

THE BENEFIT OF EXPERIENCE

THE WORKING FAMILIES TAX CREDIT REVISITED

David Willetts MP

I used to be a great admirer of the American Earned Income Tax Credit. It boosted the income of low-income working families and was better targeted than many tax allowances because it is withdrawn as income rises. Indeed, as a member of the No. 10 Policy Unit in the mid-1980s, I helped persuade Margaret Thatcher and Norman Fowler of its virtues. It was proposed in our Green Paper on the Reform of Social Security in June 1985. Despite being one of the most widely criticised features of the Green Paper it survived into the White Paper on Social Security Reform in December 1985. It was only as the measure was being taken through Parliament in 1986 that opposition became widespread and the Government had to make significant concessions. Instead of being a tax credit delivered through the pay packet it became Family Credit, a benefit for low-income working families claimed by the mother and paid to her as a benefit.

Family Credit now goes to approximately 750,000 families. Very few two-earner couples are eligible: they do not have low enough incomes. In practice therefore it tends to boost the incomes of two very divergent family types. 351,000 recipients are working lone parents. Most of the rest are couples where the wife is unlikely to be working and the husband is on relatively low pay. The average weekly award of Family Credit is £59 per week. Total expenditure is running at approximately £2.3 billion per year.

Why did we end up with a benefit rather than a tax credit? Were the arguments used to defeat my proposal valid now? And what is the most effective way of providing people with an incentive to go to work even

if it be low paid?

"Wallet versus Purse"

The most vociferous opponents of the proposal to pay the money as a tax credit were worried about the position of mothers in a traditional two-parent family. They argued that if the money were paid via the pay packet it would tend to go to the man. If it was paid as a benefit it could go to the mother and she was more likely to use the money to help the children.

The argument was put calmly and effectively by Frank Field in the Standing Committee of the Social Security Bill which introduced the measure. He argued that:

Whatever scheme is enacted, if the parents behave as we hope we ourselves would behave, it would be irrelevant. We are concerned with that minority - it may or may not be substantial - of families in which money for the children is not paid over. We must draw on our experience to decide whether it is more likely that the money will go where Parliament wishes it to go - towards the welfare of children - if it is paid to mothers rather than fathers. I believe from my experience and that of many other organisations that more money will get to children in those families where something is wrong if we pay the money to mothers rather than to fathers.

House of Commons Social Security Bill, Standing Committee B,

18 March 1986. Hansard cols 948-949

Frank Field's arguments won the day and the law specifies that claims for Family Credit should be made by the woman unless it is reasonable (e.g. because of mental incapacity) that the claim should be made by the man.

The calculation of Family Credit is based on the total income going into the household. Therefore in the case of a couple the application does have to be signed by both partners and there are two columns - one for the person claiming (i.e. the woman) to fill in information about herself, and one for information about the partner. The wording of the form assumes that the claimant (i.e. the mother) will be ticking boxes in both columns, although obviously there is no way of enforcing this. It is for the woman claiming the benefit to specify how it should be

paid.

At first Gordon Brown and his advisers dismissed the arguments on Wallet versus Purse, as I had. Now they appear to be offering a concession, though it is not as good as it seems. Information will still be needed about the incomes of both partners where two people are involved. However the Chancellor's plan appears to be that although the money will usually be paid to the working person, usually the man, it can still be paid to the woman if both partners so wish. Under the new arrangement the man will have to agree for the money to be paid to the mother. In the old arrangement the mother had to specify if she wanted the money paid to the man. The balance will have shifted significantly away from the woman.

Frank Field's analysis still stands. For most couples in most circumstances the finer points of mechanisms for claiming and paying the benefit or the tax credit will not matter. There will be sadly some families for whom it does matter; and in those circumstances it is clear that the new arrangement alters the balance of power in the relationship towards the man.

Wallet versus Purse was an issue which I was wrong to ignore. It remains an issue now.

Burdens on business

The 1985 proposal was not, however, defeated only by those concerned that the benefit should be paid to mothers. The business community, particularly the small business lobby, also opposed it. It was worried about the extra complication of far more elaborate PAYE calculations than were normally required of them. Obviously this is particularly a problem if the employer is supposed to be collecting information and calculating entitlement to benefit. But it is still a problem even if the employer is simply acting as the payment mechanism for a benefit calculated by the DSS.

This argument was put most forcefully in the Standing Committee of the Social Security Bill by Margaret Beckett who fortunately is now in the ideal position to stand up for business in the way that she wanted to then. She argued:

It would be impossible for the DHSS to make the scheme work without the co-operation of employers and if

employers, both large and small, are expressing their considerable anxiety, the Department will be running its neck in a noose. We do not object to the Department running its own neck into the noose, but we object when it is taking millions of poor working families with it.

The Association of Independent Businesses recommended ... that the proposals to pay Family Credit through the pay packet are an unwelcome development ...

