A better way to help the low paid

US lessons for the UK tax credits system

RUPERT DARWALL

With a Foreword by Ron Haskins, Brookings Institution

CENTRE FOR POLICY STUDIES
57 Tufton Street London SW1P 3QL
2006

THE AUTHOR

RUPERT DARWALL studied economics and history at Cambridge. He worked in the Conservative Research Department in the mid-1980s and was subsequently a stock analyst and corporate financier at Swiss Bank Corporation. He was a special adviser to Norman Lamont at HM Treasury in 1993. He is the author of *Paralysis or Power* (CPS, 2002) and *The Reluctant Managers* (KPMG, 2005).

Acknowledgements

The author would like to thank Phil Alexander, Norman Blackwell, Mike Brewer, Alice Close, Tim Knox and Norman Lamont.

Support towards the publication of this Study was given by the Institute for Policy Research.

ISBN No. 1 905389 30 2

Printed by 4-Print, 138 Molesey Avenue, West Molesey, Surrey

CONTENTS

FOREWORD

by Ron Haskins, Senior Fellow,
Brookings Institution, Washington, DC

I AM PLEASED TO HAVE THE OPPORTUNITY to write a brief Foreword to this superb report on tax credits for the poor. The major argument of the paper is that tax credits should be given to families that work and not to families that choose not to work.

There are two obvious problems with providing tax credits to people who do not work. First, it is a major principle of economics that giving adults non-contingent money reduces their work effort. Second, if tax credits are confined to low-income adults, they must be phased out at some point along the continuum of earnings. Thus, not only does a tax credit give people money for doing nothing; it takes away money for doing something constructive. If a major goal of the UK's system of tax credits is to increase work and to reduce poverty, it would be hard to design a less successful approach than providing the credit to non-working adults.

As Rupert Darwall argues in this report, the UK may have something to learn from the US system of tax credits for families. I would supplement his argument by pointing out that policy-makers in the US have labored to change dramatically the two systems that provide benefits to low-income families: the work support system that provides cash and other assistance to low-income working families and the welfare system itself.

The goals of the two systems can be succinctly stated: the work support system provides generous support to low-income working families; the welfare system provides spare and reciprocal support to families that do not work. I think both systems are necessary to maximize work by the poor.

Welfare recipients in the US are compelled to work by sanctions and by a five-year limit on benefits. In three words, the welfare system is based on the principles of reciprocity, compulsion, and limits. Once welfare recipients go to work, however, they are greeted by a generous work support system that gives them tax credits, child care, health insurance, and other benefits. Since roughly the mid-1980s, US policy-makers have created some programs and modified others to provide more generous benefits to working families. The most important changes have been expansions in our Earned Income Tax Credit (EITC) in 1986 under Reagan, in 1990 under Bush I, and in 1993 under Clinton. There have also been expansions of child care, health insurance, and other programs.

Consider a welfare mother of two who finds a job in the service sector for $10,000 a year and leaves welfare. In a typical state, she would give up cash welfare and food stamp benefits totaling about $6,500. In place of the $6,500 to $8,000 in welfare, she would have her $10,000 in earnings, she would receive about $4,500 in cash from the EITC, and she would still qualify for about $2,000 in food stamps, for a total income of about $16,500. In addition, she would be likely to receive some funding for child care and her children would be covered by government health insurance as long as her income is below approximately $38,000.

This approach, based on tough welfare and generous work supports, has driven down the welfare rolls by 60% since 1996, resulted in historic increases in work by low-income mothers, and dramatically reduced child poverty. Even after the recession of 2001, work by mothers remains well above its pre-welfare reform level and child poverty is still 20% lower than in 1994. It is difficult to believe that results like these can be achieved by any approach that not only fails to strongly encourage people to leave welfare but actually provides them with financial incentive to stay on it. It is to be hoped that policy-makers in the UK will pay careful attention to Mr Darwall's paper and then follow his advice to modify the system of tax credits.

But in addition, it may well prove necessary to use sanctions and time limits to cajole people to leave welfare.

Ron Haskins
July 2006

Ron Haskins is a Senior Fellow at the Brookings Institution. He was a Senior Advisor on Welfare Policy during the first George W Bush Administration and was Staff Director in Congress during the Clinton Administration's welfare reforms of the mid-1990s. He has written the definitive history and analysis of the 1996 welfare reform bill, Over Welfare: The Inside Story of the 1996 Welfare Reform Law (Brookings, to be published in September 2006).

SUMMARY

- The tax credit system performs an important role in getting cash to low-paid families.

- Tax credits work efficiently in the US where they have bipartisan support. They were developed by a Democrat senator, signed into law by a Republican President and expanded by President Reagan. In the 1990s, they were substantially expanded during the Clinton Presidency and have largely been responsible for lifting 4.3 million people and 2.2 million children out of poverty.

- The key feature of the US system is that it encourages and rewards the low paid to work their way out of poverty with a tax credit worth up to 40¢ for each $1 of pre-tax earnings.

- In contrast, and despite all the rhetoric on rights and responsibilities and the importance of work, there is no work requirement to receive tax credits. 1.4 million people are not working but are receiving tax credits.

- UK tax credits have extremely high marginal rates of tax (of up to 70%). These create a huge fiscal barrier to the low paid being rewarded for full-time work. A single mother on earnings 25% above the minimum wage can see her after-tax-and-benefit income fall to just £1.89 an hour depending on

the number of hours worked per week – a little more than one third of the Minimum Wage.

- Although tax credits *give* poor families more money, they also make it harder for poor families to *earn* more money.

- They are socially divisive, helping to create a stratified, two-class Britain – one, a class of advancement and achievement; and the other, a class of dependency, passivity and social breakdown.

- Tax credits in the UK have not been successful in other respects:
  - they discourage full-time work;
  - they are complex;
  - they are more generous to lone parents than to couples and thereby penalise mothers and fathers who live together;
  - administrative problems with over-payment are designed into the system.

- Tax credits are expensive, costing £15.8 billion last year. UK expenditure on tax credits is around 0.9% of GDP, compared to 0.3% in the US.

Recommendations

- The UK tax credit system needs to be completely redesigned.

- The objective should be similar to President Clinton's: if you have a child at home and you work 40 hours a week, you will not be in poverty.

- This objective can be delivered by a British Earned Income Tax Credit (EITC). Under this system, low paid families with children would receive an additional 35p for every £1 of earnings for the first £10,000 of pre-tax income. The EITC could be phased out at a rate of 25% up to £24,000.

- This would give a powerful boost to incentives for those earning between £5,220 and £10,000 a year.

- In this range, the current marginal rates of 58% and 70% would be replaced by net payments from the taxman.

- Above £10,000 a year, incentives are also improved for everyone receiving more than the child element of the existing tax credits.

- As is the case with nearly 99% of EITC recipients in the US, the new tax credits should be paid after claims have been finalised, removing a key weakness of the current system.

- The proposed EITC would cost only around £6bn a year.

- After taking into account transfers back to the welfare budget, this refroms would yield £8bn in savings. This could be used to improve work incentives further by reducing the basic rate of income tax to 20p.

- In addition to helping the low paid work their way out of poverty, the British EITC would increase the supply of labour, reduce dependency, increase output per head and improve economic performance.

CHAPTER ONE

THE UNDERLYING PROBLEM

POVERTY IS NOT A LINE, a statistical abstraction across a graph. Ultimately, it is not a lack of money. It is the inability to earn money and dependence on welfare.

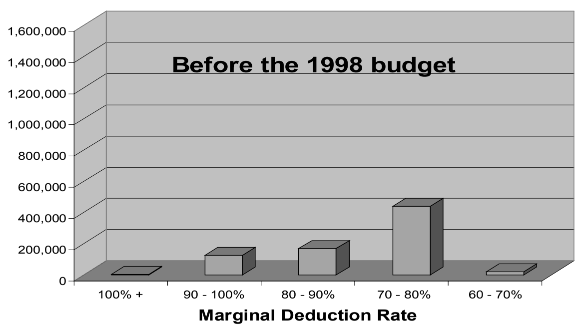
New Labour talked tough on welfare. But it has not made tax credits conditional on work. Gordon Brown, a self-confessed admirer of the US and the economic reforms of the Clinton years, did not learn the two crucial lessons of the Earned Income Tax Credit (EITC): its simplicity and pro-work incentive structure. Expanded by Bill Clinton, the US system makes work pay. In the UK, the low paid face extremely high marginal rates of tax when they get a better paid job or work longer hours. Extra work does not pay.

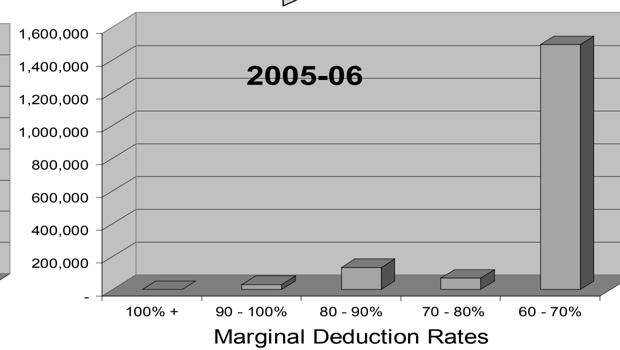
Since their introduction in 1999, tax credits have been at the nexus of tax and the welfare system. They perform an important role in getting cash to low-paid families. This role cannot be replicated elsewhere in the tax system. For this reason, tax credits are here to stay. Because the way they work puts a lid on the aspirations of those who get them to improve their lives through work, they need to be completely overhauled.

In terms of incentives, £1 of benefit withdrawn because of rising income is no different from £1 extra in tax. The interaction of the tax and benefit system in raising marginal tax rates and damaging incentives has been known for at least 40 years. One of the aims of tax credits was to tackle the problem. In fact, they have made it worse. At a net cost of around £13bn a year, around 750,000 people facing marginal rates of 80% or more have been replaced by 1,750,000 facing marginal rates of 60% or more.

What tax credits have achieved

At a net cost of £13bn a year





Nearly one million more families on high marginal deduction rates

Source: HM Treasury, *Tax credits: Reforming financial support for families*, March 2005, Table 4.3

Well-publicised problems, notably the extent of fraud and the hardship caused by clawing back of over-payments, have obscured the fundamental problem – the impact of tax credits on incentives. Take the case of a single mother earning 25% above the £5.05 minimum wage rate who is working 16 hours a week. If she decides to work 30 hours a week in the following tax year, her extra income is taxed at an effective rate of 47.3% – a higher rate than the top rate of income tax. Her after-tax income for the extra 14 hours a week falls to £3.33 an hour – over third *less* than the national minimum wage. The situation is even worse should she then decide to work 40 hours a week. Income from those extra ten hours is taxed at 70% and her after-tax income from the extra work falls to £1.89 an hour – just over one third of the minimum wage.

The message is stark: if the low paid decide to work harder, they end up working more for the government than for themselves. Although tax credits *give* poor families more money, they make it harder for poor families to *earn* more money. This is bad for them, as they can't improve their position in life through working harder. And it is bad for the economy, as it restricts the supply of labour.

For these reasons, tax credits need to be completely re-designed.

CHAPTER TWO

THE US – WHERE TAX CREDITS WORK

The US and the UK: two different approaches

The elections of President Clinton and Tony Blair were followed by significant falls in the proportion of families living in poverty in both the US and UK. The proportion of children living in poverty (on an absolute measure) fell by nearly one third in the US between 1992 and 2001 and by just over one quarter in the first three years of the Blair Government.

