.111.

2 Malcolm Wicks, *Hansard*, 13 February 2002, c.375W.

affluent taxpayers and poorer people on means-tested benefits that could all be integrated into one system?

There may be a sociological explanation. By and large, commentators and politicians have tax affairs that are more complicated than the average, with income from more than one source and which is taxed at various different rates. As higher rate taxpayers, they have to fill in tax returns to provide the Inland Revenue with detailed information about their financial affairs. People with very low incomes have to provide the Benefits Agency with complicated financial information as well. It is easy to assume from this that everyone is trapped in a seamless web of complexity. But this belief is mistaken.

The sort of information which the Benefits Agency collects for people with low incomes to assess them for entitlement to benefit is different from the sort of information which the Inland Revenue collects from high earners to assess their obligations to pay income tax. If you put the two forms together, you would end up with a form almost twice the size requiring large amounts of redundant information from unemployed people about their dividend income together with an equally large amount of redundant information from higher rate taxpayers about their weekly rents.

What we are talking about is not a continuum in which everyone is involved with either the benefits system or the Inland Revenue. We are actually talking about two extremes. For large swathes of people in the middle their financial dealings with the state have been kept pretty simple. They have incomes which take them above entitlement to means-tested benefits – if they are receiving a benefit, it is something like Child Benefit or the basic pension, which are relatively simple benefits to administer and which are paid in a fairly straightforward way. Their income tax is charged at the basic rate, deducted via PAYE (Pay As You Earn), and they do not fill in a tax return. One of the problems with the integration agenda is that the sort of complexity that already afflicts the 4.0 million people on Income Support and the 2.6 million people who pay higher rate tax is going to be spread across everyone else as well. Under Gordon Brown, families will go straight from means-tested benefits via tax credits to higher rate tax returns with no period of simplicity in between. Some families can already claim means-tested benefits and pay higher rate tax at the same time. It is little

wonder that the Social Security Select Committee claimed the new system would need 'a system of more universal tax returns'.³

There is a series of practical difficulties that are encountered by any attempt to integrate these two systems in tax credits. It is tempting to dismiss them as mere administrative points which ought to be overcome. But in fact they reflect deep underlying differences between the basis on which we pay our income tax and the basis on which we receive any means-tested benefits.

For a start, tax is paid on annual income. If a person has a very bad month in May and a good month in November, his total income is averaged out as part of an annual calculation of his tax liability. But that is not how we approach benefit entitlement. If you turn up at a benefit office in November with no income, they cannot refuse you benefit because you did rather well in May.

Gordon Brown and his advisers have come face to face with this problem when designing the Child Tax Credit. The child element of Income Support, which is currently assessed on a weekly basis, will be combined with the child element of the WFTC, which is assessed for six months at a time, and the Children's Tax Credit, which is paid annually over a tax year. Bringing these together into one integrated payment is forcing ministers down two different routes. To replicate Income Support, they need to allow for much more frequent adjustments to the Child Tax Credit than is currently the case with regard to the WFTC and the Children's Tax Credit. And to replicate the WFTC and the Children's Tax Credit, they need to have payments that carry on for quite a long time even after significant increases in income.

Gordon Brown has tried to circumvent this dilemma by basing entitlement to the tax credits on a family's annual income for the previous tax year. An interim payment will then be made and, if this proves to be inaccurate, reconciliation will take place at the end of a tax year. In addition, tax credit payments will be able to respond to 'significant' in-year changes of income. We still do not know what counts as a significant change, perhaps because the rules are likely to conflict with our ideas of natural justice.

3 Social Security Committee, *Integrated Child Credit*, March 2001, para.53, p.xxi.

Families that report a big drop in income near the end of a tax year will not get any prompt increase in the credit they receive. And if their income goes up they carry on receiving a generous tax credit until they then get a big claim for repayment at the end of the year. It is little wonder that Andrew Dilnot of the Institute for Fiscal Studies has said year-end adjustment 'Reduces certainty and increases complexity for all'.⁴

There is also a second very important practical difference between the two systems too. Income tax is paid by individuals but means-tested benefits are based on household income. We rightly recognise that a wife's income should be treated independently and should not be aggregated with her husband's. But, by and large, benefits are paid out to households. Income Support is not available to an individual who lives with a millionaire. This is not some quirk of the system – it reflects deep-seated beliefs about the basis on which you take tax off people and the basis on which you pay benefits to people. Women now have the right to have their income taxed as their own, independently of their husband's. But the trend we see now is the reverse, where tax is on the basis of household income. Feminists have been strangely silent about this. We shall study its implications in more detail in our separate chapter on the family.

There is one final feature of this so-called integration. It might look like integration along one dimension, but it is equally fragmentation along another dimension. Many families that currently receive a single in-work benefit will in future receive two credits instead. And consider a family with children that currently receives income-based Jobseeker's Allowance. In future, they will get a lower Jobseeker's Allowance payment from the Benefits Agency and, in addition, a Child Tax Credit from the Inland Revenue. At the same time, any Child Benefit they receive will cease to be paid by the Benefits Agency and will instead be paid by the Inland Revenue. MPs from all parties have complained that, 'when viewed by those on the receiving end, the splitting of Income Support/Jobseeker's Allowance, and WFTC/DPTC into separate components could be perceived as a greater fragmentation of their financial support rather than a move towards a more integrated approach'.⁵

4 Andrew Dilnot, *Work, welfare and pensions: challenges for the future*, Presentation to the Work and Pensions Committee, 7 November 2001.

5 Social Security Committee, *Integrated Child Credit*, March 2001, para.17, p.x.

III

The costs

The Government used to be against more means testing. The Prime Minister, for example, said ‘there are problems if you move to much means testing’.⁶ But Labour are now introducing a series of means tests that taper out very gradually and which go further up the income scale than ever before. This is enormously expensive and well-off families are coming within the scope of means tests for the first time ever. And because the extra money is not going to the poorest families, poverty rates remain stubbornly high.

In its final year, Family Credit cost £2.4 billion, whereas the WFTC is set to cost two and a half times as much – £6.0 billion – in 2002/03. The Working Tax Credit and the Child Tax Credit are expected to be considerably more expensive than even the WFTC but due to ‘a lamentable lack of public discussion and openness’, we do not have any Government figures on how much the measures will cost.⁷

This paucity of information is in stark contrast to past practice. The WFTC and the Children’s Tax Credit were both included in the public finances long before they were introduced. Indeed, the Government is in clear breach of its own Code for Fiscal Stability, which states that when ministers are planning measures with a fiscal impact, the cost should appear as soon as possible in the Pre-Budget Report or other economic statements. It also states that ‘where the fiscal impact of these decisions and circumstances cannot be quantified with reasonable accuracy by the day the projections are finalised, these impacts should be noted as specific fiscal risks.’⁸

The best prediction of the cost of the new credits is from the IFS. This suggests that if significant numbers of losers are to be avoided, the Child Tax Credit alone will cost £2.7 billion more than the current system of support for families with children. In addition, the Working Tax Credit is likely to cost a further £300-£400 million. In total, the cost of the main

6 The Prime Minister, *Breakfast with Frost*, BBC, 11 January 1998.

7 Institute for Fiscal Studies, *The IFS Green Budget*, January 2002, p.69.

8 HM Treasury, *The Code for Fiscal Stability*, March 1998, para.23, p.12.

benefits for children, together with the cost of in-work credits for the low-paid will more than double from less than £12 billion when Labour came to office to almost £25 billion in 2003/4.