House of Commons Social Security Bill Standing Committee B,

18 March 1986, cols 942-943

The Inland Revenue appreciates its good fortune in that employers administer PAYE for them without any payment for their administrative costs. This is very different from the system in America where every individual fills in a tax return. The Inland Revenue therefore has always been wary of asking too much of employers delivering PAYE in case it prompts them to ask the awkward question as to why they should be acting as unpaid tax collectors for the government. They are also entitled to ask why they should be acting as unpaid tax credit payers for the government.

Benefit abuse

If Wallet versus Purse and the burdens on business were the two arguments deployed most effectively when we proposed it in the mid-eighties, what have we learnt about Family Credit since?

The biggest criticism to have developed in the past few years - and it has been put most eloquently by Gordon Brown - is that it is exploited by bad employers who use it to hold down wages below their market clearing rates. This is a significant charge. It was therefore carefully investigated in a survey of a representative sample of employers carried out by the independent Institute of Employment Studies. DSS Research Report No. 32, (1995) *Employers and Family Credit*, reported the results. It found that:

Employers did not have adequate knowledge of Family Credit or sufficient information about potential recruits to adopt such practices.

Only 9% of employers agreed that the availability of Family Credit affected the wages they pay. The conclusion of the research was that Family Credit 'has little impact on employers' remuneration practices in terms of their recruitment practices, the hours employees work, and their wage-setting strategies'. This is not surprising as Family Credit is carefully targeted on particular groups and is far from being the general wage subsidy that the critics fear. Above all, there is no reason why employers should know if any of their employees are eligible for, or claiming, Family Credit.

The extraordinary feature of Gordon Brown's argument is that with an Earned Income Tax Credit employers will know about their employees' entitlements. Gordon Brown's criticism therefore does not apply to the Family Credit but it does apply to his own scheme. This was another point which Margaret Beckett made as she pressed for the Earned Income Tax Credit to be paid instead as a benefit:

.... unfortunately, there are instances in which employers deliberately manipulate the system and withhold the benefits to which their employees are entitled. All Committee members would regret and oppose that but we must recognise that it happens. For the Government to propose putting the whole weight of payments that are an important part of a family income onto a system which gives employers that freedom, is a substantial risk to take.

She also referred to evidence from the Citizens Advice Bureau about the "overwhelming anxiety at the temptation to pay subsistence-level wages". At the end of her speech she summarised the arguments as showing that:

...the answer to many of those problems is to secure payment to the mother.

House of Commons Social Security Bill Standing Committee B,

18 March 1986 cols 943-944

Gordon Brown's advisers have come up with an ingenious response to this line of argument. They claim that everything will be all right because the minimum wage will set a floor for earnings and stop employers abusing Family Credit or their new tax credit. At its most absurd this becomes the claim that the minimum wage will actually save money because so much Family Credit is going to people on very low incomes.

The facts simply do not support this claim. A single parent with two children could be earning over £10 an hour and still have an entitlement to Family Credit. Family Credit by and large goes to people whose earnings are significantly above any likely minimum wage. The Institute for Fiscal Studies calculates that a minimum wage of £4.50 an hour would only reduce the number of families on Family Credit by 6%. If Labour wants to find an argument for the minimum wage they are going to have to look elsewhere.

What about take-up?

One of the objections to Family Credit is the supposed problem of low take-up. The figure that is used is that only 70% of people who are entitled to Family Credit claim it. The latest available information on the take-up of Family Credit is for 1995/96 and the evidence then was indeed that 30% of those eligible were not claiming the benefit. However as with other benefits, the low take-up tends to be concentrated on people whose entitlement would be small. The estimated average value of weekly Family Credit payments to which people were entitled but did not claim was then £24.30 per week while the average award of Family Credit was £54.82. If we look at the value of Family Credit which is not claimed we are looking more at something in the range of 10% to 15% of the total value of the benefit.

This is far from ideal but it is quite a good performance for a benefit which people have to claim. It does not justify a shift to a significantly new system. The trend is for steadily increasing knowledge of Family Credit. At first we were very worried about low take-up but an effective advertising campaign had a significant impact. With a fresh advertising campaign, Gordon Brown could achieve yet higher take-up very efficiently.

Moreover it does not look as if Gordon Brown's tax credit will be automatic either. Employers will not be able to assess entitlement or pay the Credit automatically when they do not know the full family circumstances of their employees. They will therefore not have the means of knowing whether or not individuals on their payroll would have an entitlement to the Credit. Somebody at some point is going to have to take the initiative of claiming for themselves or their families. There will continue to be some who do not claim that to which they are entitled.

Marginal rates

Imagine that you are earning £150 per week after tax and also receiving £50 Family Credit as a top-up, so your family's total net income is £200 per week. For every extra £1 you earn you will pay

Income Tax and National Insurance contributions and lose some Family Credit. It is possible therefore that if your gross earnings go up by say £10 per week, you might lose £7 in tax and benefit withdrawal, leaving you with a new net income of £203 per week. These figures are schematic but the point is a crucial one. Increasingly, as the other arguments for the working family's tax credit have been weakened, its advocates have been left with this criticism of high marginal rates.

