# Reforming Tax Credits

**A short note by the Centre for Social Justice**
**November 2015**

The Centre for Social Justice has long been at the centre of the debate on welfare and tax credits. Our 2009 paper, *Dynamic Benefits: towards welfare that works*, revealed how the tax credit system was disincentivising people from working and set out how Universal Credit could create a fairer welfare system that helped people move into work and progress in work. We are committed to helping the Government build a welfare system that encourages, supports and sustains employment.

This short note is intended to help the Government as it reconsiders how to implement its planned cuts to tax credits. We believe it is essential that any future reform should help people transition to the new system, either by providing transitional support, or by phasing the reforms in, or both. Equally it is crucial that reform does not lead to further cuts being made to Universal Credit, thereby undermining its ability to make work pay. That would not only undermine work incentives in the very reform that the Government has introduced to make work pay.

## Context

The Government is currently balancing a number of major reform programmes intended to secure the nation's finances, make work pay and create a 'higher wage, lower tax, lower welfare society'. Central to this mission is its commitment to place the country on a firm financial footing by eliminating the structural deficit. It intends to do this by growing the economy and reducing government spending in most departments – this includes £12 billion of welfare savings to which the Conservative Party committed itself in its 2015 Manifesto.

In this year's Summer Budget, the Chancellor announced that he would look to reduce tax credit spending to the level that it had been in 2007/08 in real terms.[i] The Red Book explained that:

> ***From April 2016, the government will reduce the level of earnings at which a household's tax credits and Universal Credit award starts to be withdrawn for every extra pound earned****. In tax credits, this point (known as the income threshold) will be reduced from £6,420 to £3,850. The equivalents in*

*Universal Credit (work allowances) will be reduced to £4,764 for those without housing costs, £2,304 for those with housing costs, and removed altogether for non-disabled claimants without children.* ***The government will also increase the rate at which a person's or household's tax credit award is reduced as they progress in work****, by increasing the taper rate in tax credits from 41% to 48%.*

The Government attempted to introduce this reform by way of Statutory Instrument but was effectively blocked by the House of Lords on 26 October. Peers supported two amendments, one tabled by Baroness Meacher which stated that:

*… this House declines to consider the draft regulations laid before the House on 7 September until the Government lay a report before the House, detailing their response to the analysis of the draft regulations by the Institute for Fiscal Studies, and considering possible mitigating action.*

A second, tabled by Baroness Hollis, declared that:

*… this House declines to consider the draft Regulations laid before the House on 7 September until the Government, (1) following consultation have reported to Parliament a scheme for full transitional protection for a minimum of three years for all low-income families and individuals currently receiving tax credits before 5 April 2016, such transitional protection to be renewable after three years with parliamentary approval, and (2) have laid a report before the House, detailing their response to the analysis of the draft Regulations by the Institute for Fiscal Studies, and considering possible mitigating action.*

Notably, neither of these amendments explicitly disagrees with the principle behind the Government's reforms: the first calls on the Government to consider expert analysis and report back, the second repeats that call and asks it to report on a three-year scheme of transitional protections.

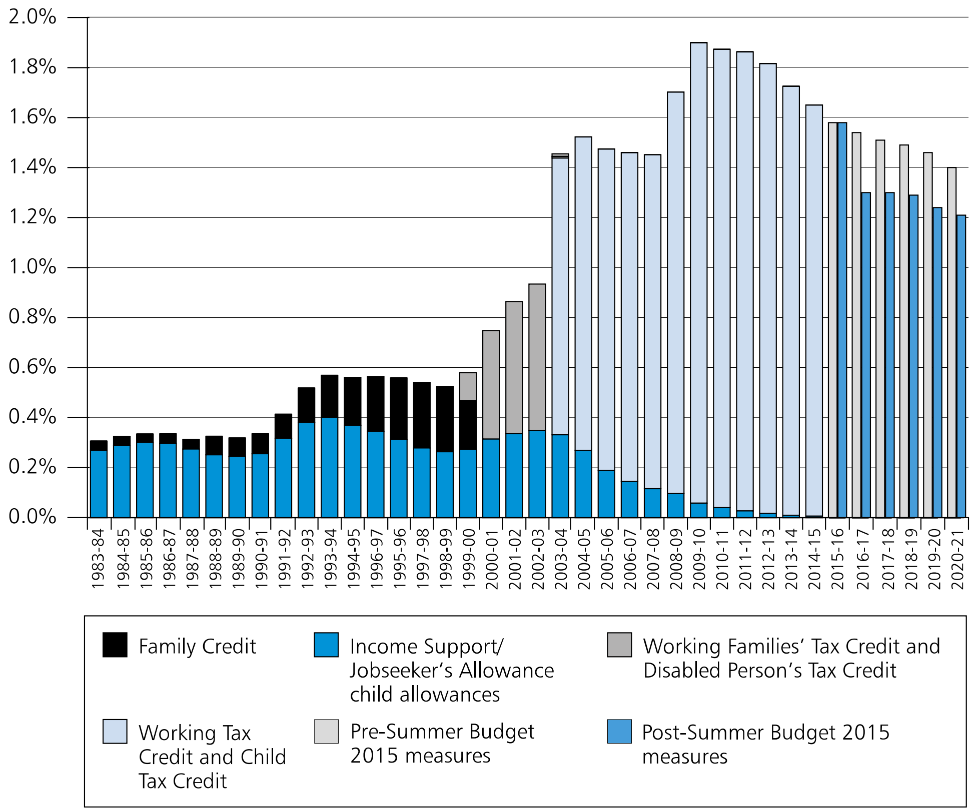
The Chancellor, responding to the Lords' decision, has subsequently announced that the Government will "continue to reform tax credits and save the money needed so that Britain lives within its means, while at the same time lessening the impact on families during the transition."[ii]