Spending on the main benefits and tax credits for children and low-paid workers £ billion

1996/7	2002/03	2003/4
Child Benefit: 6.9 Income Support [Family Premium]: 2.4 Jobseeker's Allowance [Family Premium]: 0.2 Family Credit: 2.1	Child Benefit: 9.0 Income Support [Family Premium]: 3.3 Jobseeker's Allowance [Family Premium]: 0.4 WFTC/DPTC: 6.0 Children's Tax Credit: 2.1 Baby Tax Credit: 0.2	Cost of existing system: Child Benefit: 9.2 Income Support [Family Premium]: 3.4 Jobseeker's Allowance [Family Premium]: 0.4 WFTC/DPTC: 6.1 Children's Tax Credit: 2.1 Baby Tax Credit: 0.3 plus, cost of new system: Child Tax Credit: 2.7 ⁹ Working Tax Credit: 0.4
TOTAL: 11.6	TOTAL: 21.0	TOTAL: 24.6

www.dss.gov.uk/asd, *Benefit expenditure in Great Britain 1991/92 to 2003/04*, December 2001 and *Benefit expenditure by age-based client group*; HM Treasury, *Pre-Budget Report: Building a stronger, fairer Britain in an uncertain world*, November 2001, Table B15, p.185; HM Treasury, *Budget 2001: Investing for the Long Term: Building Opportunity and Prosperity for All*, March 2001, Table A11, p.145 and Table A2.1, p.150; Institute for Fiscal Studies, *The IFS Green Budget*, January 2002, Table 5.1, p.74 and Table 5.3, p.78

The year before he came to office, Tony Blair said, 'I vow that we will have reduced the proportion [of national income] we spend on the welfare bills of social failure. ... This is my covenant with the British people. Judge me upon it. The buck stops with me.'¹⁰ He also promised that the money saved would be used to improve education and health care.¹¹ Yet, according to the

9 The costs of the CTC and the WTC shown in this table are in April 2002 prices. .

10 Tony Blair, Speech to the Labour Party Conference, 1996.

11 Tony Blair, *The Leader Interview*, BBC, 7 April 1997.

House of Commons Library, since Labour came to office benefits spending including their credits has grown from £92.2 billion in 1996/7 to a predicted cost of £126.7 billion in 2003/4. This is an increase of £34.5 billion or 37 per cent over just seven years. And it is more than the extra spent on either education or health: education spending is set to increase by £28.1 between 1996/7 and 2003/4 and health spending by £22.0 billion.¹²

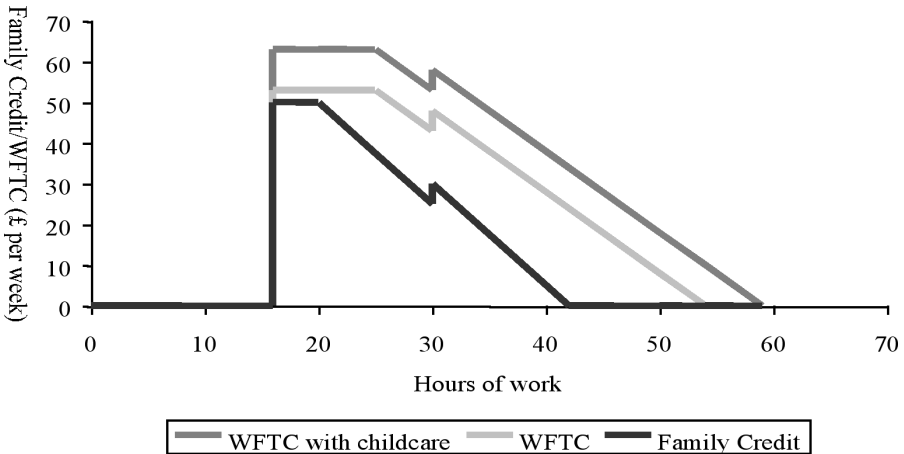
Public Spending £ billion

	Benefits	Health	Education
1996/7	92.2	40.8	36.1
2002/3	117.1	64.7	53.7
2003/4	126.7	68.9	58.1

House of Commons Library to David Willetts MP, 21 February 2002

Much of this extra spending is not reaching the people most in need. As the graph below makes clear, when Family Credit was replaced with the WFTC, the largest gains went to those who had only a very small entitlement under the old system. And many people on moderate incomes, who were not previously eligible for means-tested benefits, were able to claim them for the first time.

In work support, 1999



From Alan Duncan and Howard Reed, *Meeting Distributional and Employment Objectives Using In-Work Benefits*, May 2000, unpaginated

¹² House of Commons Library to David Willetts MP, 21 February 2002.

In fact, entitlement to the WFTC extends so far up the income scale that it is possible to be both a higher rate taxpayer and a WFTC recipient at the same time. A family with three children on £40,000 a year can claim almost £35 a week if two of their children are in eligible childcare and some families on over £45,000 can also receive the benefit.¹³

WFTC entitlement of a family with three children on £40,000, 2001/02

Earnings calculation:	
Annual (gross):	£40,000.00
Weekly (net):	£555.96
Minus £92.90 WFTC disregard:	£463.06
WFTC calculation:	
Basic credit:	£59.00
30 hour credit:	£11.45
Child credit (x3):	£78.00
Childcare Tax Credit:	£140.00
Total:	£288.45
The total WFTC payment is tapered out at 55% for each £ of earnings above the disregard until no earnings are left. If the resulting sum is positive that is an individual's WFTC entitlement.	
i.e. 55% of £463.06 is £254.68. The difference between £254.68 and £288.45 is £33.77.	
Weekly WFTC entitlement:	£33.77

The introduction of the Child Tax Credit and Working Tax Credit will herald another large jump in the number of people covered by means tests. In 1998/9, 24 per cent of households were on means-tested benefits. According to the House of Commons Library, this figure is set to reach 38 per cent by 2003/4.

13 For further examples, try the calculator at www.inlandrevenue.gov.uk/wftc/calc_wftc.htm.

The growth in means testing, 1998/9 to 2003/4

percentage

Benefit Units	1998/9	2003/4
Non-pensioner households	21	29
Pensioner households	37	57
All households	24	38

House of Commons Library figures

Labour ministers have made a series of claims about the effect of their policies on child poverty rates. In 1999, the Treasury claimed that the previous two Budgets would 'take around 700,000 children out of poverty.'¹⁴ A year and a half later, the Chancellor claimed that the WFTC 'has taken a million children out of poverty.'¹⁵ And before the last election, Labour ministers repeatedly claimed their policies had lifted 1.2 million children out of poverty: 'As a result of personal tax and benefit reforms announced in this Parliament, over 1.2 million children will be lifted out of poverty. This is an estimate, using the Treasury's tax benefit simulation model, of the impact of measures on the number of children living in households with income below 60 per cent of the median.'¹⁶

But, because Gordon Brown has spent so much on extending means tests up the income scale, rather than on targeting those most in need, in reality few people have been lifted above the Government's poverty line. The most recent annual survey by the Joseph Rowntree Foundation reported:

The latest available data on the number of children and people living in poor households reveals [*sic*] little change, confirming the slow start for the Government's policy commitment to eradicate child poverty within a generation. ... The Government says that its policies took 1.2 million children out of poverty during the last Parliament, but a major change will have need to have to taken place in the year before the general election for child poverty to have fallen by this amount.¹⁷

14 HM Treasury, *Budget 99: Building a Stronger Economic Future for Britain*, March 2001, para. 5.26, p.71.

15 HM Treasury Press Release, 23 October 2000.

16 Dawn Primarolo, *Hansard*, 14 March 2001, c.609W.

17 Joseph Rowntree Foundation, Press Release, 10 December 2001.

The Chancellor responded to these criticisms by smuggling out a new form of words to explain the Government's supposed achievement. Ministers no longer claim that over a million children have been lifted out of poverty. Instead, they say 'there are now 1.2 million children fewer in relative poverty *than there would otherwise have been.*'¹⁸ Even this clarification, which relies on very uncertain predictions about what would have happened had Labour's policies not been implemented, may turn out to be over optimistic.

