

# Tax and Benefit reform in the UK: Making Work Pay

by  
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November 6<sup>th</sup> 2000

## Draft Peer Review for the European Commission

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## Part A: Tax and Benefit Reform in the UK

### A.1 Introduction and Background

The aim of this review is to examine the effectiveness of recent tax and benefit reforms, undertaken by the Government since 1997, to achieve the UK's employment objectives in the context of the national employment action plan.

It is important to recognise at the outset that the tax and benefit reforms we consider have been supplemented by an array of other complementary reforms and have also had a distributional as well as an employment goal. In terms of other related reforms, we would highlight the introduction of a national minimum wage – helping ensure that employees see the benefit of in-work benefits<sup>2</sup> – and the introduction of active labour market policies in the New Deal. From the standpoint of distributional objectives, these have been enhanced by the increased generosity in universal and means-tested out-of-work benefits for families with children (Child Benefit and Income Support respectively) which have had significant effects as part of the UK Government's programme to abolish child poverty. Neither of these two issues are the subject of this review and we do not discuss them further here.<sup>3</sup> We also do not discuss any implications for employment of a wider shift in taxation policy first heralded by the UK Government's Statement of Intent of Environmental Taxation<sup>4</sup>.

In Appendix A we describe the main tax and benefit reforms undertaken over the period since 1997 which have an explicit objective of increasing employment. This is not meant to be an exhaustive list of all the personal tax and benefit changes since 1997 (see, for example, IFS, 2000b), but it includes the major reforms that are considered most likely to have an impact on employment. The key elements of the recent reforms are:

- the introduction of the Working Families' Tax Credit (WFTC) and the Childcare Tax Credit to replace Family Credit, phased in over 6 months from October 1999. These changes have been accompanied by increases in out-of-work benefits for families with children;
- reforms to employee and employers' national insurance contributions (NICs);
- reforms to income tax;
- the long-term announcement of an employment tax credit for workers without dependent children, and an integrated child credit to bring together existing transfer mechanisms for families with children.

<sup>2</sup> The WFTC which we discuss in detail below, can be seen to reinforce the minimum wage: a family with 2 children working 35 hours a week at the national minimum wage receives is effectively receiving over £7 for each hour of work (but a marginal wage of £1.50). At this point we do not know the exact wage distribution of WFTC recipients: but the ratio of mean (median) earnings to mean (median) hours worked is £5 (£4.24). However, it is also the case that many minimum wage recipients in the UK are young people without children, or second earners in well-off households, and therefore not eligible for the WFTC.

<sup>3</sup>The New Deal is being comprehensively evaluated by the Government; Low Pay Commission (2000) discusses the impact of the national minimum wage to date; HMT (2000b) and IFS (2000b) discuss the distributional impact of tax and benefit reforms under this Government.

<sup>4</sup> See HMT (1997a). Although some advocates of environmental tax reform stress the positive employment consequences, this has not been an argument used extensively by the UK Government. It is also doubtful whether the shift in the burden of taxation implemented to date – a cut in employers' NICs of 0.4% by 2002 to offset the new taxes on business use of energy and aggregates – will have a significant impact on employment.

We do not look in any detail at the changes to employers NICs<sup>5</sup>. We also do not consider in any detail a number of smaller, administrative changes to the tax and benefits system designed to encourage employment<sup>6</sup>.

The most radical reform, and the one that is focused on in the terms of reference, is the replacement of Family Credit with the WFTC and the Childcare Tax Credit. But Table 4 shows that this was not the most expensive reform: instead, it is a targeted reform which substantially affects the gain to work for the eligible population, around 14% of all families with children in the UK, or around 4% of the total workforce.

The rest of this paper is arranged as follows: the remainder of section A describes the reforms, the target groups, and the theoretical considerations behind using tax and benefit reform to increase employment; section B shows how the recent reforms have changed the budget constraints of low-income households, it also reviews results from studies that have predicted the employment effects of the WFTC, and presents evidence from recent administrative data on benefit and tax credit caseloads; and section C discusses the main policy debates and the future tax and benefit reforms (the integrated child credit and the employment tax credit).