Below we set out options which could help him achieve these aims whilst continuing to make work pay.

## The case for reform of tax credits

Tax Credits were introduced by Gordon Brown in 1999/00 as a replacement for Family Credit. These were then revised and revamped as Working Tax Credits and Child Tax Credits in 2003/04. As the following graph shows, expenditure in this area has substantially increased since their inception:

**Chart 1.15: Expenditure on tax credits and equivalents as a percentage of GDP**




*Source: HMRC, DWP, ONS.*

HMT, *Summer Budget 2015*

As can be seen, major increases in expenditure occurred in the years preceding the 2005 and 2010 General Elections. At the same time the number of families eligible for Tax Credits grew substantially.

As the Chancellor said in his Budget statement this year:

> *"… in 2010 this country had reached the point where a benefit that was intended to support lower income households, was instead available to nine out of ten families in this country. … [A] reformed Tax Credit System will provide support to five out of ten families – a much more sustainable balance in our welfare system."*

In order to mitigate some of the effects of these changes the Chancellor has also announced an increase in the National Minimum Wage for those over 24. This is set to increase from its current level of £6.70 an hour to £7.20 in April 2016, rising to over £9 in 2020.

Simultaneously the ongoing roll out of Universal Credit is increasing work incentives by allowing people to keep more of their money as they increase their hours.

## The Problem

Within this context, it is possible to understand the Chancellor's pledge to reduce expenditure on tax credits to 2007/08 levels. The difficulty arises from the fact that people will lose before they gain. With Tax Credits due to be cut from April 2016 and the full scope of the Government's reforms not being felt before April 2020, there are many families who may see their incomes fall substantially.

## Potential Solutions

The CSJ's view is that there is an opportunity to take stock and pause. Tax credits and the subsequent flow onto Universal Credit are fundamentally about work incentives: the incentive to move into work (the work allowance) and the incentive to progress in work (the taper). They are at the heart of the Government's 'jobs miracle'.

The projected annual budgetary saving through changes to tax credits is £4.4 billion. As the Government plans to turn a surplus of £10 billion in 2019/20 and of £11.6 billion in 2020/21,[iii] the simplest means of mitigating the effects of tax credit changes would be to rethink them. Government could do this and still generate a surplus by the end of the Parliament, protecting those who are doing the right thing by taking work.

At the same time, by 2020 only 9 per cent of people currently on tax credits will still be on tax credits.[iv] The vast majority of those on working-age benefits will have migrated to Universal Credit and the Government will have succeeded in fundamentally transforming the welfare system.

If the Government is minded to pursue its stated intent, there are a number of options at its disposal:

1. Transitional advice: help individual families understand how the changes will affect them and provide advice on how to mitigate the effects;
2. Transitional support: provide funding to help those worst affected by the changes;
3. Phase the changes in: bring in the reforms incrementally between April 2016 and the end of the Parliament to give families more time to adjust;
4. Limit changes to new claimants: allow families currently on benefits to carry on with tax credits at the same level but apply the new rates to new claimants.

### 1. Transitional Advice

When the Government's benefit cap was first introduced in 2013 the DWP sought to deliver it in such a way that encouraged people affected by it to move into work. The benefit cap is a mechanism that ensures that no one on benefits receives more than the average wage. Although the policy was right in principle and popular, many households hit by it lost significantly more than they will through the Chancellor's proposed changes to the tax credit system.

The average loss from reducing the tax credit bill is roughly £1,300 a year.[v] The average loss from the benefit cap was £4,160 in London and £2,184 outside it.[vi] A year before Britain's benefit bill was capped, every single individual impacted by the cap had the opportunity to be spoken to in person. It was explained to them that if they took steps to get into work, it would take only 16 hours of work per week to ensure they would be clear of the impact of the cap. Since the cap was introduced, over 16,300 of those capped have moved into work, not only ensuring they lost no money, but also achieving genuine life change for them and their family.[vii]

The same approach could be taken this time. By offering everyone affected a chance to talk to a JCP adviser, the Government can give advice on how to mitigate the effects of the tax credit changes.