It is likely that ministers are also overestimating the potential of the Child Tax Credit as an anti-poverty measure. It stretches so far up the income scale that it is unlikely to have much impact on poverty rates, even if we accept the Government's new measurement of child poverty with its hypothetical assessment of what might have occurred without their reforms.

18 HM Treasury, *Tackling child poverty: giving every child the best possible start in life*, December 2001, para.9, p.vi.

IV

Take-up

We have seen how most of the additional money spent on the WFTC goes to those on moderate and higher incomes and how this has reduced its impact on poverty. But this is not the only reason why poverty has remained so high under Labour. Another cause is the low take-up rates for means-tested benefits in general and for the WFTC in particular.

One of the main reasons given by the Government for replacing Family Credit with the WFTC was that take-up of in-work benefits would be higher if they looked less like traditional benefits. When it was launched, the Treasury promised the WFTC would 'help 1.5 million families, including 3 million children'¹⁹ and the Chancellor claimed the payment method would provide 'enormous scope to increase take-up'.²⁰

There has been a concerted effort ever since to encourage take-up. A major publicity campaign was launched in September 1999. Another wave of advertising followed in April 2000 and yet another six months later. Further advertisements were placed in late 2001 and all the publicity has been backed by a 24-hour helpline.

This promotional activity cost £13.8 million in 1999/2000²¹ and £7.4 million in 2000/01. The final figure for 2001/02 is not yet known, but the Government has already spent another £1.5 million²² and the campaign is still running.²³

During the final year of the last Conservative Government, the entire advertising budget for the Department of Social Security was £3.7 million and for the 1992 to 1997 Parliament as a whole, an average of around £4 million a year was spent advertising benefits. Under Labour it remained at roughly this level for the first two years but since ministers got into their stride the cost has soared. In addition to the spending on the WFTC

19 HM Treasury, Press Release, 7 September 1999.

20 Quoted in the *Financial Times*, 8 September 1999.

21 Dawn Primarolo, *Hansard*, 22 June 2000, 288W.

22 Andrew Smith, *Hansard*, 8 January 2002, c.802W.

23 See, for example, *M* (the *Mirror* magazine), 2 February 2002, p.13.

campaigns, the Government spent a further £28.4 million advertising benefits during 2000/01. Although the final total is not yet available, the figure will be similarly high for 2001/02.

The cost of advertising benefits

1992/3-1996/7 (annual average)	£4.2 million
1996/7	£3.7 million
2000/1	£35.8 million
20001/02 (final figures not yet available)	£26.5 million

Jeff Rooker, *Hansard*, 7 March 2001, c.233W; Nicholas Brown, *Hansard*, 19 December 2001, c.382W and 20 March 2002, cc.425-426W; Andrew Smith, *Hansard*, 8 January 2002, c.802W

In addition to all this central government expenditure, local authorities and voluntary groups also spend large sums promoting take-up. Surprisingly, ministers have no idea what councils do or how much they spend in this area,²⁴ but the London Borough of Newham, for example, employs an 'Income Maximisation – Welfare Rights Adviser'. Citizen's Advice Bureaux also do an enormous amount of work in this area.

Ministers used to pretend that the promotion of the WFTC had been a great success. Gordon Brown, for example, told the Press Association that the original WFTC campaign was the Government's most successful promotion.²⁵ And in early 2000 Alastair Darling claimed that 'some 1.4 million families' were in receipt of the WFTC,²⁶ even though the actual claimant count was 400,000 lower.²⁷

Despite the big increase in spending on advertising, the take-up of all the main means-tested benefits is slowly declining.

24 Malcolm Wicks, *Hansard*, 19 December 2001, c.366W; Malcolm Wicks, *Hansard*, 4 February 2002, c.761W.

25 Press Association report, October 1999.

26 *Hansard*, 27 March 2000, c.42.

27 In February 2000, 989,300 families received the WFTC, rising to 1,024,000 in May 2000 (Inland Revenue, *Working Families' Tax Credit Statistics, Quarterly Enquiry*, August 2001, 2002, p.7).

Take-up of means-tested benefits, 1996/97 to 1999/00

	1998/99	1999/00
Income Support		
caseload take-up	84%	82%
expenditure take-up	92%	91%
entitled non-recipients	685,000	785,000
expenditure unclaimed	£945 million	£1,170 million
Housing Benefit		
caseload take-up	94%	92%
expenditure take-up	96%	95%
entitled non-recipients	280,000	365,000
expenditure unclaimed	£400 million	£565 million
Council Tax Benefit		
caseload take-up	78%	77%
expenditure take-up	81%	80%
entitled non-recipients	1,500,000	1,570,000
expenditure unclaimed	£545 billion	£585 million
Jobseeker's Allowance		
caseload take-up	75%	73%
expenditure take-up	82%	79%
entitled non-recipients	320,000	335,000
expenditure unclaimed	£660 million	£695 million
TOTAL UNCLAIMED	£2,550 million	£3,015 million

Office of National Statistics, *Income Related Benefits: Estimates of Take-Up in 1999/2000*, September 2001, p.15, p.25, p.31 and p.36 (the table above is based on the mid-points of the ranges)

No detailed research has been conducted into this modest but consistent fall in take-up, though one cause does seem particularly likely. Since 1997, a huge number of small and often unnecessary changes have been made to the main means-tested benefits. Income Support for pensioners has been renamed the Minimum Income Guarantee and ninety separate Statutory Instruments have amended the Housing Benefit regulations.²⁸ These changes have added further complexity and confusion to the benefits system and fewer people are aware of their full entitlement. According to the National Association of Citizen's Advice Bureaux, 'CAB evidence is that

28 Malcolm Wicks, *Hansard*, 19 December 2001, c.375W.

both the benefit and tax systems are complicated and intimidating to those lacking in financial literacy skills ... The complexity of benefits and the claiming process is one reason why millions of pounds worth of benefits go unclaimed by people on low incomes.²⁹

In-work benefits have been altered to a greater degree than the other means-tested benefits and the fall in take-up has consequently been much larger. Treasury ministers are reluctant to admit this and will not answer parliamentary questions on the take-up of either the WFTC or the Childcare Tax Credit.³⁰ However, research completed for the Department for Work and Pensions shows only 62 per cent of eligible families receive the WFTC. This is a fall of 10 per cent on the final take-up figures for Family Credit.