The routes taken to achieve this were very different. In the UK, around 60% of the fall was caused by higher government benefits. In the US, around 60% of the fall was accounted for by changes in work patterns.[1] As the authors of this analysis note, for policymakers in the US:[2]

> *The goal was increasing work and increase work they did… Indeed work among low education single parents in the US, which had stood at 30% for decades, suddenly rose to over 50% in just a few years.*

By contrast, in Britain, as the authors put it, a more 'humane' approach was implemented by boosting the incomes of the working and non-working poor alike. According to their analysis, changing work patterns contributed only 15% to the fall in poverty. In short, the US approach enabled the poor to work their way out of poverty; the UK approach has been about higher welfare benefits.[3]

---

1 Richard Dickens and David Ellwood, 'Child Poverty in Britain and the United States', *The Economic Journal*, June 2003, table 4.

2 Ibid., p. 236.

3 See Chapter 7 for details on how the EITC works in practice.

Does this matter? Leaving aside considerations of cost – and the UK approach is much more expensive – it has big implications for the welfare of the poor themselves in terms of breaking out of the poverty cycle. A University of Michigan study has shown that, holding constant for race, parental education, family structure and a range of other social variables, the more welfare income received by a family while a boy was growing up, the lower the boy's earnings as an adult. If two boys were raised in families with identical non-welfare incomes and spent the same time in poverty, the more welfare received by one of the families, the lower the earnings of the boy raised in the family when he becomes an adult.[4] The ambition of breaking the poverty cycle is why both Democrat and Labour politicians in the 1990s emphasised the importance of work in improving the position of the poor in society.

A second reason why it matters stems from the inescapable arithmetic of means-tested benefits. The larger the benefit, the steeper the withdrawal rate and/or the higher up the income scale the withdrawal rate has to go. High marginal rates put a cap on the aspirations of the poor to work their way to a better future. Simply putting more money into tax credits gives the poor more cash and can help ameliorate poverty at the bottom of the income scale – but it does so at the cost of creating an aspiration barrier further up.

The policy debate

The debate that shaped policy in the US was initiated in the 1960s by Milton Friedman. In 1962, Friedman published his book *Capitalism and Freedom* in which he advocated a negative income tax as a solution to the disincentives caused by the high marginal tax rates which result from the interaction of tax and the welfare system. Instead of lots of different welfare benefits, a negative income tax would provide a minimum income guarantee whether

---

4 Mary Corcoran, Roger Gordon et al, 'The Association between Men's Economic Status and Their Family and Community Origins,' *Journal of Human Resources*, Fall 1992, pp. 575-601.

or not someone worked and give them what they would value most – cash, rather than benefits in kind. It could streamline the benefit system, replace a rag-bag of different programmes and cut marginal tax rates at the bottom of the income scale.[5]

Such were the attractions of the proposal that in 1966 Friedman's negative income tax formed the capstone of the Johnson administration's war on poverty. However, Johnson himself disliked the idea on the grounds that a guaranteed annual income undermined work effort. In 1969 a negative income tax was adopted by the Nixon administration as the Family Assistance Plan (FAP). But the Democrat chairman of the senate finance committee, Senator Russell Long, opposed it on similar grounds as President Johnson had. Interestingly, in the early 1970s, it was the Republicans who were in favour of a minimum income guarantee and the Democrats who stressed the importance of work.

As senators began to understand how existing welfare programmes had heavy disincentives on work, a policy which merely reduced and redistributed those disincentives was not politically acceptable. As the economist Robert Moffitt notes, 'work requirements are fundamentally at odds with the idea of a Friedman-style negative income tax. With such a tax, non-workers are not queried about the reason for their lack of work.'[6]

After the defeat of FAP in 1972, Senator Long developed the idea of a 10% income bonus scheme for the low paid. A variant was passed with the 1975 tax bill as the Earned Income Tax Credit. It added a 10% supplement to wages up to $4,000 a year which was phased out at 10% over the next $4,000 of income. In 1978, a flat range was added after the phase-in to give it its present shape. The EITC had support of both Republicans and

---

[5] The account here of negative income tax and the Earned Income Tax Credit is taken from Robert Moffitt, 'The Negative Income Tax and the Evolution of US Welfare Policy', *Journal of Economic Perspectives*, 2002, revised 2003; and *The Earned Income Tax Credit,* Joseph Hotz and John Schloz, 2000, NBER.

[6] Moffitt, p. 18.

Democrats. President Reagan expanded the EITC as part of the 1986 Tax Reform Act, enabling Reagan to declare that 'millions of working poor will be dropped from the tax rolls altogether.'[7]

In the early 1990s, expanding the EITC became a signature issue for President Clinton. In his first state of the union speech, Clinton proposed a huge expansion of the EITC: [8]

> *By expanding the refundable earned income tax credit, we will make history; we will reward the work of millions of working poor Americans by realizing the principle that if you work 40 hours a week and you've got a child in the house, you will no longer be in poverty.*

Perhaps the programme's identification with Clinton meant that the EITC became a Democrat issue; perhaps too because of the increase in its cost – from around $10bn a year to well over $30bn. From a UK perspective, Clinton's approach is both more ambitious in intent and far less expensive than Gordon Brown's. With Clinton, it is clear what he believed the EITC should do: by rewarding work, to enable families with children to work their way out of poverty. The EITC is well-designed to achieve that objective.

The same could not be said of Gordon Brown's tax credits. In Britain, anyone who is on tax credits and is working 40 hours a week is in effect a charity worker, handing over 70% of the extra cash they earn to the government. In relative terms, Gordon Brown's tax credits cost three times as much as President Clinton's. Spending on the EITC is around 0.3% of GDP compared to 0.9% for the UK tax credits.[9]

So, perhaps surprisingly, Gordon Brown's tax credits resemble Milton Friedman's negative income tax, favoured by President

---

7 22 October 1986.

8 17 February 1993.

9 The UK figure is based on £10.1bn scored as public spending in the national accounts.

Nixon and the Republicans in the early 1970s. As a Treasury policy paper puts it, tax credits 'have brought many of the key attributes of a system of negative taxation.'[10] Acknowledging the advantages of a negative income tax, the Treasury paper then sees disadvantages in 'the risk of undermining the government's approach of matching rights and responsibilities which requires the unemployed to seek work.'[11]

It is difficult to square this statement with reality. For those with children, the child tax credit is a minimum income guarantee. Nothing is expected in return. This indicates the confusion between, and misalignment of, policy objectives and policy means, which, as will be seen, is the fundamental cause of the policy failure.

1996 welfare reform

After winning control of Congress in 1994, the Republicans introduced legislation to promote work by making welfare conditional on finding work, to time-limit welfare to five years, to promote marriage and to reduce out-of-wedlock births. It was signed into law by President Clinton in 1996.

Welfare reform was based on sociological evidence that extended periods of welfare kept poor people poor, that work provided the best path out of poverty and that, because the child poverty rate for single parent families is about five times higher than for married couple families, the most effective way to reduce child poverty is to increase the proportion of children in families with stable marriages. As such, it marked a complete change in the direction of welfare policy of the previous 50 years or so.

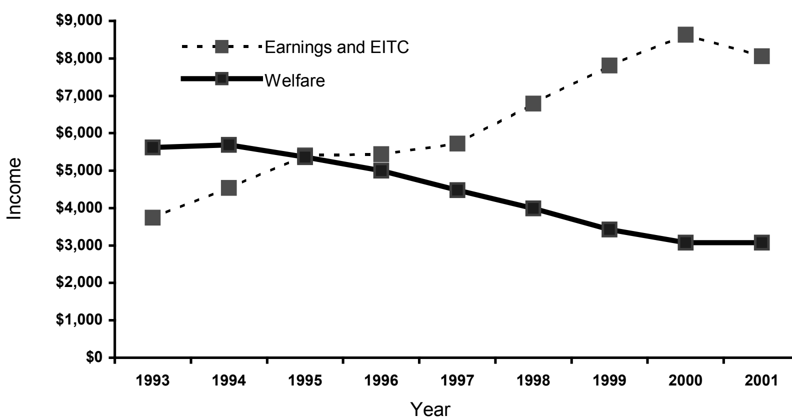
---

10 HM Treasury, *Tax credits: Reforming financial support for families*, March 2005, para 3.2.

11 Ibid., para. 3.16.

What is remarkable is the extent to which the goals of the 1996 law have been delivered. Overall poverty, child poverty, black child poverty and poverty of single mothers have all declined. Employment of single mothers has increased and the number of people on welfare has fallen. It appears to have halted the seemingly inexorable rise in the proportion of out-of-wedlock birth, which had climbed from 8% of all births in 1965 to 33% in 1994, with falls in the rate of out-of-wedlock birth rate among blacks.[12]

Earnings and EITC compared to welfare income for bottom two fifths of female-headed families (1993 – 2002)



Source: Richard Bavier with US Census Bureau data (Welfare income is cash, school lunch, food stamps and housing; constant 2002 dollars). Prepared by Brookings Welfare Reform & Beyond Initiative, 2005

The chart above shows how welfare reform and expansion of the EITC have succeeded in pulling poor families up the income scale. One analysis has estimated that 20% of the increase in employment

12 The Heritage Foundation, *The Continuing Good News About Welfare Reform*, February 2003.

was caused by the economic growth, another 50% was linked to welfare reform and the remaining 30% traced to the EITC.[13]

Most policies can look good in times of plenty, so the big test came with the 2001 recession. In previous recessions, welfare rolls went up and stayed higher than before. With the 2001 recession, welfare rolls kept falling, albeit at a slower rate.

Evidence of the success of welfare reform has swung around some previous opponents. Indeed, Wendell Primus, a Clinton appointee at the Department of Health and Human Services, who had resigned over the issue, said five years later:[14]

> *In many ways, welfare reform is working better than I thought it would. The sky isn't falling anymore. Whatever we have been doing over the last five years, we ought to keep doing.*

Who could say the same about tax credits here?

Lessons for the UK

When New Labour sought office in 1997, its election manifesto promised to 'design a modern welfare state based on rights and duties going together.' It also stated that it would 'stop the growth of an underclass in Britain'. And it said that:[15]

> *We will also examine the interaction of the tax and benefit systems so that they can be streamlined and modernised, so as to fulfil our objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening community and family life.*

These objectives are surely right. In the US, they were being achieved through policies based on the following principles:

- **Tax credits should reward work.** The EITC is unambiguously positive in terms of work incentives. It only benefits those in work – unlike UK tax credits. Across every

13 Cited in Hotz and Scholz, p. 40.

14 *The New York Times*, 12 August 2001.

15 *Labour Party Manifesto,* 1997.

dimension (simplicity, incentives, cost and capacity to meet policy objectives), the EITC is superior to UK tax credits.

- **Conditionality for receiving welfare benefits.** In the US, these include tightly supervised job search requirements for the unemployed, and sanctions for school truancy for those with school age children.

- **Time-limited welfare for those of working age.** In the US, welfare is temporary, designed to help families through a period of misfortune or misadventure. It does not finance a way of life. Time limiting means-tested benefits such as housing benefit helps overcome the problem of high marginal rates whilst giving help when most needed.

- **Recognising the link between child poverty and the lone parenthood.** The long-term rise in the out-of-wedlock birth ratio has been supported by welfare policies. Changes in those policies can halt and reverse it.