## A.2 The goals and target groups of the policy

The Government's stated rationale for the tax and benefit reforms has been expressed in terms of both increasing employment and reducing poverty, particularly among families with children<sup>7</sup>. The UK's Employment Action plan says that "although significant improvements have been achieved in the last few years, employment can go higher and its distribution be made fairer. The number of workless households, for example, remains unacceptable – one in five households of working age have no-one in work."

Although the tax cuts will affect all workers, two groups were particularly targeted by the introduction of the WFTC: lone parents and low-income couples with children. The Government's rationale for targeting these groups is primarily based on its desire to reduce child poverty, and the belief that the best way to reduce child poverty permanently is to reduce the proportion of families with children where no adults work<sup>8</sup>. Appendix C shows employment and worklessness rates over the 1990s. Table 3 (Appendix C) shows how employment rates for mothers in couples vary substantially by the employment status of the partner. Figure 13 (Appendix C) shows the distribution of hours for these groups during the mid 1990's. Virtually no men work part-time in the UK. Women, on the other hand, work at a wide range of hours levels. There is also a clear indication of the impact of the in-work benefit system on female labour supply, with a spike in the distribution of hours for lone parents at the 16 hours point, the lowest number of hours a week needed for eligibility for FC.

The UK's tax and benefit reforms contribute to the Employment Plan by affecting the work incentives of those with low potential labour-market returns. Any policy designed to alleviate poverty among families is open to the potentially harmful disincentive effects of the welfare trap. Thus, although supporting low incomes, poverty-alleviating systems typically reduce the financial incentives for workers in such

<sup>5</sup> Partly because recent UK research has focused on the impact on employment of changes in personal – rather than employer – taxes and benefits only. However, we acknowledge that the implicit assumption behind much of this research - that only workers see a benefit from personal tax cuts, and only employers benefit from cuts in employer taxes on earnings - represents an extreme set of assumptions. Other Member States have cut employer taxes to encourage low-skilled employment, and it would be an interesting project to compare this with increasing in-work benefits.

<sup>6</sup> Including: benefit "run-ons" to ease the initial cash-flow problem faced by people leaving benefits for work; "linking rules", designed to encourage people to try work by giving them certainty of financial support if the job does not work out; and changes to the way WFTC treats receipt of maternity pay, designed to help low-income mothers retain links to the labour market.

<sup>7</sup> Set out originally in HMT (1997b), HMT (1998b) and HMT (1999b).

<sup>8</sup> We do not discuss whether this is an effective, anti-poverty policy; Piachaud and Sutherland (2000) attempt this.

families to seek work.

Recent decades have seen little increase in the real return to work for low-skill individuals in the UK, as in other countries. This again acts to reduce the financial incentives to work for such individuals. Low attachment to the labour market can then be enhanced through low earnings in work, and a benefit system in which benefits are reduced rapidly on entering work.

In-work benefits (or earned income tax credits) are also utilised as a method of poverty relief that does not create adverse work incentives. They do this by targeting low-income families but enforcing a work contingent eligibility rule. The UK's reform to Family Credit follows a considerable expansion of the Earned Income Tax Credit in the US during the 1990s, and the Canadian Government's experimental programme Self-Sufficiency Program<sup>9</sup>, although the UK has had a system of in-work benefits since 1971. In the UK, eligibility is based on the presence of children, reflecting in part the higher out-of-work benefits for families with children, and partly the extra work-related costs of having children. But - in the UK and elsewhere - in-work benefits are also being discussed for low-income workers with or without children.

In terms of poverty alleviation, in-work benefits can be much more effective and better targeted than minimum wages and, in contrast to the usual means-tested transfers, can have positive as well as negative work incentives. In fact, the positive incentives to work created by in-work benefits are often a central motivation for their introduction, reinforced, in the UK, by the recent tax cuts for low-paid workers. But the high benefit reduction rate can create incentives for lower effort or hours of work among existing workers. In general terms, the success of an expansion of in-work benefits will depend upon the relative size and behavioural responses of four key groups affected by the reform<sup>10</sup>:

- non-working adults who would be eligible for in-work benefits if they moved into work;
- working adults already receiving in-work benefits;
- working adults who are made eligible for in-work benefits because of the increased generosity;
- working adults who are still not eligible for in-work benefits.