*Take-up of in-work benefits, 1999 and 2000*³¹

	1999 FC	2000 WFTC
Caseload take-up	72%	62%
Expenditure take-up	81%	76%
Entitled non-recipients	300,000	700,000

Alan Marsh, Stephen McKay, Alison Smith and Augusta Stephenson, *Low-income families in Britain: Work, welfare and social security in 1999*, Leeds, 2001, Table 10.19, p.260; Stephen McKay, *Low/moderate-income families in Britain: Work, Working Families' Tax Credit and childcare in 2000*, Leeds, 2002, p.57 and Table 3.18, p.59.

Take-up is much lower for some groups than it is for others: 78 per cent of eligible lone parents receive the WFTC, but fewer than half of all eligible couples (49 per cent) and less than a third of eligible two-earner couples (31 per cent) do so.³²

Ministers should have been aware that replacing Family Credit with the WFTC would cause a fall in take-up. A number of studies have shown that

29 NACAB, *Summing up*, 2001, p.27.

30 See, for example, David Willetts' question to the Chancellor of the Exchequer, *Hansard*, 15 November 2001, c.842W.

31 The figures for FC and WFTC in this table are assessed in the same way as each other, but differently to those in the table for the other means-tested benefits. This is because the Government has failed to provide WFTC figures that are directly comparable to those for other benefits.

32 Stephen McKay, *Low/moderate-income families in Britain: Work, Working Families' Tax Credit and childcare in 2000*, Leeds, 2002, Table 3.18, p.59.

'misconceptions [about take-up] are most likely where a new or reformed benefit confers eligibility on a wider range of households than before, especially if the range includes groups who would not generally regard themselves as part of the claiming population.'³³ Introducing a new or reformed benefit may be worthwhile in itself, but it is likely to depress take-up. Given the short life span of the WFTC, ministers need to explain why they did not simply retain Family Credit – possibly at a higher rate – instead of replacing it with a benefit which was always destined to have a lower take-up and which is less well-targeted.

A take-up rate of 62 per cent suggests that around a further 700,000 eligible families were not receiving the WFTC. Whilst some of these families would only have been entitled to comparatively small sums, some were losing out by over £120 a week. The total saving to the Exchequer is in the region of £1.5 billion a year.

Benefit payments forgone by eligible non-recipients of the WFTC

Weekly amount forgone by each non-recipient family	Proportion of eligible non-recipient families	Number of eligible non-recipient families	Total expenditure forgone (annual)
<£20	36%	252,000	£131 million
£20<£40	23%	161,000	£251 million
£40<£60	17%	119,000	£309 million
£60<£80	11%	77,000	£280 million
£80<£100	5%	35,000	£164 million
£100<£120	5%	35,000	£200 million
£120+	3%	21,000	c.£150 million
TOTAL	100%	700,000	£1.5 billion ³⁴

Based on Stephen McKay, *Low / moderate-income families in Britain: Work, Working Families' Tax Credit and childcare in 2000*, Leeds, 2002, Figure 3.3, p.58

When challenged on the low take-up rate, the Government's response has been to claim that more families have claimed the benefit since the survey

33 Peter Craig, 'Costs and Benefits: A Review of Research on Take-up of Income-Related Benefits', *Journal of Social Policy*, 20,4 (1991), p.558.

34 The figures in this table are based on the authors' own calculations. The Institute for Fiscal Studies give a comparable figure of £1.4 billion for total expenditure foregone (Institute for Fiscal Studies, *The IFS Green Budget*, January 2002, p.82).

was conducted.³⁵ Although the increase has been slow, it is true that more families are claiming the WFTC than previously.³⁶ But this is unlikely to have had much impact on take-up measured as a proportion of all eligible families. Since the survey was conducted, the value of the WFTC has increased by more than inflation and the number of people in employment has gone up with the result that many more families have become eligible.

If change and confusion are the main causes of the big drop in the proportion of eligible families receiving in-work benefits, the new system due in 2003 is likely to create further problems. If take-up of the Child Tax Credit falls by 10 per cent under the new system – the same as the fall when the WFTC replaced Family Credit – then only about half of all eligible claimants will receive it.

35 Department of Work and Pensions, Press Release, 10 January 2002. (This press release is misdated 10 January 2001.)

36 In August 2001, 1,224,800 families received the benefit (Inland Revenue, *Working Families' Tax Credit Statistics, Quarterly Enquiry*, August 2001, 2002, p.7).

V

Marginal rates

Means testing has long been a feature of Britain's social security system. But it has always suffered from a fundamental dilemma. The effect of a means test is to produce very high marginal rates of withdrawal of benefit for those to whom it applies: in the limit case, where a benefit is fully payable to all who earn below a certain figure and not available at all to those over it, the rate is 100%. There is, then, a choice between having a very steep means test over a narrow range of earnings or a less steep one over a wider range of earnings. The steep means test has the advantage that not many people suffer high rates of benefit withdrawal, but the disadvantage that those who do suffer high rates. The less steep means test has the advantage that almost no one faces very high rates of benefit withdrawal, but the disadvantage that a large number of people who are actually quite high up the income scale are eligible for means-tested benefits and do suffer quite high rates of withdrawal.

Gordon Brown has gone for the second option and the price we are paying is to bring many more people into high marginal rates of tax and benefit withdrawal. The table below shows that 1.1 million households now face a marginal rate of at least 50%, whereas only 760,000 did so in 1998.

Working households facing high marginal tax and benefit withdrawal rates

Marginal rate	Before 1998 Budget	After 2001 Budget	Illustrative example
100% or more	5,000	0	--
90% or more	130,000	40,000	Basic rate taxpayer on Housing Benefit, Council Tax Benefit and WFTC tapers
80% or more	300,000	210,000	Basic rate taxpayer on Housing Benefit and WFTC tapers
70% or more	740,000	255,000	Basic rate taxpayer on Council Tax Benefit and WFTC tapers

60% or more	760,000	900,000	Basic rate taxpayer on WFTC taper
50% or more	760,000	1,100,000	Non-taxpayer on WFTC taper
40% or more	800,000	1,120,000	Basic rate taxpayer on Council Tax Benefit taper

HM Treasury, Pre-Budget Report: Building a stronger, fairer Britain in an uncertain world, November 2001, Table 4.3, p.75; Dawn Primarolo to David Willetts, *Hansard*, 18 May 2000, c.264W and 24 January 2002, c.987W

By extending the principle of means testing to hundreds of thousands of additional people, the Child Tax Credit and the Working Tax Credit will magnify this problem. The figures are uncertain because we do not know the rates of the credits, but the effect will be to push many more people into high rates of tax and benefit withdrawal.

Under the Child Tax Credit, single-earner families that currently do not receive any means-tested benefits could see their marginal deduction rates more than double, from 32 per cent to 69 per cent.³⁷ Computer modelling suggests that, in total, the Child Tax Credit is likely to increase the marginal rates of 2.3 million parents and to reduce them for just 1.8 million. The table below shows the overall effect, but because it concentrates on bands it does not show all the changes.