- **Low tax rates.** High tax rates exacerbate the effects of tax credit tapers. To work, tax credits need low income tax rates.

Given similar objectives, there is much that should have been – and still can be – learnt from the US. The US has had tax credits for the low paid for 20 years. And as the economist Robert Barro wrote in 1996 when President Clinton was enlarging the programme:[16]

> *The EITC was originally a Republican idea – started by the Ford administration in 1975 and expanded by the Reagan administration during the glorious 1980s… Mr Clinton's support is not sufficient reason to regard the program as mistaken. In fact, it has a well conceived structure that ought to be retained and perhaps expanded.*

---

16 *Wall Street Journal*, 21 May 1996.

CHAPTER THREE

GORDON BROWN'S TAX CREDITS

THE CHILD TAX CREDIT and the working tax credit were announced in the 2002 budget and introduced in 2003. They replaced a range of other tax credits introduced by the Government since 1999, including the working families' tax credit and the children's tax credit. In addition, the child tax credit subsumed the child allowances in income support paid to those out of work.

How tax credits work

Synopsis: The child tax credit and the working tax credit comprise various elements depending on each claimant's circumstances. These elements are added up to make a total tax credit award. When a claimant's pre-tax income is greater than £5,220 a year, this award is reduced by 37p for every extra £1 of pre-tax income. When combined with income tax and national insurance, this leaves the low paid with only 30p out of every £1 they earn above £7,185 a year.

Child tax credit now constitutes the single largest channel of welfare payments to families with children. 90% of such families receive it. It is made up of a number of elements: a family element of £545 a year (doubled for a baby less than one year old), a per child element worth £1,765 a year and elements for disabled and severely disabled children.[17] Tax credits start to be withdrawn when pre-tax earnings go above £5,220 a year. Income above this level is subject to a 37% taper until all tax credits have been removed except for the family element, which has its own 6.6%

[17] All amounts are for the 2006/07 tax year.

taper for pre-tax incomes of over £50,000 a year, being fully phased out at £58,257. Because the taper is on pre-tax income, it cumulates arithmetically with income tax and national insurance, resulting in marginal tax rates of up to 70%.

In a significant change from the working families' tax credit which it replaced, recipients do not have to work to be eligible for child tax credit. This obviously weakens the incentive to work: you get it whether you work or not, while the taper on income over £5,220 a year acts as an additional 37% tax. In terms of improving incentives and rewarding work, this change is regressive.

The working tax credit operates in a similar way. It too has a number of elements. For those with children working at least 16 hours a week, there is a basic and parent's element of £3,305 a year and a 30 hour element of £680. In addition, there are childcare elements enabling claimants to reclaim 80% of childcare costs up to £175 a week for a single child and £300 a week for two or more. The childcare element has a strong bias toward institutionalised childcare and against children being looked after by members of their own family. Working tax credit is aggregated with child tax credits and tapered away above the £5,220 income threshold at 37%.

Both are fully refundable tax credits. Each £1 of award extinguishes pound for pound for any tax liability to zero and beyond, giving rise to net payments from the taxman. These can be substantial – with net payments of over £5,000 a year in some cases and, depending on family circumstances, no net tax payment for pre-tax incomes up to £14,000 a year. This comes at the cost of high marginal rates which makes it far less worthwhile for people to move up the income scale and do better for their families through their own effort.

The following table illustrates this for a single mother earning an hourly wage 25% above the national minimum wage of £5.05 an hour. At 16 hours a week, her annual income is just into the 10% income tax band and above the NICs lower earnings limit, resulting in a tax payment of £1.82 a year before tax credits. Tax credits are higher than pre-tax income: they more than double take home pay.

But from that point, the system is far less generous. Working 30 hours a week means being eligible for the £680 30-hour element of the working tax credit, but this does not offset a £2,247.83 reduction in tax credits (£1,567.83 after the 30-hour element) plus the £1,199.56 increase in income tax (now payable at 22%) and NICs. The effect is that the extra 14 hours a week are taxed at an average rate of 47.3% reducing income after tax to £3.33 an hour.

It gets even tougher if this single mother works an additional ten hours, from 30 to 40 hours a week. With no additional working tax credits to offset the 37% tax credit taper, these ten hours generate £3,152.46 of extra pre-tax income but only £945.74 of post-tax income – a tax rate of 70%. It is hard to see why anyone on tax credits would want to work 40 hours a week. (For detailed calculations, see Appendix 1.)

People do not work just to pay tax. They work to increase their after-tax income. Tax credits, sitting on top of a 33% basic rate of income tax and NICs, create a massive barrier for the low paid to advance in life by working harder and earning more.

Illustration of impact of tax credits on parent with one child earning 25% above the minimum wage (2006/07)

	16 hours/ week	**30 hours/ week**	**16→30 hours/ week**	**40 hours/ week**	**30→40 hours/ week**
Pre-tax income	£5,043.69	£9,457.39	*£4,413.70*	£12,609.85	*£3,152.46*
Total IT & NICs	£1.82	£1,201.39	*£1,199.56*	£2,241.70	*£1,040.31*
IT & NICs per hour	-	*£0.80*	*£1.72*	*£1.12*	*£2.08*
Tax credit	£5,615.00	£4,727.17	*£887.83*	£3,560.76	*£1,166.41*
Total tax refund	£5,613.18	£3,525.78	*-£2,087.40*	£1,319.06	*-£2,206.72*
Income after tax	£10,656.86	£12,983.17	*£2,326.30*	£13,928.91	*£945.74*
Income after tax/hour	£10.45[18]		*£3.33*		*£1.89*
Average tax rate	-111.3%	-37.3%	*47.3%*	-10.5%	*70.0%*

18 Excludes child tax credit as payable without need to work.

Tax credits and child poverty

Synopsis: Tax credits are meant to be an important tool in reducing child poverty. In reality they disincentivise full-time work and they penalise mothers and fathers who live together – both important factors for breaking the poverty cycle. Last year, there were 1.4 million people not working who received tax credits.

The Government has a long-term goal of eradicating child poverty by 2020 and tax credits have been engineered to deliver cash to low paid families with children. The system's focus is on supporting the low paid during the years they are raising children. Of the 4.6 million working families in receipt of tax credits last year, only 282,000 received the working tax credit and not the child tax credit. The value of child tax credit is linked to the number of children in a family and, apart from those with a disability, the 16 hour element of the working tax credit is only available to families with children.

The Government argues that child poverty is a particular problem in Britain. According to the Treasury, in 1998, the UK had the highest proportion of children in low-income households in the European Union.[19] Its research showed poverty and its negative impacts were being transferred from one generation to the next. In listing the determinants of inter-generational poverty – low income in childhood, growing up in a household where no one worked, poor schooling, family attitudes and expectations – the Treasury omitted what an increasing body of sociological evidence suggests is the single most important.[20] Not that the Prime Minister's strategy unit is much better. In a 58 page document on life-chances, this factor merits a single line: 'some family structures – such as lone parenthood – may increase the risk of childhood poverty.'[21]

---

19 HM Treasury 2005, para 2.24.

20 Ibid., para 2.27.

21 Prime Minister's Strategy Unit, *Life chances and social mobility: an overview of the evidence*, 2004, p.38.

The Treasury document points out that the UK has one of the largest gaps between employment rates for co-habiting mothers and lone parents. In some countries, such as Italy and Spain, the employment rate for lone mothers is higher than for couple mothers. In others, such as Canada, the US, France and Germany it is more or less the same. In the UK, the falling employment rate of lone mothers, together with the increase in the number of lone mothers, led to a steady rise through the 1980s and 1990s in the number of lone parents on income support.

For all the Government's strong words on the importance of work and reducing welfare dependency, policy is weak. There is no work requirement for people to receive tax credits, which 1.4 million workless people did last year.

Perhaps it is natural for a finance ministry to view poverty as essentially an economic problem caused by a lack of resources; if that were the case, the solution to the problem would be straightforward: more resources. But according to Christopher Jencks, Harvard professor of social policy, even people with little education and few skills can greatly reduce their risk of poverty and provide a decent upbringing for their children by following three simple rules – graduate from high school, work steadily and marry before bearing children.[22]

As shown above, tax credits disincentivise full-time work. They are also disproportionately more generous to lone parents than to couples. According to Mike Brewer of the Institute for Fiscal Studies, 'the WFTC only ever gives a negative financial incentive to form a couple.'[23] The same can be said of the current tax credits system.[24] The system incentivises families to live apart – or at least

---

22 Cited in A Wax, *Policy Review,* December 2005 & January 2006, p. 74.

23 *Comparing In-Work Benefits and the Reward to work for Families with Children in the US and the UK*, Fiscal Studies (2001), vol. 22, no. 1, p. 68.

24 Any system of assessing income on a household rather than on an individual basis, and which withdraws cash with rising incomes, inevitably penalises marriage and declared cohabitation.

to tell the government that they are. As a result, the government is paying tax credits and benefits to 2.1 million lone parents when there are only 1.9 million in the UK because, as the IFS points out, 'it is often financially worthwhile to pretend to be a lone parent, rather than a couple.'[25]

How much do tax credits cost?

Synopsis: Tax credits are expensive. The cash cost in 2004-05 was £15.8bn, which included £2bn of over-payments.

According to Inland Revenue accounts, the child tax credit and working tax credit cost around £15.8bn a year in 2004-05[26] compared to £2.4bn spent on Family Credit in 1998/99, its last full year.[27] Total tax credit entitlement that year was reckoned to be £13.8bn, the remaining £2.0bn representing estimated over-payments and other accruals.

Spending on tax credits (2004/05)

	£bn
Entitlements	
Child tax credit	10.0
Working tax credit	3.8
	13.8
Over-payments etc	2.0
Actual spending	**15.8**
As per National Accounts	
Public spending	10.1
Negative taxation	3.7
Increase in debtors	1.7
Total	15.5

Source: Notes 3 & 6, *Department of Inland Revenue 2004-05 Accounts*

25 'Government paying tax credits to 200,000 more lone parents than live in the UK', IFS press release, 12 March 2006.

26 Notes 3 & 6, Department of Inland Revenue 2004-05 Accounts.

27 Mike Brewer, Alan Duncan et al., *Did Working Families' Tax Credit Work?*, HMRC, 2005, p. 7.

Tax credits are also costly to administer. Distributing them cost £475m, equivalent to 3.4p for every pound of tax credit entitlement.[28]

In terms of the national accounts, tax credits are treated as negative tax to the extent they are less than or equal to the income tax liability of the family unit. Amounts greater than this are scored as public spending. This has the effect of reducing the amount of reported income tax revenues by 3% (equivalent to 0.3% of GDP).

Over three quarters of tax credit entitlements are scored as public spending. In other words, £10.1bn of tax credits is the amount left over after families have paid all their income tax and national insurance. There is no other way for the tax system to deliver this cash – an average of £1,655 per family. Whether called negative tax or benefit, in the absence of tax credits, these families would not get this money – an important point if tax credits were to be abolished.

How tax credits differ from personal allowances

Synopsis: Tax credits are lump sum payments targeted at the low paid which can completely offset a family's tax liability and *lead to a net cash payment from the taxman. By contrast, the maximum help that raising the personal allowance delivers is reducing someone's income tax to zero.*

Tax credits operate in a fundamentally different way from the income tax personal allowance. Below the tax credit taper, increasing the level of tax credit increases the amount of cash received pound for pound; increasing the tax credit by £100 results in a £100 increase in cash to a tax credit recipient. By contrast, raising the personal allowance by £100 increases the amount of cash to the basic rate taxpayer by £22. For people earning less than the personal allowance, further increases in the personal allowance leave post-tax income unchanged.