An expansion of in-work benefits improves work incentives for the first group, but reduces work incentives for the other three (although some of the other components of the WFTC reform – reducing the taper rate and increasing the generosity of support for childcare – may increase work incentives for the second group as well). In addition, by assessing eligibility on family income – rather than individual income – the expansion of in-work benefits is likely to lead to some adverse incentives for individuals in families with more than one potential worker.

We quantify some of these effects in Section B, but highlight them here to emphasise that not all of the tax and benefit reforms will have an unambiguously positive impact on employment.

### **A.3 The legal and financial provisions to implement the policy**

The Appendix contains estimates of the financial cost of the components of the tax and benefit reform.

### **A.4 Institutional arrangements and procedures of implementation.**

<sup>9</sup> See Blundell (2000) for a review of in-work benefits in the US, UK and Canada, and Brewer (2000) for a detailed comparison of the US and UK package of support for low-income families with children. EITC and SSP references include Eissa and Liebman (1996) and Lin et al (1998).

<sup>10</sup> Taken from Blank, Card and Robbins (2000),  
November 26-27, 2000

The WFTC is now considered a tax credit, and can be paid through the wage packet by employers, rather than being paid as a benefit. Administration of WFTC moved from the Benefits Agency (part of the Department of Social Security) to the Inland Revenue. We do not discuss this any further here.

## Part B: Existing Estimates of the Impact of the Reforms

The programme of tax and benefit reforms announced by the UK Government was not implemented in a big-bang, but instead announced and implemented as a gradual – and as yet uncompleted - programme of reform (the first changes were made in April 1998, and will not be completed – assuming there is no change of government – until at least 2003 for the employment tax credit for people without children and the integrated child credit). This means, in contrast to, say, the discrete reforms to Family Credit in the UK during the 1990s<sup>11</sup>, that we cannot yet (and perhaps never will be able to) do an effective *ex post* evaluation.

In this section, we assess four broad sources of evidence:

- we discuss the change in the theoretical budget constraints for a variety of family types. The aim of this section is examine how we would expect the reforms to influence work incentives by examining the changes in typical budget constraints faced by individuals. This will provide an intuitive explanation for the results generated by the various labour supply models examined later. It must be stressed that these examples are merely illustrative and it is dangerous to generalise too widely on the basis of them;
- we outline the results of three studies that estimated the *ex ante* labour supply impacts of various parts of the package of tax and benefit reforms using labour supply models that simulate the choices of individuals as their earnings opportunities change (Gregg et al, 1999; Blundell et al, 2000; Paull et al, 2000). The UK Government has since used the first of these methodologies to estimate the employment impact of the actual package of personal tax and benefit reforms announced by this Government (see HMT, 2000b, para 2.13);
- the last Government piloted and evaluated a scheme called Earnings Top Up (ETU), which provided an in-work benefit to adults without children. Although there are some concerns with the evaluation results, they are relevant to an assessment of the WFTC and employment tax credit;
- although the tax and benefit reforms have been implemented piecemeal, the major reform – the WFTC – was fully phased in by April 2000, and so we can look at recent survey and administrative data to see what impact it is having.

We then look briefly at some of the concerns, unintentional effects and obstacles encountered.

We note here that the Inland Revenue has an evaluation programme for the WFTC, but so far there has been no commitment by the Government to evaluate the complete tax and benefit reform package.

### B.1 The quantitative results of the policy so far

<sup>11</sup> See Duncan and Dilnot (2000).  
November 26-27, 2000

*a) The effect of the reforms on budget constraints and work incentives*

Appendix B shows the effect of the tax and benefit reforms on the budget constraints on some specimen low-income family types. The key findings are that:

- low-income families with children with one earner have seen the financial gain to work increase, mainly due to the WFTC;
- this effect is reduced, though, for families who claim help with rental costs through Housing Benefit;
- second earners in low-income families with children will face reduced incentives to work from the WFTC;
- the reforms have increased the generosity of government financial support for all family types regardless of in-work income; this redistribution has been heavily targeted towards families with children.