An eager reformer comes along and says that it is absurd that, if you are earning £150 a week, you are facing a combined rate of taxation and benefit withdrawal of 70%. Instead we are offered a reform in which for every extra £1 you earn you keep, say, 50p of it as a minimum. Instead of a 70% rate of tax and benefit withdrawal you now face a 50% rate. So far, so good. (Of course anything which Gordon Brown does through his new tax credit he could equally do by adjusting Family Credit.) The only problems are fundamental ones arising from the laws of arithmetic.

Your benefit or your new tax credit is tapering out more gradually so it must go higher up the earnings scale. You extend your assistance from low-income working families to higher-income groups because it takes longer to earn your way out of entitlement to the benefit or credit. Your reform has increased the incomes not just of people earning £150 per week but those earning £200 per week as well.

Two consequences follow from this. First, the new more gradual taper is going to cost you a lot of money. You have brought within the scope of your benefit or credit many more people. You are devoting more social security expenditure or sacrificing tax revenues to pay more to these middle-income earners. It is not a cheap option.

The second consequence is that you have increased the combined marginal tax rate and benefit withdrawal of these people that you have brought within the scope of your benefit. Before, if you were earning say £200 per week you might not have had any entitlement to Family Credit so you were simply facing Income Tax and National Insurance payments which meant a marginal rate of approximately 30%. But now you are losing your new benefit or credit as well and your marginal rate has gone up to 50%. The price that the Government will pay for reducing very high marginal rates in a concentrated part of the earnings scale is spreading quite high rates much further up the income scale.

There is a further complication which the IFS has identified. At the moment Family Credit mainly goes to single-earner couples. By and large if there are two earners in the household their income is going to be high enough to take them off Family Credit. Labour's new lower

taper will for the first time reach a significant number of two-earner couples. Often these will involve a wife with relatively low earnings. All the evidence is that these women are particularly sensitive to changes in their marginal rates of taxation (it is why there is a distinct clustering of female earnings below the lower earnings limit for National Insurance contributions). The Government is proposing massively to increase marginal rates facing the section of the working population which is most sensitive to them. The consequences on their behaviour could be very significant indeed.

Tax benefit integration: what exactly is the Chancellor proposing?

Tax benefit integration is a will-o'-the-wisp. It was attempted by Harold Wilson in the mid-1960s and then by Edward Heath in the early 1970s. They both failed and by and large the idea has not resurfaced until now. The Chancellor's proposal is a half-hearted attempt at tax benefit integration which gets the worst of all possible worlds.

You cannot straddle the two systems because they work on fundamentally different principles. The tax system focuses on the incomes of individuals whereas by and large the benefits system looks at the needs of households and families. Women have proudly secured for themselves independent taxation of husband and wife (when I proposed Earned Income Tax Credit for families we had not yet moved to independent taxation of man and wife). The benefits system cannot simply assess individuals regardless of the circumstances of the other members of the household in which they are living.

Furthermore, we are taxed on our incomes over a year. If you have three months of high earnings and three months of zero earnings you expect that to be averaged out in the calculation of your income tax liability. The benefits system helps people by looking at their needs over much shorter time scales. If you have no money now, the fact that you had some money three months ago or may have it in three months' time is not much consolation so the benefits system will focus on your current needs. They are different systems with a different logic.

If the Chancellor had had the courage of his convictions he would have moved entirely to a working families tax credit which was firmly and exclusively part of the tax system. He would have looked at individuals' incomes, and introduced some special tapering of personal tax allowance which could be delivered entirely through the pay packet. Instead we have a muddled compromise. The basis of entitlement will still be family income. Employers do not and cannot know about family income. The Inland Revenue has no means of adding together the incomes of different members of a family. Assessment will therefore

still be done via the benefits system. Payment can be by the employer but equally, if both partners agree, it can be as a benefit paid to non-working partner. If a benefit is paid by the employer it appears to count as a negative PAYE payment. If it is paid to the partner it appears to be a conventional social security payment through the order book (but perhaps as a bold new innovation, an Inland Revenue order book). This seems to involve two bureaucracies handling one measure. The complex interactions between the Inland Revenue, the benefits system, the employer and the claimant will massively increase administrative costs. Instead of a system that was reasonably well understood and doing a useful job we are now going to have a muddle. It is a wasted opportunity.

Conclusion

The Working Families Tax Credit will not deliver the objectives which Gordon Brown has set himself:

- it will put women at a disadvantage;

- it will increase administrative burdens on business;

- it will spread means-testing higher up the earnings scale;

- it will cost far more than Family Credit;

- it will increase marginal rates of taxation and benefit withdrawal for people on middle-incomes;

- it will particularly hit women on modest earnings in two-earner couples.

The working families tax credit will not work.

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