---

28 Note 3.4, Department of Inland Revenue 2004-05 Accounts.

The refundable nature of tax credits also means that raising the personal allowance is not a substitute for tax credits because it cannot give the low paid a net payment. The most raising the personal allowance can do is reduce someone's income tax liability to zero. Neither would it offset National Insurance Contributions (NICs), an income tax in all but name, unless the Lower Earnings Limit (the threshold at which NICs become payable) is raised at the same time.

In terms of the cost to the Exchequer, raising tax thresholds is also less efficient in getting cash to the low paid. But the trade-off is the tax credit taper, which raises the marginal rate of tax faced by the low paid as they progress up the income scale. Whilst raising personal allowances has an implicit cost in terms of marginal tax rates – the higher the personal allowance, the higher the tax rates needed to raise the same amount of revenue – with tax credits, the disincentives caused by much higher marginal tax rates fall exclusively on tax credit recipients.

In other words, the pluses and minuses of the tighter targeting of tax credits is borne by the low paid. The incentives trade-off therefore is between higher personal allowances, with slightly higher tax rates for all income taxpayers, or much higher marginal rates concentrated solely on those eligible for tax credits.

What has caused the problems with tax credits?

Synopsis: The risk of over-payment and claimant error are inherent in the design of tax credits because they involve making provisional payments through the year to low-paid families which only become final after the end of the tax year. Naturally the low-paid do not treat tax credits as provisional, causing the problems of over-payment and claw-back.

Tax credits have encountered severe operational problems, with significant levels of claimant errors, fraud and over-payments. An analysis of a sample of tax credit payments led the Inland Revenue to estimate overpayment of £460m due to claimant error and fraud. That estimate is subject to a wide margin of error, as it was based on cases likely to be more compliant.[29] As a result, in October 2005, the Comptroller and Auditor General issued a qualification to his audit report on Inland Revenue's accounts for the third year in a row. The House of Commons Treasury select committee has also issued a report criticising the administration of tax credits.[30] However the problems with tax credits stem less from administration than from design.

For 2003/04, the second year of operation of the new tax credits, the Inland Revenue estimated total over-payments of £2.2bn.[31] Half the over-payments related to 238,000 families who had been over-paid £2,000 or more.[32] Over-payments arise mainly because claimants' income had increased by more than £2,500 during the tax year and because of changes in family circumstances. The tax authorities have attempted to recover over-payments by reducing future tax credit payments. To mitigate hardship to claimants, recovery of excess payments can take place over several years.

Over-payment was always going to be a risk. Tax credit payments are provisional and only become final after the end of the tax year, following a renewal process when the Inland Revenue asks claimants to confirm their circumstances, including their actual income for the year just ended.

Unsurprisingly, many tax credit claimants do not treat their payments as provisional. It would defeat the objective of making the system responsive to changing circumstances if they did, the whole point being to calibrate the appropriate quantum of financial support to families through the year. Although claimants are encouraged to tell the tax authorities about changes in income

---

29 Department of Inland Revenue 2004-05 Accounts, p. 67.

30 House of Commons Treasury Select Committee, *The administration of tax credits*, June 2006.

31 National Audit Office, *Comptroller and Auditor General's Standard Report on the Accounts of the Inland Revenue 2004-05*, para 12.

32 Ibid., para 2.10.

through the year, they are not required to. By contrast, families claiming help with childcare costs as part of the working tax credit have to tell the Inland Revenue if their spending on childcare costs changes by more than £10 a week within any four week period. As with the government paying more lone parents than there are in the country, the system has built-in incentives to dishonesty.

In an attempt to deal with the contradiction at the heart of the system, there is a £2,500 annual disregard. If families' incomes rose by less than £2,500, it would make no difference to their tax credit entitlement that year, although it would be reflected in next year's amount. The disregard is a way of redefining away the problem of over-payments inherent in the policy design.

In response to the hardship and publicity caused by attempts to claw back over-payments, the Government announced in the 2005 Pre-Budget Report that the annual disregard was being raised from £2,500 to £25,000 for the tax year beginning April 2006. The Government claimed these changes would cost at most £200m a year.[33] Bearing in mind that over-payments cost around £2bn a year and that the Inland Revenue estimated that the £2,500 annual disregard cost about £800m in 2003/04, it would not be surprising if this turned out to be a considerable underestimate.[34]

How well do tax credits meet policy objectives?

Synopsis: Tax credits undermine the Government's goal of promoting work incentives and put more people on high marginal rates.

Even putting to one side the inherent problems of fraud and over-payment, would the current design of tax credits be capable of delivering the policy objectives set for it?

33 IFS Green Budget, January 2006, pp. 138-139.

34 National Audit Office, op. cit., para 2.10.

The Government's stated aim is to promote work incentives. The belief that work provides the best form of security and independence is, so it says, 'at the heart of the government's reforms of the tax and benefit system.'[35]

Is this declaration more than words? The short answer is 'no.' An econometric study commissioned by HM Revenue and Customs (HMRC) examined the impact of the working families' tax credit (WFTC), the predecessor of the current tax credits, on labour supply. It concluded that:

- the aggregate effect of the WFTC was to increase the supply of workers by 81,000; and,
- reduce the number of workless families with children by almost 100,000.[36]

However, these improvements were offset by contemporaneous changes to the tax and benefit system affecting families with children which acted on balance to reduce the supply of working parents. The authors noted that 'because the extra spending on in-work support was accompanied by large real increases in entitlements to out-of-work benefits, some people have viewed WTFC as part of attempts by UK governments since 1992 to increase the amount of money paid to low-income families for their children, whether in or out of work, whilst maintaining welfare benefits for adults in real terms.'[37] The net result of the tax and benefit changes made at the same time as the WFTC was to dampen its already limited effect – an increase in participation of 22,000 individuals and a reduction in the number of workless families with children of 43,000.[38]

The position has since worsened. Unlike the WFTC, the child tax credit is available to families with children whether they work

---

35 HM Treasury (2005), para 3.2.

36 Mike Brewer, Alan Duncan et al., p. 54.

37 Ibid., p. 4.

38 Ibid., p. 54.

or not. This can only reduce work incentives. When the working tax credit was introduced, the IFS questioned what it was meant to do, as there was no evidence that individuals without children are deterred from working by inadequate financial incentives.[39] Although the Government claimed that introducing the working tax credit would help tackle the poverty trap for those without children, the IFS estimated that around 50,000 would see a fall in their marginal tax rate. However, if everyone entitled to the tax credit claimed it, around 800,000 people would see a rise in their marginal tax rate. Overall nearly half a million more people would face marginal tax rates of 50% to 70% because of the tax credit taper.[40]

Putting an extra half a million people on high marginal tax rates with the Working Tax Credit is a poor trade-off in return for the estimated 22,000 people drawn into employment by the WFTC *before* the switch to the new tax credits. In contrast, there are just over three million top rate taxpayers. In terms of improving incentives to work for the low paid, tax credits must be accounted a spectacular policy failure.

---

39 Mike Brewer, *The New Tax Credits*, IFS, 2003, p. 3.

40 Ibid., p. 12.

CHAPTER FOUR

TAX CREDITS AND THE TAX SYSTEM

THE GOVERNMENT VIEWS the taxpayer's relationship with the tax system as similar to that between a household and a bank. At various points in their lifecycle, households might be net contributors to the Exchequer when their tax liability exceeds the financial support they receive from the state. When state financial support exceeds their tax liability they will be net beneficiaries. And when their tax liability and the payments they get cancel each other out, neither of the two.[41]

This model assumes that tax is a frictionless, costless transfer. That is consistent with the Treasury's view that taxes have no cost to society, which became part of the Treasury's official doctrine after 1997.[42] Although this accords with a traditional Keynesian model of the way the economy works, it ignores the impact of tax on incentives. Paying money to the taxman is not same as putting money into a savings account: the money is not yours to spend later, and there is no relationship between how much an individual pays in to the Exchequer in tax and what they get out. When taxes on income are raised, after-tax income is reduced,

41 HM Treasury, 2005, para 3.5.

42 In the previous Government's guidance to spending departments on how they should assess public spending projects, the public discount rate explicitly recognised the cost of taxation. When the guidance came to be revised under the current government, these appraisals now assume that taxation has no economic cost, the public sector discount rate being solely a function of social time preference comparisons. *The Green Book,* 2003, Annex 6.

changing the relative value of supplying work and consuming leisure. As a result, less work is supplied and less income and output generated.

For reasons more of political calculation than economic analysis, the main rates of tax on income today are much where Nigel Lawson left them at the end of the 1980s. The economy's continued growth despite a rising tax burden suggests that tax *rates* may be more important than the tax *burden*.

1988/89 Tax rates compared with 2005/06 tax rates

	1988-89	2005-06	Change
Income tax – basic rate	25%	22%	– 3%
Employee NICs	9%	11%	+2%
Income tax – top rate + NICs rate above Upper Earning Limit	40%	41%	+1%
Employer NICs	10.45%	12.8%	+2.35%

Although the basic rate of income tax has been cut by three percentage points, this has been partially offset by a two percentage point rise in employee NICs. Employer NICs have also been raised. The 2002 budget increased the top rate by one point, the first time the top rate of tax on incomes had been increased since Denis Healey was chancellor. Nonetheless, what is striking is the stability of fairly low tax rates for very nearly two decades.

There are of course other ways of raising revenue without increasing rates – in particular through reducing the value of the higher rate threshold in relation to average earnings and over-indexing the NICs Upper Earnings Limit. The fact that income tax rates have been stable for so long through at least four big tax-raising budgets (two in 1993, one in 1997 and another in 2002) says something important about the political market: Voters are much more sensitive to changes in income tax rates than to changes in allowances and thresholds. In terms of cutting taxes, the economics and politics point in the same direction – it is the marginal rate that counts.

A relatively simple and flat income tax system

Before allowing for the impact of tax credits, this stability left the structure of income taxes relatively simple and relatively flat, as illustrated in the following chart. Some points to note:

- 75% of income tax payers are on the basic rate of income tax. When added to NICs, most of these taxpayers face a marginal rate of tax of 33% (the income tax base and NICs are slightly different).[43]

- Only 11% of taxpayers face a marginal rate at the 10% starting band – in reality a 21% band when NICs are included.