*b) Ex ante estimates of the labour supply impact of the tax and benefit reforms*

Several projects by researchers at the IFS have used simulation techniques and microeconomic data to assess the impact of the tax and benefit reforms on the participation of key target groups. The methodologies used in the various studies were as follows:

- Gregg et al (1999) use a transitions model of labour market entry. The model estimates a relationship between the probability of moving into work over a period of a year and the financial incentives to enter work at the wages earned by actual work entrants. Assuming that the rate at which men and women already in work are leaving work does not change, it is possible to derive estimates of how tax and benefit reforms will affect employment in the long-run;
- Blundell et al (2000) develop a statistical simulation model of family labour supply behaviour based on individual survey data and incorporating a complete description of each family's budget constraint and childcare availability. This requires a description of the budget constraint for individuals who are currently out of work, and so an assessment of their likely market wage;
- the results from the Paull et al (2000) study only refer to single mothers, and the main emphasis of the work is on the reforms to child support, but we can use the work to look at the introduction of the WFTC. The simulations are based on labour supply estimates from a pooled sample of approximately 4,000 single mothers.

Table 1. summarises these results by showing the predicted impact **of the WFTC only** on employment in the three studies. The first two studies reported in the table cover all groups, while the third study is only for lone mothers. Although each study uses a different data source and a slightly different methodology, there is broad agreement on the impact for most of the client groups. This is an encouraging finding which gives us more confidence that the results of these studies accurately capture the potential labour supply effects of the WFTC.

**Table 1. Predicted employment impact of the WFTC on families with children**

Group	Gregg et al.		Blundell et al.		Paull et al.	
	Number	%	Number	%	Number	%
<b>Lone parents</b>	28,600	1.85	34,000	2.20	24,700	1.60
<b>Women in couples, partner not working</b>	14,610	1.75	11,000	1.32	—	
<b>Women in couples, partner working</b>	-29,050	-0.83	-20,000	-0.57	—	
<b>Men in couples, partner not working</b>	16,820	0.48	13,000	0.37	—	
<b>Men in couples, partner working</b>	1,790	0.05	-10,500	-0.30	—	
<b>Total employment effect</b>	32,770		27,500			

*Note:* The studies calculate the effects of the WFTC scheme as originally announced in the 1998 Budget, and so do not include the effect of other tax and benefit reforms nor the increases in the WFTC announced in the 1999 and 2000 Budgets.

*Source:* Blundell and Reed (2000).

Overall, Blundell et al predict a gross increase in participation of some 58,000 workers, while Gregg et al predict some 60,000 additional workers. The results predict an unambiguous positive impact on the participation of lone mothers. The results also predict a sizeable positive impact on participation for men and women in couples with out-of-work partners. As highlighted earlier, the papers predict a moderate negative impact on women in couples with children and employed partners. This reduces the aggregate employment effect, but is of less concern if the aim is to reduce the number of families with no earners. Finally, the results differ in sign for men with partners in work – and this is the result that explains the difference in the totals. For this group, the effect of an increase in the wife's income leads to a theoretical negative impact on participation in the study by Blundell et al. The study by Gregg et al does not find a negative effect, but this may be because it models entry into work only, and does not directly model the decision of those in work to stop or reduce work.

None of these studies estimates the impact of the full package of tax and benefit reforms announced by the Government since 1997 (in part, because the Government has continued to announce reforms in successive Budgets). It is important to remember that the WFTC alone is part of an overall package, not least because, since 1997, the Government has substantially increased the level of out-of-work benefits for families with children, as well as reducing taxes and increasing in-work benefits. But the only estimate to date of the employment effects of the full package of reforms was published in HMT, 2000b, para 2.13. This was based upon the Gregg et al methodology, so it does not look at the impact of the reforms on people already in work, and estimated that 160,000 extra people would move into work.

*c) Earnings Top-Up evaluation*

Since October 1996, an in-work benefit called Earnings Top-Up has been available to people without children in 8 pilot areas across the UK. Initial findings from the 1<sup>st</sup> year of the pilot found that “there is little in the data to oppose the view that most of the first year of expenditure on ETU in the pilot areas had gone to the people who would anyway have done the jobs they did, working the hours they would have worked for the wages they would otherwise have accepted”<sup>12</sup>. But this failure to detect any large impact of the programme may be due to the short time period of its operation. We should also be wary of making inferences across to those entitled to the WFTC as they have quite different characteristics from those entitled to ETU.

*d) Administrative and survey data*

We have three years of data on employment and benefit claimants since the present Government took office.