## 2. Transitional Support – discretionary payments

One option open to the Government is to make transition funds in the form of discretionary payments that could be applied for by those who find the reduction in their income difficult to handle. This was the approach taken by the DWP when the benefit cap was introduced. The department provided additional funding in the form of Discretionary Housing Payments (DHPs) – £65m in 2013/14 and £45m in 2014/15 – to ensure that those who were not able to make a behavioural change immediately were supported over a transitional period.[viii] It also issued guidance to local authorities on how they might allocate it to help people cope, for example, before they found work.

Similarly, in 2013/14, the Government made £55m available in DHPs to support households with the removal of the spare room subsidy, rising to £60m in 2014/15.[ix] This has meant that the policy has been able to deliver annual savings of about £500m a year whilst offering transitional support to many of those affected.[x]

The Government could repeat this by making money available to local authorities to help those who are placed in a particularly difficult situation by the changes – giving them time to adjust to the new circumstances and find more work.

## 3. Phased change

As Paul Johnson of the IFS has noted, it is possible for the cuts to be implemented "gradually rather than overnight" because of the targets that the Government has set itself:

> *"The Chancellor has a target to get to a budget balance by the end of the decade. As long as it's still £4 billion at the end, it makes not a great deal of difference."*[xi]

The Government's changes to the National Living Wage and to tax thresholds are all being introduced incrementally between now and 2020. HMT have committed to increase, by the end of the Parliament, the National Living Wage to over £9 an hour by 2020 (up from £6.70 today) and the income tax threshold to £12,500 (up from £10,600). It is expected that these changes will be introduced incrementally, however the proposed tax credit changes are due to be introduced abruptly in April 2016.

A major problem is that many people will lose before they will gain. It is therefore important that the Government considers whether changes to tax credits could be introduced incrementally. Currently the income threshold is due to be reduced from £6,420 to £3,850 and the rate at which a person's or a household's tax credit award is reduced as they progress is due to be increased from 41 per cent to 48 per cent as of April next year. To avoid this cliff edge, the Government could phase in these changes, e.g.

| | *Income Threshold* | *Taper rate* |
|---|---:|---:|
| 2016/17 | £6,420 | 41% |
| 2017/18 | £5,560 | 43.3% |
| 2018/19 | £4,710 | 46.6% |
| 2019/20 | £3,850 | 48% |

Obviously this will come at some cost over the Parliament but it would still enable HMT to find the required level of savings by 2019/20 as planned and, crucially, give families more time to adjust to the changes and to benefit as the National Living Wage and income tax thresholds rise.

4. Flow only

The means of impacting least on families, whilst still achieving the structural change that the Chancellor is looking for, would be to make the changes applicable only to families who are moving into low income work and claiming tax credits for the first time. No family would experience a loss and tax credit spending or equivalent would, over time, revert to its 2007/08 levels. This would inevitably be a much longer process and would produce considerably less in the way of savings initially but it would still allow the structural transformation of the system without existing families being subject to potentially large reductions in their income.

## Conclusion

All of these options will cost money, however, they should still allow the Chancellor to acquire a surplus by 2014/15 without needing to take funds from other budgets. If the Government does seek to mitigate the costs of its new policy on tax credits it is essential that it does not do so by reducing the amount of money Universal Credit has at its disposal. To do so would be to weaken fundamentally Universal Credit's ability to make work pay and so jeopardise the excellent investment that the Government has already made into its flagship welfare policy.

[i] Hansard 8 July 2015

[ii] Hansard 27 October 2015

[iii] HM Treasury, *Summer Budget 2015* (2015) https://www.gov.uk/government/publications/summer-budget-2015/summer-budget-2015; HM Treasury, *Policy Paper: Summer Budget 2015* (July 2015), https://www.gov.uk/government/publications/summer-budget-2015/summer-budget-2015

[iv] National Audit Office, *Universal Credit: progress update* (2014) https://www.nao.org.uk/wp-content/uploads/2014/11/Universal-Credit-progress-update.pdf

[v] S. Kennedy & R. Keen, *Tax Credit Changes from April 2016*, House of Commons Library (Sept 2015)

[vi] Department for Work and Pensions, *Benefit Cap: analysis of outcomes of capped claimants* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/385970/benefit-cap-analysis-of-_outcomes-of-capped-claimants.pdf

[vii] https://www.gov.uk/government/news/benefit-cap-thousands-of-people-move-into-work-or-off-housing-benefit

[viii] Department for Work and Pensions, *Use of Discretionary Housing Payments GB* (2015), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/437116/use-of-discretionary-housing-payments-2014-15.pdf

[ix] Department for Work and Pensions, *Use of Discretionary Housing Payments GB* (2015), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/437116/use-of-discretionary-housing-payments-2014-15.pdf

[x] OBR Policy Measures Database; W. Wilson & R. McInnes, *The Impact of the Under-Occupation Deduction from Housing Benefit (social rented housing)*, House of Commons Library (December 2014), http://researchbriefings.files.parliament.uk/documents/SN06896/SN06896.pdf

[xi] Quoted in the Telegraph, 29 October 2015