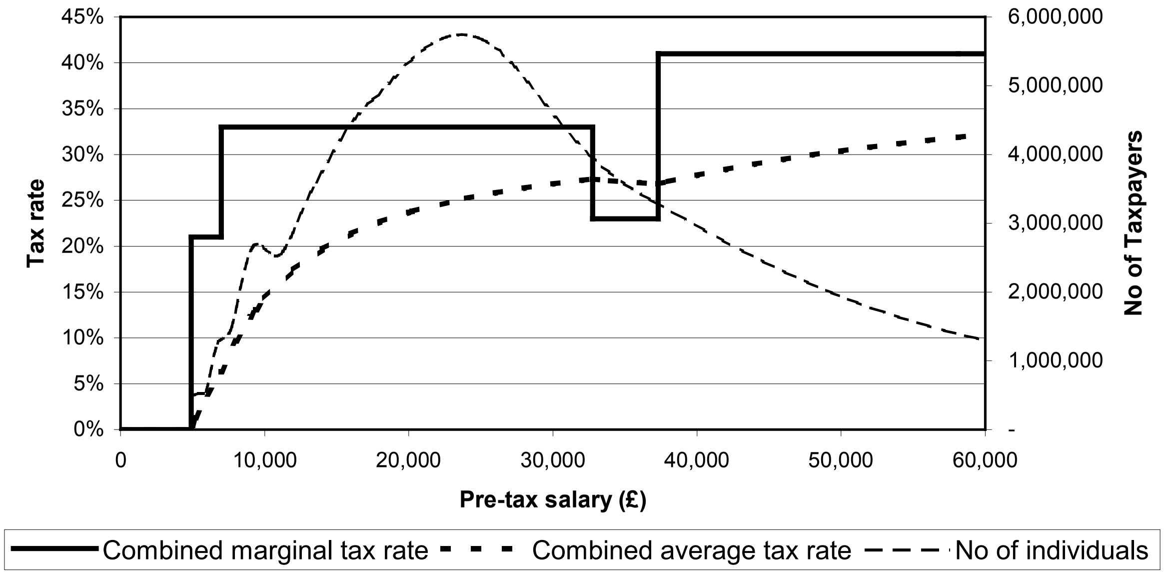
- Another 11% are higher rate taxpayers. The 3.2m upper-rate taxpayers pay over half the income tax raised in Britain.

- One area of sunshine is the 23% band (22% basic rate plus 1% NICs) between the NICs Upper Earnings Limit (above which income is no longer liable to NICs at the 11% rate) and the 40% band of income tax. Reducing the Upper Earnings Limit (UEL) is probably one of the most efficient ways of cutting marginal rates and improving incentives because of the increasing number of taxpayers who would benefit from a 10% cut in their marginal rate as the UEL is lowered toward average earnings.

---

[43] For 2004-05, see www.hmrc.gov.uk/stats/income_tax/table2_1.pdf

COMBINED INCOME TAX AND NATIONAL INSURANCE RATES (2005-06)



Note: The vertical and horizontal lines show the combined marginal tax rate for income tax and NICs, the upward sloping curve shows how the average tax rate increases with rising income and the right hand scale shows the number of taxpayers across the income range.

The next chart shows the overlay of tax credits on this structure. This example shows, for a single mother with one child, what happens to her marginal and average tax rates as she moves up the income scale. Immediately apparent is the increase in complexity and the impact on marginal tax rates at the bottom end of the income scale:

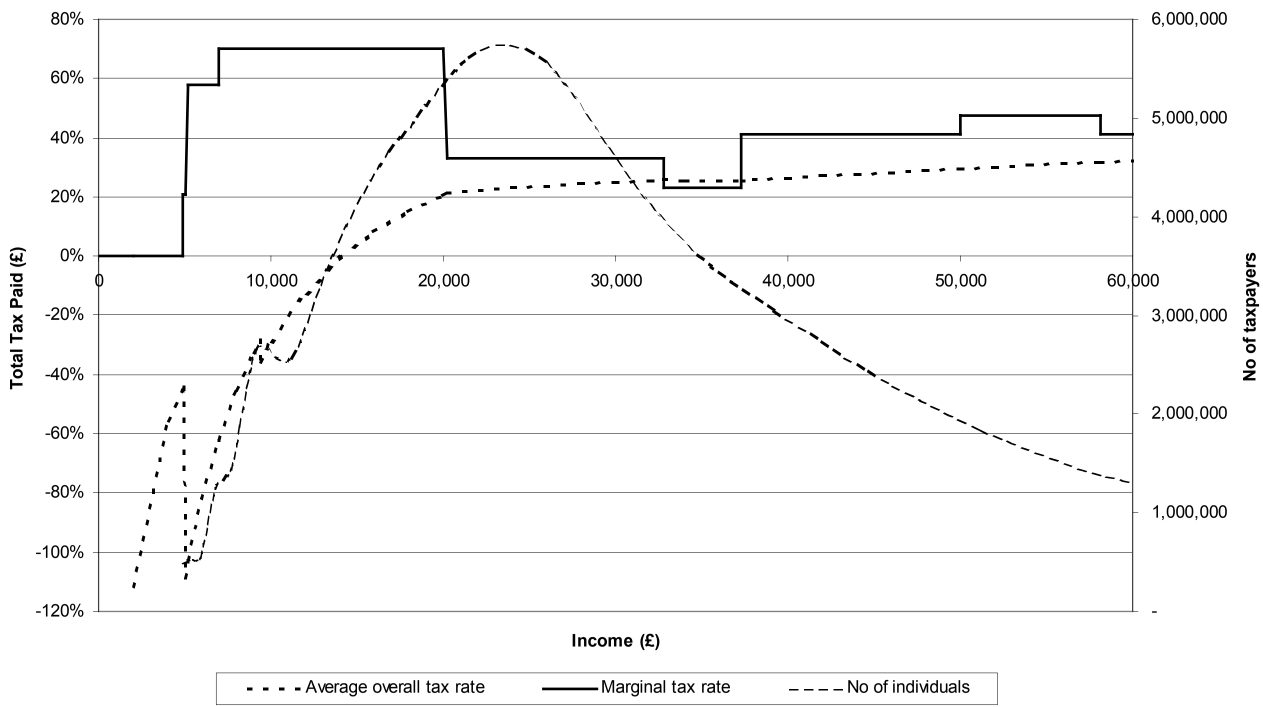
- Although the average tax burden is negative until around £14,000 due to tax credits, she faces a 58% marginal tax rate at £5,220 and a 70% marginal rate when she hits the basic rate tax threshold.

- The 70% marginal tax rate extends a long way up the income scale. Each additional child extends the income range of the 70% tax rate by £4,770, so it is possible for the 70% band to extend from £7,185 of income to well above average earnings.

- Delayed withdrawal of the family element of the child tax credit has the effect of raising the upper rate of tax to 47.6% on incomes between £50,000 and £58,000. However, this is economically insignificant as only 120,000 families eligible for it have earnings in this income range.[44] 1.88 million families are eligible solely for the family element, the rest of their tax credit entitlement having been tapered away, implying that the Government is spending over £1bn a year on transfers to families who are not low paid.

44 HMRC, *Child and Working Tax Credits Statistics*, April 2005, table 4.1.

AVERAGE AND MARGINAL TAX RATES (TAX CREDITS INCLUDED)



OBJECTIVES OF REFORM

THE CURRENT DESIGN of tax credits does not begin to meet the Government's stated aim of promoting incentives to work. In effect, the deal the government is offering the low paid is: we will give you more money, but in return the system will make it much harder for you to earn more. It might have been designed to bring about a stratified, two-class Britain – one, a class of advancement and achievement; and the other, a class of dependency, passivity and social breakdown.

Straddling the tax and welfare systems, an effective re-design should recognise the different functions of the two systems:

- **The tax system.** Raising a given amount of tax revenue at the lowest cost to the economy;

- **The welfare system.** For those of working age (other than the disabled), to provide support through periods of hardship and help lift working families out of poverty.

The function of the tax system is relatively straightforward. The principal criterion by which it can be assessed is that of economic efficiency. There is broad agreement among economists about the general features of a more economically efficient structure of taxes. While the direction is clear – lower, flatter, broader – politics determines priorities and the speed of travel.

For those able to work, an effective welfare system should promote behaviour which helps welfare recipients to improve their position in life and which avoids financing behaviour which perpetuates the poverty cycle. In principle, the extent to which the welfare system should go beyond helping lift people out of poverty to equalise incomes should be reflected in different amounts of welfare spending and in the *volume*, not the *structure*, of taxes.

Equally, those genuinely unable to work should be entitled to a benefit (such as incapacity benefit) which recognises that. In such cases, the marginal withdrawal rate is not an issue. There is then no need to complicate a system that is aimed at improving incentives for working.

An important caveat. There are less than five million people in work receiving tax credits[45] and nearly 30 million income taxpayers. Fixing tax credits needs to be consistent with the approach a future government takes to reforming tax as a whole, not the other way round.

Reform objectives

<table>
<tr><th>Tax reform</th><th>Welfare reform</th></tr>
<tr><td>▪ Encourage wealth creation and economic growth
A strong, growing economy raises living standards, expands the tax base and makes public spending more affordable</td><td>▪ Reduce the transmission of poverty to the younger generation
Encourage work, support married and couple families and reduce/remove bias in favour of lone parenthood</td></tr>
<tr><td colspan="2">▪ Reduce dependency, enable the low paid to be self-supporting and work their way off welfare
Reward work by cutting high marginal tax/benefit withdrawal rates for those on low incomes</td></tr>
<tr><td>▪ Maximise revenue flowback to the Exchequer
Larger tax cuts for the same revenue. Tax cuts which maximise revenue flowback likely to be most pro-growth</td><td>▪ Contain the growth of welfare spending
Taxpayers' money is not free; higher taxes damage growth and hurt the poor</td></tr>
<tr><td colspan="2">▪ Reduce complexity, opportunities for fraud and collection/distribution costs</td></tr>
</table>

45 Ibid., table 1.1.

Incentives and the marginal rate

The 2005 Treasury policy document on tax credits defined the Government's goal clearly: [46]

> *The tax and benefit system should ensure that work is financially rewarding… For those who can, work provides the best form of security and independence.*

It then makes a serious conceptual error:[47]

> *'The first principle of tax and benefit reform… is that a modernised welfare system should **promote incentives to work, by reducing the tax burden on the low paid**…*

The aim of improving incentives is right, but simply reducing the tax burden will not achieve it. The incentive to work is driven by the marginal tax rate, not by the tax burden. This analytical error is the fundamental reason why Gordon Brown's tax credits have failed.

The average rate of tax – the tax burden – is important for a different reason. It is not about incentives, but about whether low income earners have enough post-tax income to live on.[48] It is therefore about welfare rather than incentives. In terms of public policy, the welfare objective can therefore be characterised as being about fairness and equity, and, at the bottom of the income scale, about the relief of poverty.

In a world which only took account of static effects, Gordon Brown and the Treasury might be right to argue that tax credits are a more cost effective way of fulfilling the welfare function than lower tax rates or higher tax allowances. However that analysis takes no account of the dynamic benefits that come from cutting

---

[46] HM Treasury (March 2005), paras 3.2 and 2.21.

[47] Emphasis in the original. The text goes on correctly to address the importance of reducing the number of households on high marginal withdrawal rates. HM Treasury (March 2005), para 4.1.

[48] Conceptually it is possible to design a tax system with very high average tax rates and low marginal rates. According to the economist Mancur Olson, this is what Stalin did (see *Power and Prosperity*, Basic Books, 2000, pp. 115-119).

marginal tax rates or the damaging consequences of the very high effective tax rates that tax credits have introduced.

Raising personal allowances can help achieve improvements in both welfare and incentives, but is less efficient than either tax credits or rate cuts in achieving their respective primary ones. It has positive incentive effects for those moving down a tax band, who therefore face a significant fall in their marginal tax rate, but has no incentive effect for those who do not. And, unlike cutting tax rates, raising thresholds has little revenue flowback potential.

In terms of increasing tax credits *vs.* cutting tax rates, it is true that reducing tax rates can never increase anyone's tax burden. But increasing tax credits will always worsen incentives for some people. Cutting tax rates mitigates the disincentive costs of tax credits.