The introduction of the WFTC, and the substantial increase in generosity, has had a marked effect on the number of people claiming in-work benefits. Figure 14 (Appendix D) shows that caseload has risen by 30% in the 12 months since May 1999. Table 2 (Appendix A) shows that the average award has risen from £63 to £76 a week over the same period. Average gross weekly income of claimants is now £153, and average weekly hours worked 30.5. 52% of recipients are lone parents.

There has been a large increase in take-up of the Childcare Tax Credit compared to the childcare disregard under Family Credit. 111,000 families were receiving help with childcare costs in May 2000, a 156% increase over 12 months. The average amount of costs claimed was £32 a week. But although a large increase, this is still only 10% of the total WFTC caseload (Table 2, Appendix A).

Obviously some of the change in WFTC caseload is due to the increased generosity, and cannot really be taken as a measure of success in increasing employment. Appendix C shows data on employment and worklessness. Employment has grown steadily since 1993, and the proportion of workless households, having peaked in the mid 1990s, is at its lowest level since 1990. Figure 14 (Appendix D) shows, in line with the fall in the proportion of children in workless households, that the number of lone parents on Income Support has been on a downward trends since 1996. This is an important indicator as around half the children living in workless households and living in poverty are living in a household headed by a lone parent (compared to a fifth of all children).

What we ideally want to know is how much of the increase in employment and fall in worklessness is due to the tax and benefit reforms and how much is due to strong economic growth. There has been no work that has attempted to decompose recent employment changes, although such work would be difficult given existing data<sup>13</sup>. We can learn a little more by looking at data on cross-benefit flows, shown in Appendix D Figure 16 shows that the proportion of WFTC/FC claimants still claiming in their own right 12 months later has risen slightly since October 1999. Figure 15 breaks down the WFTC/FC caseload by their situation 12 months ago. It shows that almost all of the caseload increase (around 75%, taking the last 4 quarters of FC as a baseline) since October 1999 comes from people who were not claiming any means-tested benefits or tax credits 12 months before. Both these two facts are consistent with the increased entitlement of the WFTC compared with FC<sup>14</sup>.

<sup>12</sup> Finlayson et al (2000).

<sup>13</sup> US studies can attempt to decompose changes in poverty or employment between the effect of economic growth, welfare reforms and in-work benefit expansion, but that is because the US has substantial intra-state variation in these conditions that allows identification of the separate effects. See, e.g., CEA (1999), Schoeni and Blank (2000) and Neumark and Wascher (2000).

<sup>14</sup> Some care is needed in interpreting these figures. We would expect the introduction of the WFTC to have two effects on the proportion of people who renew a FC/WFTC claim. First, FC was claimed by the main carer, almost always a woman, but either adult in a couple is

It is informative to compare the predicted labour supply effects discussed earlier with the available administrative data. Both the Blundell et al and Gregg et al estimates in Table 1 imply that around 30,000 currently-workless lone parents with children will enter work as a result of WFTC<sup>15</sup>. The Government's equivalent (and unpublished) estimate for the package of tax and benefit reforms is around 40,000 lone parents with children. Although we cannot make accurate inferences from this high-level analysis of administrative data, we cannot yet see a change in the behaviour of lone parents of this magnitude. Comparing February 2000 with August 1999, only 5% (10,000 families) of the increase in the WFTC/FC caseload is due to lone parents moving from Income Support to WFTC. Figures 17 and 18 (Appendix D) confirm that there has been no appreciable change in the dynamics of lone parents on IS since the WFTC introduction: there are 130,000 fewer lone parents claiming Income Support now than the peak in 1996 (a 13% fall), but this represents a steady decline over the past 4 years.

But this does not mean that the structural labour supply estimates above were too optimistic: there are several important reasons that could explain the discrepancy:

- we have presented an extremely crude analysis that does not, for example, control for any underlying changes in the number of lone parents moving from IS to WFTC/FC (for example, the number of lone parents moving from Income Support to WFTC/FC fell by 7,000 in the 12 months to August 1999). We also cannot identify lone parents on other out-of-work benefits;
- the structural labour supply estimates are long-run estimates, and we only have 5 months of data on benefit flows since the WFTC introduction. Workless lone parents typically spend several years claiming Income Support, so we might expect a long process of adjustment to the new regime;
- the Blundell et al and Gregg et al figures do not model the exact reforms that were implemented: on the one hand, lone parents will also be affected by tax cuts, on the other hand, they have also seen increases in out-of-work benefits.