Effect of the CTC on marginal deduction rates of adults with children

Marginal rate	Before 2003 reforms (000s)	After 2003 reforms (000s)	Change (000s)
100% or more	168	134	-34
90-100%	26	37	+11
80-90%	304	216	-88
70-80%	35	102	+67
60-70%	1,033	1,194	+162
50-60%	817	409	-408
0-50%	6,396	7,217	+821
0%	3,451	2,921	-531

Institute for Fiscal Studies, *Credit where it's due? An assessment of the new tax credits*, October 2001, p.14

37 Institute for Fiscal Studies, *Credit where it's due? An assessment of the new tax credits*, October 2001, p.14

The effect of the Working Tax Credit is less ambiguous. Anyone who does not already receive some form of means-tested benefit but who claims the Working Tax Credit will see a big increase in their marginal rate and a basic rate taxpayer could see an increase of 37.4 per cent. The only Working Tax Credit claimants who will see a fall in their marginal deduction rates are the 40,000 people whose increased income will take them above the threshold for claiming Housing Benefit or Council Tax Benefit.

The table below shows the overall effect of the Working Tax Credit on marginal rates, though once again the precise impact on each individual is masked by the bands.

Effect of the Working Tax Credit on marginal deduction rates for adults without children

Marginal rate	Before 2003 reforms (000s)	After 2003 reforms (000s)	Change (000s)
100% or more	129	131	+1
90-100%	3	25	+22
80-90%	80	74	-5
70-80%	102	101	-1
60-70%	43	260	+216
50-60%	19	72	+53
0-50%	12,821	12,624	-197
0%	4,235	4,145	-90

Institute for Fiscal Studies, *Credit where it's due? An assessment of the new tax credits*, October 2001, p.24

So under the system in place from 2003, 351,000 more adults than at present will face a marginal withdrawal rate of over 60 per cent. And some people who currently earn less than the income tax threshold and who do not claim any means-tested benefits will face the problem of high marginal withdrawal rates for the first time.

In future, all these people will find it harder to know whether to accept promotion, or to do a bit of overtime, or to accept a better-paid job, because every extra bit of earnings will only lead to a very small increase in disposable income. The change sends out exactly the wrong message.

VI

Families and tax credits

These changes to taxes and benefits can have potentially very important effects on relations within families because they alter the relative incomes of men and women. They can also change the relative incentives facing first and second earners. The Chancellor appears however to be strangely uninterested in such effects. The Treasury has never tried to offer any coherent assessment of the overall effects of their tax credits on family relationships. This is surprising as it was arguments about such effects which tore apart the Callaghan Government. The issue then was virtually identical to the one facing Labour ministers today. The then Labour Government was committed to phasing out the tax allowance for children (which went mainly to male earners) and to replacing it with a new Child Benefit, including the old Family Allowance, and paying it to the mother. Trade unions were very unhappy that workers' take home pay would fall as a result. Under pressure from them, the Callaghan Government decided not to proceed with the changes. But a young campaigner at the Child Poverty Action Group called Frank Field got hold of the confidential documents recording this and used them to cause the government such embarrassment that Child Benefit came in after all. This issue has been known ever since as wallet versus purse.

This time round the Government has been massively redistributing money between husbands and wives within the family without ever offering any assessment of the effects. The introduction of the WFTC in place of Family Credit took money away from the caring parent who received the benefit to give it to the (usually) male earner as a supplement to his pay. We were told that this was necessary to improve his incentive to work. In 2003 most of this money is to be taken off the earner and once more given to the parent with care so that, we are told, it will be spent on the child. The Government has never provided any evidence to back either of these propositions nor has any assessment been offered of the reasons why the balance between these two considerations has so dramatically shifted.

This is but the most striking of a series of confusions about the effects of these policies on families. There are three distinct problems with tax credits

that affect the internal balance of families in different ways, and have been introduced without due consideration of these effects. First, they erode the principle of individual taxation of husbands and wives. Second, they are biased against one-earner couples. Third, they act as a disincentive to families on modest incomes who would otherwise use small part-time earnings by the wife to boost their finances.

The Children's Tax Credit eroded the principle of independent taxation of husband and wife. The new Child Tax Credit takes this further. The Children's Tax Credit is withdrawn if either partner is paying higher rate tax. This means that a couple in which each is earning £30,000 per year receives the Children's Tax Credit but not a one earner couple where one partner is earning £45,000 per year. It is a clear bias against one earner couples – and is not the only one, as we shall see later in this chapter. Gordon Brown's solution to this is to say that in 2003 a couple will lose the Child Tax Credit if their combined income exceeds the higher rate tax allowance. Couples are in effect being taxed on their joint incomes, in clear breach of the principle of independent taxation, and 1.4 million couples will lose out financially as a result.³⁸ This does not just affect married couples. It applies to cohabiting couples too, and they are supposed to inform the Revenue if this will affect their entitlement to the Child Tax Credit. This is a vivid example of how much more intrusive the tax system becomes as it takes on some of the traditional roles of benefits.

There is a further effect on families, this time when they are on more modest earnings. The principle of independent taxation meant that people entering work had about £4000 that they could each earn tax free. Whatever her husband earned, a wife entering work could work a few hours per week with no deduction of tax. She kept 100 per cent of what she earned. The government has however taken the WFTC, soon to become part of the Child Tax Credit, up the income scale so that it affects two-earner couples. And it is of course based on total household income. A wife with modest earnings in such circumstances suddenly finds herself facing not a marginal rate of tax and benefit withdrawal of 0 per cent but of 55 per cent. This creates a major disincentive for her to work. It is one of the main reasons why the IFS is unable to show a significant positive effect on work incentives from the Chancellor's measures.

38 Dawn Primarolo, *Hansard*, 2 November 2001, c.880W.

There is a further effect of these measures which clearly penalises one-earner couples. The Childcare Tax Credit is available only to lone parents or to two-earner couples. One-earner couples are not allowed to claim it, even if they have as low an income as other parents who are allowed it. The Chancellor's argument is that the non-working spouse should be doing the child care. Nevertheless it is a clear financial penalty to such couples. It also creates an incentive for single parents not to settle down with a new partner, and not to declare one if they are cohabiting.

There are complicated effects on families here. They are potentially very important. The Treasury is reluctant to offer any sort of assessment of their impact on families. This is not good enough for a Government that claims it wants to support the family.

VII

Tax credits and red tape

The Government regard the WFTC as a tax credit, rather than a benefit. Before it was introduced Martin Taylor, the then Chief Executive of Barclays Bank, reported to the Government that:

as a tax credit rather than a welfare benefit, it would reduce the stigma currently associated with claiming in-work support; it would prove more acceptable than social security benefits to most claimants and taxpayers as a whole; [and] paid through the wage packet, it would reinforce the distinction between the rewards of work and remaining on welfare.³⁹

In 1998, Taylor admitted that the evidence to prove these assertions was ‘difficult to come by.’⁴⁰ Since then, the Policy Studies Institute and the National Association of Citizen’s Advice Bureaux (NACAB) have both considered how the WFTC has worked in practice. Their conclusions suggest the measure may have had the opposite effect to that predicted by the Government.

The Policy Studies Institute’s detailed investigation was conducted on behalf of the Government. The first part of the research, which took place before the WFTC was introduced, found that only 7 per cent of Family Credit claimants wanted to receive their benefit through the pay packet.⁴¹ The second wave, conducted after the WFTC had been introduced, found that 89 per cent of in-work benefit recipients prefer other payment methods.⁴² In addition, 44 per cent of people who receive the WFTC through their employer said this has ‘caused particular concerns’.⁴³

39 HM Treasury, *Work incentives: A Report by Martin Taylor*, 1998, para. 3.19, p.22.

40 Social Security Select Committee, *Tax and Benefits: Implementation of Tax Credits*, December 1998, Minutes of Evidence, Martin Taylor, 17 June 1998, Question 11 p.2.