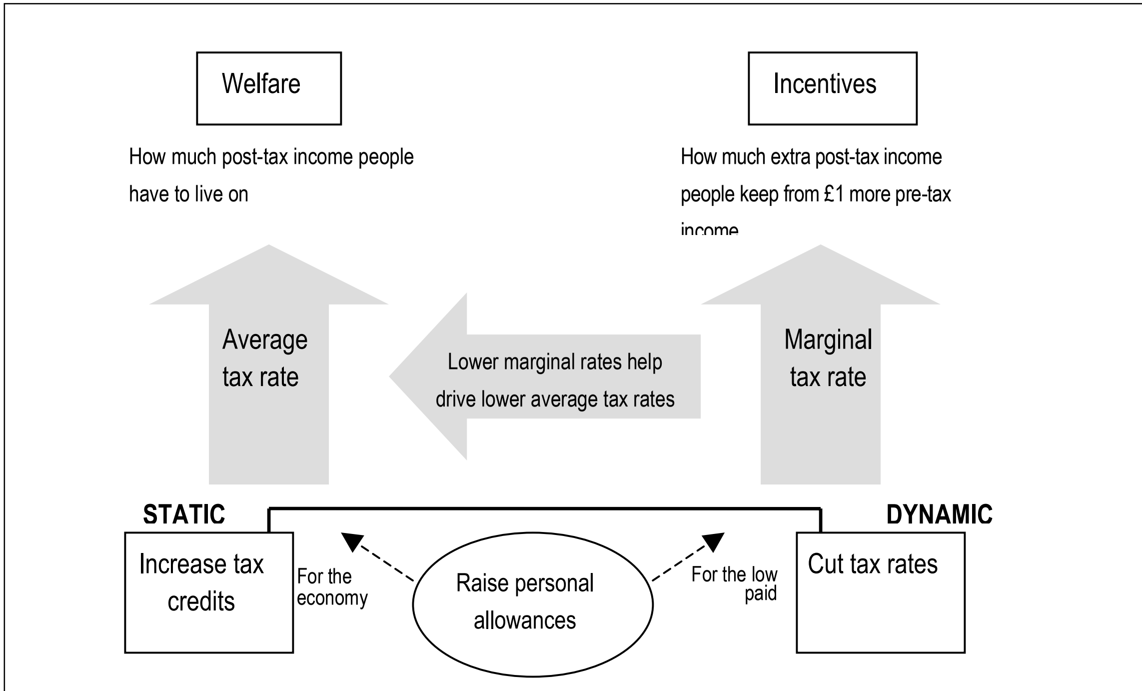
In contrast to the static welfare impact of tax credits, cutting tax rates has a dynamic effect on welfare by increasing the size of the economy and thus accelerating the rise in living standards. As illustrated in the following diagram, raising the personal allowance is closer to the static end of the static/dynamic dial for the economy overall and at the dynamic end for the low paid to the extent they move down a tax bracket and it cuts their marginal tax rate.

Over time, the dynamic impact is much more powerful than the static. In their study on public spending, Vito Tanzi and Ludger Schuknecht found that in terms of disposable income, big welfare countries delivered only a 0.6% higher share of GDP to the poorest 40% of households. This extra welfare requires higher taxes and spending than smaller welfare countries, equivalent to 20%.[49] Starting from the same baseline GDP, a 0.1 percentage point a year growth differential between high tax and low tax countries would see the poorest 40% in a small welfare state country overtake their counterparts in the big welfare country within seven years and be 0.6% better off than those in the big welfare countries after 12 years.

---

49 V Tanzi and L Schuknecht *Public Spending in the 20th Century*, Cambridge University Press, 2000, p. 114.

Matrix of policy instruments and objectives



Which outcome is more equitable? And, more importantly, which do people prefer – slightly greater income equality or faster income growth?

Higher growth by itself will not erode inequality, but economic growth is the best way of reducing poverty and expanding opportunity. For those of a centre-right disposition, there really should be no contest: the goal should be poverty reduction, not income equalisation – and that goal is best served with tax policies which lead to economic growth.

In contrast, tax structures with rising tax rates do not make society more equal, but result in less income to go around. Only transfer payments can make society more equal. As Paul Samuelson puts it, the ultimate burden of a tax is totally different from the incidence of tax. In a critique of the Conservatives' 1979 budget which raised VAT, Arthur Laffer wrote:[50]

> *Higher taxes on the rich hurt rich and poor alike. It is equally as true that higher taxes on the poor make both the poor and rich worse off. Everyone stands to gain when either group is benefited. Far from being adversaries, the lot of each group is tied to the success of all.*

That is why the most economically efficient taxes are those with the lowest possible rate and the broadest possible coverage. The best way to help the poor is to have low taxes and to top up their incomes with well designed, pro-incentive tax credits.

---

50 *Wall Street Journal*, 20 August 1979.

CHAPTER SIX

RAISE THRESHOLDS OR INCREASE TAX CREDITS?

Synopsis: Large cuts in tax – whether by raising personal allowances or cutting the basic rate – have only a small impact in mitigating the disincentives of the tax credit taper. Keeping tax credits as they are is therefore not an option – which leaves a choice between abolition or replacing them with something better.

WOULD RAISING PERSONAL ALLOWANCES be a better way of getting cash to the low paid? One way of looking at this is by seeing what would happen if you wanted to get an extra £1,000 to the low paid. This shows how raising the personal allowance helps improve incentives but how tax credits deliver the extra money at lower direct cost to the Exchequer with a hidden cost of extending high marginal rates higher up the income scale.

Raising allowances reduces people's tax bill at the top rate of income tax they pay, which for 75% of taxpayers is the 22% basic rate. This implies raising personal allowances by £4,545. Notice though the impact of raising allowances on top-slicing taxable income. For the 10% taxpayer, raising the personal allowance by £4,545 is worth a maximum of £215 (because the width of the 10% band in 2006-07 is £2,150); while higher rate taxpayers would have their taxes cut by £1,819.

Impact of raising personal allowance by £4,545 (2006/07) for a single mother earning 25% above the minimum wage

	16 hours/week	30 hours/week	40 hours/week
Pre-tax income	£5,043.69	£9,457.39	£12,609.85
Increase in after tax income	£0.87	£714.93	£1,000.00
Marginal tax rate before	21%	70%	70%
Marginal tax rate after	11%	48%	70%
Change	-10%	-22%	0%

The implication of this table is clear. Raising the personal allowance benefits the lowest paid the least, which is unsurprising given they pay the least tax.

Raising the personal allowance does improve incentives at the bottom of the income scale when people are moved down a tax bracket. Even after raising the personal allowance by £4,545, those on tax credits hit the 70% band (22% income tax + 11% NICs + 37% tax credit taper) when they earn £11,733 a year – which someone earning only 16% more than the minimum wage would do if they worked 40 hours a week.[51]

This is not only ineffective in helping the poor. It is also extremely expensive. Based on the Treasury's tax ready-reckoner, raising personal allowances to deliver £1,000 of extra income to the basic rate taxpayer would reduce tax revenues by £29.1bn in 2006-07.[52] Restricting the maximum tax cut to £1,000 for higher rate taxpayers would reduce the revenue loss by £2.6bn to £26.5bn – equivalent to cutting the basic rate by over 7½p to 14½p in the pound.

There are ways of using allowances to target tax reductions more narrowly. For example, Lord Blackwell has developed a

---

51 Personal allowances would have to be more than tripled to take tax credit recipients out of the 70% band.

52 HM Treasury, *Tax ready reckoner and tax reliefs*, December 2005.

£10.7bn proposal to increase the personal allowance by £2,465 to £7,500, and to make it fully transferable within couples with dependent children.[53] This would cut taxes for a one-earner couple by £1,972. In addition to capping the tax reduction to the basic rate, it would also involve abolishing the 10% band, so losing some of the incentive gain at the bottom of the income scale. It would however provide an incentive for couples further up the income scale to remain together to raise their children.

However, raising tax allowances cannot cut anyone's tax bill to less than zero, so it cannot deliver £1,000 to those towards the bottom of the income scale. By contrast, increasing the family element of the child tax credit would – at a cost of £5.8bn. That cost could be further reduced by raising the child element by £602 to give the notional average family (of 1.66 children) £1,000 at a cost of £4bn.

The problem with is that this does not make it easier for the low paid to work their way to a better life. Each £1,000 of extra tax credits extends the 70% tax bracket £2,703 further up the income scale. Putting more people on 70% tax rates only makes it harder for families to earn their way to a better future; it would reduce the supply of labour; it would result in less economic activity; and it would shrink the tax base. Everyone would end up losing.

So, under this option, the single mother would still face high marginal rates. She does get more money from the government, but the barrier to her doing better through her own efforts remains just as steep. As this example shows, increased spending on the current design of tax credit is pure welfare. There is no incentive gain.

The impact on incentives of raising personal allowances and increasing tax credits is illustrated in the following table. It also shows what would happen if the £26.5bn from increasing personal allowances were used to cut the basic rate to 14½p instead.

[53] Lord Blackwell, *Take poor families out of tax!*, CPS, October 2005.

Impact on incentives of raising thresholds or increasing tax credits for a single mother earning 25% above the minimum wage

	16→30 hours/week	30→40 hours/week
After-tax income per hour		
£1,000 higher tax credit	£3.33	£1.89
£4,545 higher personal allowances	£4.34	£3.90
14 ½ % basic rate	£3.57	£2.71
Average tax rate		
£1,000 higher tax credit	47%	70%
£4,545 higher personal allowances	31%	38%
14½ % basic rate	43%	57%
Marginal tax rate		
£1,000 higher tax credit	70%	70%
£4,545 higher personal allowances	48%	70%
14½ % basic rate	62.5%	62.5%

Compared to raising tax credits, raising personal allowances improves her after-tax income by 30% for the first extra 14 hours (from 16 to 30 hours a week) and more than doubles it if she decided to work a further ten hours. Before this point is reached, however, she has hit the 70% tax band. Beyond that point, working those extra hours becomes next to pointless.

Cutting the basic rate to 14½% reduces marginal rates to 62½%, so raising personal allowances is better for incentives at 30 hours, but worse for the next segment, when she starts paying tax at the basic rate. In percentage terms, a 62½% marginal rate raises the net gain to earning an extra £1 by 25% – but both would leave marginal rates far too high.

This illustrates an important fact about the current system of tax credits. Tax cuts totalling 2.2% of GDP by themselves are not able to overcome the damaging impact on incentives caused by the reach of the 37% tax credit taper. This leaves two options:

- to abolish tax credits and use the money to raise the personal allowance; or,

- to re-design the system completely to make tax credits worker-friendly as part of a reform of the tax system to improve incentives and restore economic dynamism.

WHAT SHOULD BE DONE?

IN-WORK PAYMENTS to top up the wages of the low paid are necessary. Simply abolish tax credits and six million families – or ten million people – would be worse off. It is also clear that their design is flawed because the 70% marginal tax rate disincentivises the low paid from getting full-time work and earning more. Spending more is not the answer as it would extend high marginal rates further up the income scale.

The Earned Income Tax Credit (EITC) in the US works much better and should be examined for lessons which can be applied in the UK. Why look to the US? As Gordon Brown told the *Washington Post*: "the economy that I admire most is the American economy."[54] Since the industrial revolution, the US is the only developed economy to have reversed a period of relative economic decline and returned to the top of the growth league for over two decades.

How the EITC works

The EITC is an employment subsidy paid as a fully refundable tax credit to families. It is pitched towards families with children, although low paid workers without children are eligible at a lower rate. The tax credit is phased in, the top rate being 40% for families with two or more children. For every $1 of pre-tax income, they get an extra 40¢ up to $10,750 of pre-tax income, to give a maximum tax credit of $4,300.[55] At $15,040, the tax credit is phased out at the

54 "Labor's Pains", *Washington Post,* 14 May 2006.

55 All figures are for the 2004 tax year.

rate of 21.06%. Different phase-in, phase-out rates and maximum tax credits apply to families with a single child and childless workers.

Aside from the relative simplicity of the EITC compared to the child and working tax credits, the biggest difference is that the EITC has a phase-in. This means that the value of the credit rises income. This portion is an unambiguously pro-work incentive. Unlike the child tax credit, no work income results in no tax credit. Getting an extra 40¢ for each dollar earned is a strong signal that work pays.

The EITC's phase-out rate or taper is lower than the British tax credits – a maximum of 21.06% compared to 37%. These lower rates are layered on top of a lower rate tax structure, which also has higher allowances and personal deductions. Phase-out of the EITC is completed within the 15% band of federal income tax. Together with employee payroll taxes (similar to our employee NICs) of 7.65%, this results in a maximum marginal tax rate of 43.7% as EITC is tapered away compared to 70% in the UK.[56] Another lesson for Britain: tax credits require low income tax rates to work.

EITC policy results

Unlike the British tax credits, alignment of policy design with objectives means the EITC delivers positive results in terms of incentivising work. According to the Nobel economist Gary Becker:[57]

> *Empirical studies confirm the prediction of economic theory that the EITC increases the labour force participation and employment of people with low wages because they need to work in order to receive this credit.*

The EITC reduces poverty: a report by President Clinton's council of economic advisers after the expansion of the EITC in the 1990s says it lifted 4.3 million people out of poverty in 1997 and reduced the number of children living in poverty by 2.2

---

56 In addition, there are state incomes taxes, which vary from state to state, and some states have their own EITC.

57 *Business Week*, 3 June 1996.

million.[58] In their analysis, Hotz and Schloz found that the EITC creates a strong incentive for non-workers to enter the labour force, since it increases the marginal value of working by raising the effective wage.[59]

Any means-tested payment such as the EITC involves some redistribution of incentives and disincentives. In the case of EITC, the trade-off is between higher labour market participation at the bottom of the income scale for a reduction in hours offered, typically by the second earner in two earner couples, further up the income scale.

In explaining broad public and political support for the EITC, Hotz and Schloz note that the EITC:[60]

> *…subsidizes the incomes of people who in some sense are "doing the right thing." The appeal of this reaches across party lines. In addition, unlike the safety net programmes, the EITC has unambiguously positive labour market participation incentives.*

Avoiding problems caused by over-payments

EITC is paid as a lump sum after the end of the tax year. There is an advanced payment option to allow recipients to receive the tax credit through the year, to make EITC payable like tax credits here. Given the problems in Britain caused by clawing back over-payments, it is significant that in 1998, only 1.1% of EITC recipients chose the advance payment option.[61]

Low income families appear to use the EITC as a form of savings account. According to one study of EITC recipients, 61% said they planned to use their EITC payment for investment purposes (such as paying for education, acquiring or servicing a car, or paying for a move) and 28% said they were saving at least some of the EITC for

58 Council of Economic Advisers, *Good News for Low Income Families: expansions in the Earned Income Tax Credit and the Minimum Wage*, 1998.

59 Hotz and Schloz, p. 22.

60 Ibid., p. 62.

61 Ibid., p. 60.

future use.[62] If the low paid in Britain are anything like 98.9% of American tax credit recipients, it would suggest that pro-incentive tax credits like the EITC could bypass the post-payment adjustment problems which have bedevilled the British system.[63]

Replacing tax credits with a British EITC

Any reform of the UK tax credit system should be judged by the same test as President Clinton's: if you've got a child at home and you work 40 hours a week, you will not be in poverty.

On the basis of the standard UK measure of poverty (60% of median income), this implies a poverty line of just under £11,800 a year ignoring for the time being adjustments for family size (see Appendix 2 for further discussion of this). The following table shows that working 40 hours a week at the national minimum wage generates a gross income of £10,087. After tax and NICs are deducted, a total top-up of £3,121 is needed. This can be delivered via an EITC with a 35% phase-in up to £10,000 of pre-tax income. Every £1 of earnings would generate a 35p tax credit up for the first £10,000 a year.[64]

Calculation of UK EITC to meet the President Clinton test

	£	£
40 hours @ national minimum wage	10,087	
Target income	(11,800)	
		(1,712)
Income tax	(853)	
NICs	(556)	
		(1,409)
Total EITC payment required		**3,121**

62 Cited in Council of Economic Advisers (1998), pp. 5-6.

63 Note that EITC forms a lower proportion of post-tax income than tax credits do in the UK.

64 The EITC phase-in rate can be adjusted to reflect family composition, as happens in the US. For families with one child, there is a 34% phase-in compared to 40% for families with two or more.

As with any tax credit, the next step is setting the taper. There are difficult decisions involved here, particularly in determining from what point and by how much tax credits should be withdrawn. The steeper the taper, the greater the disincentives for those on the taper range, but the smaller the number of earners disincentivised by it. It also reduces the cost to the Exchequer.

A clear constraint is to avoid pushing disincentives further up the income scale. In this case though, the size of maximum tax credit awards and the steepness of the taper of the current system make it possible to improve incentives over nearly all the taper range.

As can be seen from the table, a 25% EITC taper starting at £10,000 a year nearly meets these constrains. On a static basis, a 35% phase-in/25% phase-out EITC would cost the Exchequer around £4.4bn a year. For someone on the minimum wage working 40 hours a week, it would deliver £12,156 of after-tax income.

	Withdrawal rate	**End of phase-out**	**Static cost**
Existing tax credits	37%		£16bn
- one child		£18,679	
- two children		£23,449	
Proposed EITC	25%	£24,000[65]	£4.4bn

Notes: To calculate the end of the phase-out, the CTC & WTC award subject to 37% taper is assumed to comprise the child, basic and 16 hour elements only. Also, the range of the existing tax credit taper varies with claimants' individual circumstances – the number of children, amount of eligible childcare costs and hours worked a week. 55% of families receiving tax credits have two children or more while only 337,000 families received the WTC childcare element. Before allowing for childcare costs (which further extend the phase out), families receiving the 16 hour element with one child exit the current tax credit taper at £18,670 and families with two children at £23,449. For the 1.8 million families receiving the £680 30 hour element, the taper is extended to £20,508 and £25,287 respectively. See HMRC, *Child and Working Tax Credits Statistics*, April 2005, tables 3.2, 4.3 and 4.4.

65 The end of the phase-out would change if phase-in rates were varied to reflect family composition.

Note that:

- A 25% EITC taper starting at £10,000 would mean that across 62% of the taper (from £10,000 to £18,679), the impact on incentives is 100% positive, with tax credit recipients getting a 12 point cut in their marginal rate.

- For the next 34% of the EITC taper range (from £18,679 to £23,449), the effect on incentives depends on the size of each family's existing tax credits, in particular the number of children.

- Over this portion of the range, the 55% of families with two or more children would see their marginal rate drop from 70% to 58%.

- Those with one child receiving just the CTC family element (i.e. all their other tax credit entitlements have been tapered away) would have an increase in their marginal rate from 33% to 58%.

- Only 15% of families with children have three or more, so for the remaining 4% of the phase-out (£23,449 to £24,000), the incentive effect is likely to be negative for 85% of people in this narrow range.

The following table shows that replacing existing tax credits with a 35% EITC transforms the gains for the low paid from working more than 16 hours a week. The improvement in incentives is particularly powerful above £5,220 a year and is improved further above £7,185. The exception is those above the existing 37% tax credit taper.

Net Gain from extra £1 of earned income

	Now	After	Change
Above 16 hours/week	£1.00	£1.35	+35%
Above £5,035	79p	£1.14	+44%
Above £5,220	43p	£1.14	+265%
Above £7,185	30p	£1.02	+340%
On existing taper	30p	42p	+40%
Above existing taper	67p	42p	-37%

Note: Assumes one earner per household

What can be done about the 58% marginal rate (22% income tax + 11% NICs + EITC 25% taper) over the EITC phase-out? There are two strategic approaches to the problem. The first is not to have a phase-out at all. The £16bn approximate cost of this is similar to the cost of the current tax credits. Indeed, there is a case for going further and combining the personal allowance with the EITC. This could incorporate refinements to adjust for family size and reduce the disincentives to marry and co-habit. The second approach focuses on the other components that make up the 58% marginal rate – NICs and the basic rate of income tax.

Costings of the proposals

The previous table looked at the impact on incentives from the point of view of a taxpayer. The following table looks at it from the standpoint of the Exchequer.

The purpose of replacing current tax credits with the proposed EITC is to change work patterns by improving incentives. The aim is to encourage the low paid to earn more. To the extent this happens, EITC costs will be greater than implied by static cost estimates. These will be partly offset by higher income tax and NICs revenues.

Impact on Exchequer of £1,000 change in claimant pre-tax earnings

	Incentive to increase earnings?	Inter-action with tax	Net cost
EITC phase-in			
< £5,035	✓	Below personal allowance	– £350
£5,035 – £7,185	✓✓	Higher EITC payment less 21% IT & NICs	– £140
£7,186 – £10,000	✓✓	Higher EITC payment less higher 33% IT & NICs	– £20
EITC phase-out			
On existing tax credit taper	✓	Lower EITC payment + higher 33% IT & NICs	+ £580
Above existing tax credit taper	××	Higher EITC payment and lower IT & NICs	– £580

Over the EITC phase-in, the change in incentives is greatest above £5,220, where the current 37% taper starts, and is then intensified above the £7,185 basic rate threshold. Where the gains to work are greatest and the largest supply-side response could be expected, the cost of extra EITC tax credits is progressively offset by increased tax revenues, because people pay tax on their extra earnings.

Over the EITC taper, the change in incentives depends on whether EITC recipients are on the existing tax credit taper. If they are, the improvement in incentives yields a double benefit to the Exchequer: extra income reduces EITC payments and increases income tax and National Insurance revenue.

On the other hand, the effect goes into reverse above the existing taper. Here, the marginal rate goes up by 25%, the amount of the EITC withdrawal rate. This worsens incentives. A reduction in work and earnings means increased EITC payments and reduced tax and NICs. The extra cost to the Exchequer reflects real losses to society: work which without the proposed EITC would have taken place, no longer does. This illustrates the importance of designing the EITC so that the taper is lower than the CTC/WTC taper and that the number of people who end up on a higher marginal rate is minimised.

For costing purposes, a rough and ready assumption is that these first round dynamic effects would, after a build up, add £1.5bn a year to the static costs of the proposed EITC.

Out of work benefits

With the proposed EITC, the tax system would no longer support people who were out of work, that function being restored to the benefit system. The cost of the tax credits currently paid by HMRC would therefore be transferred back to the DWP's budget.