41 Alan Marsh, Stephen McKay, Alison Smith and Augusta Stephenson, *Low-income families in Britain: Work, welfare and social security in 1999*, London, 2001, p.307.

42 Stephen McKay, *Low./ moderate-income families in Britain: Work, Working Families’ Tax Credit and childcare in 2000*, London, 2002, Table 3.16, p.54.

43 *Ibid.*, p.55.

NACAB's research, which was based on the experiences of WFTC claimants who had contacted their local CAB for advice, concluded that 'sticking to the existing payment method could run counter to the central goal of tackling child poverty. For some people, payment via the employer causes serious problems that affect their ability to continue in paid employment. For them, it is simply not worth the trouble it can cause.'⁴⁴

'A CAB in West Yorkshire advised a client who got a job working 24 hours over three days with a market trader. The client applied for and received working families' tax credit of nearly £80 per week. The client was dismissed within weeks, simply because the employer did not want to pay working families' tax credit with wages.'

'A CAB in Somerset reported a family with a child aged four months. The working partner was told by his employer that he would not pay working families' tax credit, and that he would dismiss the client if he applied for it.'

'A CAB in West Sussex reported a client who was awarded working families' tax credit. The client's employer refused to administer the payments, and suggested that the client reduce her hours below the 16-hour threshold. The client believed her employer was putting pressure on her to resign.'

NACAB, *Work in progress: CAB clients' experiences of the Working Families' Tax Credit*, February 2001, p.22, p.23 and p.24

American evidence backs up the view that, when offered the option, few people are happy with the idea of receiving in-work benefits through the payroll. The American Earned Income Tax Credit can be paid in advance through the pay packet, but more than 99 per cent of EITC claimants do not make use of this option, preferring to receive it after the end of the tax year instead.⁴⁵

44 National Association of Citizens Advice Bureaux, *Work in progress: CAB clients' experiences of the Working Families' Tax Credit*, February 2001, para. 2.41, p.27.

45 United States General Accounting Office, Tax Administration, *Earned Income Tax Credit Noncompliance*, 8 May 1997.

It is not only claimants that have lost out as a result of the WFTC's payment method. Employers have faced equally serious problems. Because the WFTC is not a true tax credit, Labour have not been able to distribute it through existing PAYE systems: WFTC is fixed for six months, whereas PAYE codes operate cumulatively.

This is one of the reasons why the Inland Revenue predicted that the recurring costs for business of administering the WFTC would be £105 million and the one-off costs would be £44 million. These figures do not include the additional costs of administering the Disabled Person's Tax Credit or the costs to childcare providers of verifying Childcare Tax Credit claims.

Cost to employers of administering the WFTC, broken down by company size

Number of employees	Recurrent (£m)	Non-recurrent (£m)
1-4	25	1
5-9	12	1
10-99	15	12
100-499	12	10
500-999	9	4
1,000-4,999	17	7
5000+	8	3
Government (all sizes)	7	5
TOTAL	105	44

Tax Credits Act 1999 and Accompanying Regulations: Regulatory Impact Assessment, December 1999, table 3, p.10

By April 2003, when the WFTC will be replaced, the total cost to employers of administering the benefit will have been almost £0.4 billion, even on the Government's figures. This has fallen disproportionately on small businesses – although fewer than 10 per cent of WFTC claimants paid through the wage packet work for companies with fewer than 5 employees, around a quarter of the annual administration costs relate to companies of this size.⁴⁶

⁴⁶ *Tax Credits Act 1999 and Accompanying Regulations: Regulatory Impact Assessment, December 1999, table 2, pp.8-9.*

‘This is the latest and worst regulation for small businesses to cope with. The whole concept is insane. We are already unpaid national insurance, income tax and VAT collectors and now we are expected to be unpaid benefit agencies too. The additional work is horrendous. It is a step backwards. We need financial support, not a helpline.’

(A manufacturer of air fresheners with one employee on WFTC, who had to spend £350 on new software and £150 on new payroll slips.)

The Government has said that the introduction of the Working Tax Credit provides an opportunity to ‘look closely at the way payment through the employer works’.⁴⁷ But despite all the evidence that has come to light on the problems of paying tax credits through the payroll, ministers are using the same old arguments to justify paying the Working Tax Credit through employers: ‘paying the working tax credit through employers will be simple. It supports the transition into work and assists employees and employers.’⁴⁸

The Government also claims that businesses’ compliance costs ‘will be broadly unchanged’ from 2003 and ‘may fall in the longer term’.⁴⁹ This is because the number of people without children who are entitled to the Working Tax Credit is expected to be roughly equal to the number of families who would previously have been paid the WFTC through their employer, but who will receive only the Child Tax Credit under the new system.

But the optimism of ministers is almost certainly misplaced. There are a number of key differences between the WFTC and the Working Tax Credit.

First, the Working Tax Credit is a considerably more complicated benefit than the WFTC. It has more variables and the level of an award can be changed during a pay period. Although they have refused to put a figure on it, the Inland Revenue accept this ‘might generate a cost for employers’.⁵⁰

47 Inland Revenue, *New Tax Credits (Consultation Document)*, July 2001, p.22.

48 Dawn Primarolo, *Hansard*, 7 February 2002, c.1087.

49 Inland Revenue, *New Tax Credits (Consultation Document)*, July 2001, p.22.

50 Inland Revenue, *The New Tax Credits: A Regulatory Impact Assessment*, November 2001, para. 2.17.

Secondly, the Working Tax Credit will go to different people, often in different kinds of jobs, from WFTC claimants. The Institute of Directors have complained that:

‘The good news [for employers] is outweighed by the bad news ... The work would be considerable ... thousands of employers who currently do not have to worry about delivering tax credits would suddenly be caught in the net. Employers who are already caught would have to handle more cases. They would also suffer an increased cash-flow burden from having to fund more credits between payday and PAYE accounting day.’⁵¹

Thirdly, the defining features of the Working Tax Credit, such as the assessment period, will be different from those of the WFTC and will therefore need different payroll systems.

These differences between administering the WFTC/DPTC and the new Working Tax Credit are in reality so great that the Inland Revenue have said the final payments under the old system may have to be paid directly, rather than through the pay packet, to enable employers to make all the necessary changes.⁵²

51 Institute of Directors, *Regulation Comment*, January 2001.

52 Inland Revenue, *The New Tax Credits: A Regulatory Impact Assessment*, November 2001, para. 2.18 and para. 4.2.

VIII

Tax credits as enablers of fraud

The WFTC is remarkably susceptible to fraud in the traditional – illegal – sense. And it is also easy for claimants to cheat the system without breaking any rules. The Childcare Tax Credit element, which is worth up to £7,280 a year (£140 a week), is particularly easy to abuse because the money can be paid to the claimant at a fixed rate for a full six months even if no childcare is used.