Whatever the precise design of DWP support for workless families, its aim should be to avoid re-creating disincentives to working. While the existing tax credits, by pushing withdrawal tapers further up the income scale, removed disincentives to labour market participation, the equalisation of in-work and out-of-work payments acts in the opposite direction.

Here again, Britain can learn from the US. At the heart of the 1996 welfare reform are strong work requirements and time-limiting of welfare payments. To many at the time, this sounded hard-hearted, but recall the Clinton administration official who resigned, saying later, 'whatever we have been doing over the last five years, we ought to keep doing.' Efficacy should be the test, or as New Labour has it, 'what matters is what works.'

Those unable to work should receive a welfare payment that recognises their incapacity. In this case, the marginal withdrawal rate is obviously not an issue.

Fiscal implications

The following table sets out the estimated fiscal impact of switching to an EITC whilst maintaining spending levels on out-of-work benefits. In addition, the costings allow for £1bn in respect of the disability elements of the current system. Part of the projected £4.6bn of negative income tax in 2006-07 related to tax credits other than CTC and WTC. These are assumed to total £0.5bn (see Appendix 3).

Overall, replacing the existing tax credits with a £6bn EITC on these assumptions would yield a net fiscal benefit of around £8bn a year.

EITC: fiscal impact (2006-07)

	£bn
EITC – static cost	4.5
EITC – dynamic cost	1.5
	6.0
DWP spending	4.5
Disability elements	1.0
Gross cost	11.5
Less: Saving from spending on existing tax credits	(20.2)
Add: Non-CTC & WTC tax credits	0.5
Net fiscal cost	(8.2)

What can be done with the £8bn to improve incentives

There are three main options for further improving incentives with the £8bn released by replacing the current tax credits with the proposed EITC:

- **doubling the width of the 10p band.** Only £1,500 wide when introduced in 1999, £8bn would widen the 10% band to £4,630 and raise the standard rate threshold to £9,665, with those claiming EITC receiving £1.14 net for every pound earned on the 10p band.

- **raising the personal allowance to £7,000.** Based on pro-rated costings of the £10.7bn CPS proposal for a transferable personal allowance for couples with children, this would cut the marginal tax rate over the proposed EITC taper from 58% to 36% up to £14,000 for qualifying couples and to 46% up to £16,150 of pre-tax income.

- **cutting the basic rate by 2p.** This would reduce the marginal rate from 58% to 56% over the whole of the EITC phase-out.

The first two options improve incentives where the EITC already delivers large incentive gains; and does not improve them where the EITC does not. By contrast, cutting the basic rate improves incentives where the EITC weakens them[66] and also improves incentives for 22 million basic rate taxpayers. Of the three, it also encourages economic growth and revenue flowback the most, while the other two have next to no effect.

This illustrates the policy symbiosis between low tax rates and tax credits. Because reducing the proposed EITC component of the 58% marginal tax rate on the taper would extend the taper up the income scale, action has to focus on the other two components. For this reason the goal should be to cut the basic rate to 15% – and lower the marginal rate to 51% across the proposed EITC taper. Replacing the current tax credits with an EITC would enable a reforming government to make an immediate 2p down payment and reduce the basic rate to 20p.

Advantages of the proposed EITC

Replacing child tax credits and working tax credit with the proposed EITC solves the problem of high marginal rates below £10,000 a year and reduces it across most of the income range above this level. This is the fundamental cause of the failure of the existing system. When the low paid get 35p in tax credits for every £1 they earn, it sends a strong signal that work pays. President Clinton made it work in the US. It can work here.

---

66 This happens between the end of the existing tax credit (£18,679 to £23,449) and at the end of the EITC phase-out (£24,000).

- With a British EITC, low paid families with children would get 35p for every £1 of earnings for the first £10,000 of pre-tax income.

- This would give a powerful boost to incentives for those earning between £5,220 and £10,000 a year.

- In this range, marginal rates of 58% and 70% would be replaced by net payments from the taxman.

- Above £10,000 a year, incentives are also improved for everyone receiving more than the child element of the existing tax credits.

- Replacing the existing tax credits with an EITC would save £8bn a year which can be used to further improve incentives.

- In addition to helping the low paid, it would increase the supply of labour, increase output per head and improve economic performance.

APPENDIX ONE

ILLUSTRATION OF CURRENT TAX CREDIT CALCULATIONS

	16 hours/ week	30 hours/ week	*Change*	40 hours/ week	*Change*
Hours/year	799	1498.2	*699.2*	1997.6	*499.4*
Pre-tax income*	£5,043.69	£9,457.39	*£4,413.70*	£12,609.85	*£3,152.46*
Personal allowance/LEL	£5,035.00	£5,035.00		£5,035.00	
Taxable income	£8.69	£4,422.39		£7,574.85	
Basic rate threshold		£2,150.00		£2,150.00	
Income above basic rate threshold		£2,272.39		£5,424.85	
Income Tax @ 10%	£0.87	£215.00		£215.00	
Income Tax @ 22%	-	£499.93		£1,193.47	
NICs @ 11%†	£0.96	£486.46		£833.23	
Total IT & NICs	**£1.82**	**£1,201.39**	***£1,199.56***	**£2,241.70**	***£1,040.31***
IT & NICs per hour	*£0.00*	*£0.80*	*£1.72*	*£1.12*	*£2.08*
Tax credits					
Child tax credit (CTC)					
▪ Family element	£545.00	£545.00		£545.00	
▪ CTC – child element	£1,765.00	£1,765.00		£1,765.00	
Working tax credit					
Basic element	£1,665.00	£1,665.00		£1,665.00	
Couple/lone parent element	£1,640.00	£1,640.00		£1,640.00	
30 hour element	-	£680.00		£680.00	
Maximum	£5,615.00	£6,295.00		£6,295.00	
First income threshold		£5,220.00		£5,220.00	
Excess income		£4,237.39		£7,389.85	
37% of excess income		£1,567.83		£2,734.24	
Tax credit due	£5,615.00	£4,727.17	*£887.83*	£3,560.76	*£1,166.41*
Total tax refund	£5,613.18	£3,525.78	*-£2,087.40*	£1,319.06	*–£2,206.72*
Income after tax	£10,656.86	£12,983.17	*£2,326.30*	£13,928.91	*£945.74*
Income after tax/hour	£10.45‡		*£3.33*		*£1.89*
Average tax rate	-111.3%	-37.3%	*47.3%*	-10.5%	*70.0%*

* Pre tax income calculated at 125% of National Minimum Wage (£5.05 an hour).

† NICs have been calculated on an annual basis.

‡ Excludes child tax credit.

APPENDIX TWO

THE POVERTY LINE

UNLIKE THE US, the poverty line used in the UK is a relative measure. It is of course understandable that the measure of poverty should rise over time as society becomes wealthier. However, there is something problematic about a definition of poverty which means that if the number of people at the top of the income scale were to fall, there would, as a matter of logic, be fewer people officially defined as being in poverty.

The UK poverty line is adjusted for family composition (single/couple and number of children) as indicated in the table below. To put these values into context, the official definition of poverty for a couple with two children would be only 16% below unequivalised average income.

Leaving to one side whether raising incomes to within 16% of the average can properly be considered part of an anti-poverty campaign, having transfer programmes this close to average earnings inevitably requires a large amount of fiscal churning and/or high marginal withdrawal rates. Instead of expensive transfers, the focus ought to be on increasing average incomes with pro-growth economic policies.

Estimated equivalised poverty line (2006-07)

No. of children	Single parent	Couple	Child benefit
1	£10,266	£14,160	£907
2	£12,626	£16,520	£1,515

After including child benefit, the proposed 35% EITC delivers more than what is needed to lift a single parent working 40 hours a week on the minimum wage above the official definition of poverty. Correspondingly the phase-in for a couple would need to be higher.

Although the existing tax credits can theoretically deliver sufficient cash, for those on low pay this requires full-time work. Because tax credits disincentivise full-time employment, the reality is different:

- Of couples claiming tax credits working 35 hours or more a week, 65% are above the 37% tax credit taper and are therefore out of the main tax credit system.

- Of those who are not above the taper, there are only 1.3 million couples with children where the main earner works 16 hours or more a week.

- There are only 176,000 couples with a second earner working 35 hours or more.[67]

67 HMRC April 2005, tables 4.1 and 4.2.

FURTHER DETAILS ON EITC REPLACEMENT COST

ONE OF THE GOVERNMENT'S reasons for introducing child tax credit in 2003 was to combine in-work and out-of-work benefits in respect of children. So child allowances in Income Support and Jobseekers' Allowance were wrapped up as part of the child tax credit. From 2003, new claimants were paid benefit via CTC and the Inland Revenue and existing claimants continued to be paid benefit by the Department of Work and Pensions (DWP).

According to the Inland Revenue, in April 2005, there were 1.4 million families in which no adult was in work, almost all of whom received the maximum CTC 'or the equivalent via benefits.'[68] This implies spending of around £4½bn. However the government does not publish figures showing how the cost is split between the Inland Revenue (now HMRC) and the DWP.

How much might that be? The table below shows the Inland Revenue spending on tax credits in 2004-05 and spending on them by the government as a whole. The £4.9bn difference suggests that in 2004-05 the bulk of the spending on financial support in respect of the children of the 1.4 million out-of-work adults was via the DWP rather than the Inland Revenue. The table also shows spending on tax credits is projected to increase by £0.9bn in two years to £20.2bn in 2006-07 (col. 4).

---

68 Ibid., p. 3.

Spending on tax credits – Inland Revenue & total government

£bn Source	2004-05 Inland Revenue	2004-05 Budget 2006	Difference	2006-07 Budget 2006
Negative income tax	3.7	4.3	0.6	4.6
Public spending	10.1	15.0	4.9	15.6
Increase in debtors	1.7	n/a	-	-
Total	15.5	19.3	5.5	20.2

Sources: Notes 3 & 6, Department of Inland Revenue 2004-05 Accounts, and Tables C8 & C11, Budget 2006

CENTRE FOR POLICY STUDIES

The Centre for Policy Studies is one of Britain's best-known and most respected centre-right policy research centres. Its Chairman is Lord Blackwell, a former Head of the Prime Minister's Policy Unit and its Director is Ruth Lea, whose career spans the civil service, the City and the media.

The CPS is the champion of the small state. It believes people should be enabled and encouraged to live free and responsible lives. This is an exciting agenda for the 21^{st} century – and the right agenda for the 21^{st} century.

The role of the CPS is twofold. First, it is to develop coherent and practical policies to roll back the state, to reform public services, to support families and to challenge threats to the UK's independence.

Second, it is to create the environment in which these policies can be implemented. The CPS influences and persuades politicians, government,the media and other opinion-formers that its policies would, if enacted, significantly change and improve people's lives.

The CPS is independent of all political parties and special interest groups. It is a non-profit-making organisation which relies entirely on the donations of individuals and companies.

Become an Associate Member of the Centre for Policy Studies

The CPS runs an Associate Membership scheme which is available at £100.00 per year (or £90.00 if paid by bankers' order). Associates receive all major publications and (whenever possible) reduced fees for conferences held by the Centre. Since our task depends on the support of associates and sponsors, we encourage those who are able, to set a voluntary subscription level. If you wish to discuss becoming an Associate or a Donor or sponsor a project, please contact:

The Secretary
Centre for Policy Studies
57 Tufton Street, London SW1P 3QL
Tel: 020 7222 4488 Fax: 020 7222 4388
e-mail: mail@cps.org.uk Website: www.cps.org.uk