When the Childcare Tax Credit was introduced it was claimed that friends would register each other as eligible childcare providers. But the Government dismissed these fears. Dawn Primarolo said, ‘Martin Wolf argues that the [Childcare Tax] Credit is flawed because it is open to widespread abuse. If his example of lone parents looking after each other’s children was to be the outcome of the policy, then I would agree with him. But it will not be.’⁵³

The Government has been proved half right. In reality, there is little evidence of this type of abuse. But this is only because people have spotted a much easier way to abuse the rules. Instead of registering friends or family as eligible childminders, they book places with existing childcare providers instead. Once they have received sufficient proof of the cost of this childcare to apply for the Childcare Tax Credit, they cut all contact with the childcare provider and pocket the money for the next six months.

A large number of childcare providers have provided evidence about this practice and many of them are increasingly reluctant to offer places to WFTC recipients because they cannot risk being left with empty places. Yet, as the House of Commons Library confirms, WFTC claimants who cheat the system in this way are acting within the law.⁵⁴

Case Study 1: ‘It’s appalling. We have 87 places at our nursery but 9 of these are empty because parents have registered their children and then not sent them along. Social services have told us that all the nurseries in our area are

53 Dawn Primarolo, letter to the *Financial Times*, 5 April 1998.

54 House of Commons Library Letter to David Willetts MP, 9 October 2000.

suffering in the same way – some are on the verge of bankruptcy as a result and we alone are currently owed £9,300 which we will never see. The worst aspect of this mess is that the children do not benefit from the money intended for their care.’

Case Study 2: ‘One of my clients is on WFTC benefit, which pays for most of her childcare fees. I have today served her notice for continual non-payment of my fees. The National Childminding Association advised me to telephone the WFTC to inform them that as of this Friday my client would cease to be entitled to this benefit as she will cease to be my client. I was appalled to be told by the WFTC that there is nothing they can do. This lady will continue to receive £150 per week for non-existent childcare expenses – for the next SIX MONTHS!! The WFTC informed me that current legislation does not allow them to stop childcare contributions, and that they are "inundated" by childminders in my position. ... I am absolutely livid to know that someone who owes me £600 is being given £600 per month for the next six months when she has no right to it.’

Case Study 3: ‘I am happy to complete Working Families Tax Credit forms and often recommend that people apply for the Working Families Tax Credit forms if the client did not realise they may be eligible. My problems arise with obtaining monies from clients once the child care aspect of the Tax Credit has been granted. I fill in the form, let the child have a place at nursery / Before School Club / After School Club / Playscheme and then ask for money. I am finding that the money is so slow in coming and in some cases the client removes the child, owing us monies from £221.80 to £1090.90 (these are genuine debts owed by people on Working Families Tax Credits). ... I have spoken to the Fraud Hotline about my recurring problems and it seems this is a nationwide problem that childminders, nurseries and pre-schools are suffering financially from. It was the hotline that suggested I write to you requesting that the Government change the laws on Working Families Tax Credit and have childcare fees paid directly to the carers i.e. childminders, nurseries and pre-schools. The problem costs us approximately £2,000.00 per annum’.

For business reasons, these sources have chosen to remain anonymous.

Although this particular ‘fraud’ is legal, it is still surprising – given the level of fraud in the benefits system as a whole and the number of allegations that have been made to the dedicated hotline – that not one single person has been prosecuted for any type of fraud in their Childcare Tax Credit claim.

Childcare Tax Credit investigations, October 1999 to November 2001

Allegations communicated to the Inland Revenue via the Childminder’s hotline	Investigations	Penalties	Prosecutions
1,672	438	2	0

Dawn Primarolo, *Hansard*, 19 December 2001, c.323W

Despite the wealth of evidence collated by childcare providers about these problems, the Government has recently announced that the childcare element of the new Working Tax Credit will be paid in the same way as the existing Childcare Tax Credit, rather than direct to the childcare provider. This decision has been condemned as ‘very strange’ by Rosemary Murphy, the Chief Executive of the National Day Nurseries Association.⁵⁵ Moreover, under the new system, claimants will not need to provide the Inland Revenue with written confirmation of their childcare costs as they currently have to do.⁵⁶

The WFTC as a whole is also subject to a huge amount of illegal fraud. No-one outside central government knows exactly how serious this problem is because ministers refuse to reveal what they know. The Inland Revenue began a year-long benchmarking exercise to establish the level of fraud in tax credit claims in September 2000.⁵⁷ Despite being questioned repeatedly on the results of this exercise, ministers are still unable or unwilling to reveal what it uncovered: ‘We shall be considering the results, and questions of publication, within the next few months.’⁵⁸

It is possible that the WFTC will be abolished before the level of fraud within it is made public. But the evidence that does exist suggests the WFTC is almost certainly riddled with fraud. Over 16,000 allegations about

55 Rosemary Murphy to Nicholas Hillman, 10 January 2002.

56 Inland Revenue, *The New Tax Credits: A Regulatory Impact Assessment*, November 2001, para. 2.21

57 Dawn Primarolo to James Clappison, 11 April 2001.

58 Dawn Primarolo, *Hansard*, 5 February 2002, c.851W.

improper WFTC and DPTC claims have been made to the Inland Revenue through the Benefits Anti-Fraud hotline and almost 50,000 WFTC/DPTC claims have been investigated. Yet there have been only 28 prosecutions and 7 custodial sentences.

Fraud in the WFTC/DPTC, October 1999 to December 2001

Number of applications identified as being appropriate for further investigation	60,614
Number of applications investigated	48,595
Number of allegations communicated to the Inland Revenue via the Benefits Anti-Fraud hotline, October 1999 to December 2001	16,676
Number of investigations that proved instances of fraudulent/non-compliant activity	9,665
Number of penalties	645
Number of prosecutions	28
Number of custodial sentences	7

Dawn Primarolo, *Hansard*, 13 February 2002, c.368W; 7 February 2002, c.1143W; *Hansard*, 5 February 2002, c.851W; *Hansard*, 31 January 2002, 515W

The Government has admitted that 17 of the 28 people prosecuted ‘had other benefit offences heard concurrently.’⁵⁹ In other words, it is not clear how many of the WFTC/DPTC prosecutions were uncovered by the Inland Revenue and how many are the by-product of investigations by fraud investigators from elsewhere. By 2003, the Inland Revenue will administer the Child Tax Credit, the Working Tax Credit and Child Benefit – worth £29 billion in total – so the failure to tackle fraud in the existing tax credits augurs poorly for the future.

Moreover, there are reasons to believe the new tax credits may be even more susceptible to fraud than the existing ones. WFTC applicants have to provide documentary proof of their earnings, whereas applicants for the Child Tax Credit and the Working Tax Credit will not need to do this.⁶⁰ The complexity of the new system will also make it easier for fraud to enter the system. Claimants will need to provide detailed information on changes to their annual income, on their average hours of work and on their childcare costs.

59 Dawn Primarolo, *Hansard*, 17 January 2002, c.433W.

60 Inland Revenue, *New Tax Credits: Supporting families, making work pay and tackling poverty*, July 2001, para.64, p.23.

IX

The curious case of the working tax credit

The Working Tax Credit is a very curious benefit. The Chancellor's plans for integrating benefits paid on behalf of children takes away the rationale for not letting adults without children claim in-work benefits. Because the Government's other policies have left no reason for barring people who are not parents from claiming in-work benefits, they have had to widen entitlement to include those without children. And, under the new system, the Working Tax Credit will represent the vestigial remnant of the Chancellor's old belief that credits should be paid through the payroll wherever possible.

As with the WFTC and the DPTC, the lower age limit for the Working Tax Credit will be 16 for parents and for people with disabilities. But for childless people without disabilities, it will be restricted to full-time workers aged 25 and over. This is because the Government believes that 'those aged 25 or over are more likely to face severe financial barriers to work or suffer persistent poverty.'⁶¹

Ministers have not provided any detail to show that people aged over 25 face particular difficulties and poverty in childless families is in fact concentrated amongst those in which the adults do not work full-time and amongst the young. Both of these groups are explicitly barred from claiming the new credit. It is perverse to design a new tax credit for a specific group – childless adults – and to then exclude the people within that group who have the most to gain from the measure. And it is for these reasons that the IFS have claimed that the Working Tax Credit may have no impact on poverty whatsoever.⁶²

And there is another problem with the Working Tax Credit as well. Take-up is likely to be considerably lower than for other means-tested benefits because awards will be comparatively small and because the measure is excessively complicated. Average claims will be worth less than £20 a

61 Dawn Primarolo, *Hansard*, 19 December 2001, c.328W.

62 Institute for Fiscal Studies, *The IFS Green Budget*, January 2002, p.79.

week.⁶³ Many people who are eligible will have little experience of claiming state support, yet they will be expected to understand a credit that has seven separate elements:

a basic element;

an element for lone parents or couples;

a further element for those working a certain number of hours per week;

an additional element for workers who have a disability;

an additional element for claimants with a severe disability;

an additional element for those over a prescribed age returning to work (this will be time limited);

and, an element to help meet child care costs with an approved provider.

It is likely that the take-up of the Working Tax Credit amongst eligible adults without children may be similar to the take-up of the WFTC amongst two-earner couples, as they also tend to have small entitlements and to face increased marginal deduction rates. If this is the case, take-up could be less than one-third of all eligible recipients.

The Working Tax Credit has another odd feature as well. Help with childcare costs will be paid as part of this credit, rather than as part of the Child Tax Credit. But this element of the Working Tax Credit alone will be paid direct to the parent with care alongside the Child Tax Credit.

So the Working Tax Credit is not well targeted on people living in poverty. Recipients will receive comparatively small sums. It is very complicated and take-up is likely to be low.

63 Institute for Fiscal Studies, *The IFS Green Budget*, January 2002, p.83.

X

Summary and Conclusion

The Government claims to believe in evidence-based policy. This is an admirable basis for formulating policy which we strongly support. In this pamphlet we have tried to assemble the evidence on tax credits, despite a scandalous refusal by the Treasury to answer even elementary factual questions about them. The evidence disproves just about every claim made for tax credits.

The reason why tax credits have escaped so lightly from serious criticism is that they are wrongly thought to be the only way to implement a very desirable principle. This is the principle that we should try to boost the incomes of people in low paid jobs, especially if they have family responsibilities. This principle has been implemented in the British social security system ever since Keith Joseph introduced Family Income Supplement in 1971. That was replaced in 1988 by Family Credit, on which we were spending over £2 billion when the last Conservative government lost office. Gordon Brown could have achieved just about everything he wanted in a far more effective and straightforward way by keeping Family Credit and, if he wished, spending more money on it. But that would have involved admitting that there was such a thing as help for people in low paid jobs before 1997. The new tax credits make it easier for Ministers to pretend that nothing came before them. It is this attempt to integrate taxes and benefits via tax credits which is the subject of our critique, not the principle of helping low paid families.

There is no empirical evidence of any advantages from paying benefits through the pay packet as tax credits. When explicitly asked for such evidence the Treasury have been unable to offer any. Martin Taylor, who was originally brought in to advise on the subject, could only refer vaguely to 'psychological matters'.⁶⁴ Indeed, after shifting to tax credits delivered through the pay packet in 1999, the Chancellor himself seems to have had

64 *Social Security Select Committee, Tax and Benefits: Implementation of Tax Credits*, December 1998, Minutes of Evidence, Martin Taylor, 17 June 1998, Question 11 p.2.

his doubts about this approach because much of this expenditure is to revert to being a direct payment to the parent with care in 2003. However, he is at the same time creating a new credit delivered through the pay packet, the Working Tax Credit, which will trap a new and different group of employees and employers in payroll delivered benefits.

There are real differences between taxes and benefits which are all too easily dismissed as mere administrative matters when they reflect the underlying difference between paying in our taxes and taking out our benefits. For example, income tax is paid on annual income whereas benefits take account of needs which may change over a much shorter period. We value the principle of independent taxation so that spouses are taxed separately. However, we assess means-tested benefits on household income because we do not regard someone as poor if his spouse is rich. In trying to integrate these different systems we create new problems.

This tax credit agenda is also very expensive. The expense is not, by and large, in higher payments to the poorest people but in payments to people higher up the earnings scale who are brought into means tests for the first time. These costs are hidden by the Chancellor's trick of redefining them as tax reductions. We asked the House of Commons Library to estimate the growth of social security spending between 1996-97 and 2003-04 including the Chancellor's credits. The figures show a bigger increase in social security spending over the period than in either health or education spending. No other department scrutinises the Treasury's spending on tax credits so the budget for them can grow like topsy, whilst every other department has to face sceptical scrutiny from the Treasury.

The expense of tax credits would be even greater if all the people who were entitled to them took them up. But take-up of means-tested benefits is declining and take-up of the new tax credits is even lower. Fewer than half of eligible couples are claiming the WFTC. Often Ministers estimate the effects of their policies on poverty assuming 100 per cent take-up of benefits. Sadly, this is a far from the case.

Tax credits in particular suffer from catastrophically low levels of take-up. This indicates that people do not like them and are uncomfortable with them. The limited evidence we have from surveys tends to confirm this. 89

per cent of families in one survey said they would rather receive in-work benefits in ways other than through the employer. In the USA the Earned Income Tax Credit, on which the Chancellor is supposed to have modelled his scheme, is received via the payroll in less than 1 per cent of cases. Policy has rested on the belief that it is better for people to get their benefits via the payroll when the evidence shows that they prefer the opposite. That is one of the reasons why take up is so low.

The low levels of take up are despite record levels of spending on advertising and take-up campaigns run by many local authorities. During the last three years, the amount spent on advertising one single benefit – the WFTC – is equal to the amount spent publicising all benefits during the 1992 to 1997 Parliament.

The tax credits are also particularly at risk of fraud. The widespread abuse of the Childcare Tax Credit has caused real problems to childcare providers. Parents book a place at a childcare centre, take the credit as cash and never use the place. The Revenue is not skilled in tackling social security fraud and has failed to address it. 16,000 suspected cases of tax credit fraud have been notified to them, and there have been 28 prosecutions.

The purpose of all this is supposed to be to reduce very high marginal rates facing families. But what it has done has been to spread means testing and high rates of tax and benefit withdrawal further up the income scale. The total number of people facing marginal rates of more than 60 per cent will grow by 350,000 by 2003.

Between October 1999 and April 2003 the Chancellor will have introduced five new tax credits for families, scrapped four of them and then introduced two more. That averages out as a new tax credit for families every six months. It is time for the Chancellor to expose these policies to the same level of scrutiny as all other items of expenditure. He will find that the evidence simply does not justify the claims made for these policies. The suspension of disbelief cannot go on.

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