Evaluating the true labour supply impact of the WFTC reforms will be a crucial objective of the IR's WFTC evaluation programme.

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allowed to claim the WFTC. As the dataset used for these analyses tracks claimants only, couples on FC who switched claimants after the WFTC introduction would appear in the "Not claiming (in own right)" category in Figure 16 and the "New claimer (in own right)" category in Figure 15. Second, the increased generosity of WFTC over FC means that families experiencing a rise in earnings are now more likely to retain in-work benefit eligibility. The first factor will *increase* the flow off WFTC/FC, the second *reduce* it. We observe an overall *reduction* in the flow off WFTC/FC, so the impact of increased generosity must be greater than the impact of couples switching claimants. We also cannot say that all of the "New claimers (in own right)" represent newly-entitled families: some may be couples who switched claimers.

<sup>15</sup> We cannot analyse couples who move into work because of the difficulties in classifying couples who change claimants when they change benefits/tax credits.

## B.2 Unintentional Effects: extending high marginal deduction rates and the impact on childcare

We highlight two potential side effects of the UK's tax and benefit reform. As above, it is too early to make any definitive evaluations of the achievements of the tax and benefit reforms, and the Government's evaluation of the WFTC may be able to answer these questions more thoroughly. The two issues are:

- what is the long-term effect of increasing the number of families facing high marginal deduction rates and in-work benefits assessed on family income ?
- what effect is the Childcare Tax Credit having on the childcare market ?

One concern about in-work benefits is that they reduce the incentive for individuals to increase earnings, with adverse long-term impacts on employment and income. There are two possible negative effects: individuals already in work might reduce their hours of work; and, once in work, they might be less inclined to seek wage progression and invest in human capital.

Figure 12 in Appendix C shows the hours distribution for low-education lone parents<sup>16</sup>. It shows that there has been a spike in the distribution at 16 hours throughout the 1990s. This reflects the work incentives implied by the budget constraint for lone parents: there are good financial incentives to take work of 16 hours a week or more, but, once at 16 hours/week, the incentive to increase work effort and earnings is poor<sup>17</sup>.

Wage progression can arise for a number of reasons. Moving individuals into work is a necessary condition and one that is enhanced by the in-work benefit reforms. But wage progression also most obviously occurs when individuals increase their wage over time by taking a job with "prospects" (i.e. some on-the-job training, learning-by-doing, or firm-specific human capital acquisition) or because individuals can increase their wage by investing in their own human capital outside of the job market (i.e. through improving their health while in work or by improving their education before ever starting work). Means-tested in-work benefits reduce the returns to any form of future wage-enhancing investment: they may encourage work, but encourage it in jobs where the opportunities for wage progression are limited.

A similar argument can be made about the fact that in-work benefits are assessed on joint family income. It may be the case that, in a dynamic setting, the WFTC is encouraging second earners in a couple to reduce their work effort, and so suffer the long-term experience and training penalties described above<sup>18</sup>.

There is little evidence yet on how important these concerns are. The most reliable evidence on wage progression comes from the evaluation of Canadian Self Sufficiency experiment, which shows that individuals who enter work because of the in-work benefit programme tend to take lower wage jobs, and experience little wage progression<sup>19</sup>. Future work in the UK needs to consider the effect of the WFTC on wage-progression incentives by investigating the types of jobs that welfare recipients take relative to low-skilled workers who are not eligible: we don't yet know the answer, although researchers at the IFS are currently investigating the long-term employment impact of Family Credit on lone mothers in the 1990s. Inland Revenue's evaluation will also need to look to see if the theoretical impact on second earners in couples is a concern in practice.

<sup>16</sup> Defined as those who left school at aged 16 or less.

<sup>17</sup> See Brewer (2000) for some quantification of this point and comparison with the US.

<sup>18</sup> This is argued by Rake (2000), for example.

<sup>19</sup> Cossa et al (1999) presents a theoretical framework for analysing the problem.

The lack of suitable childcare is frequently identified by lone parents as a barrier to moving into work<sup>20</sup>. State-provided childcare is lower in the UK than many other Member States. The Government has tried to increase the supply of childcare places through the National Childcare Strategy and subsidise demand through a generous childcare tax credit. So far, the number of working low-income families receiving help with childcare costs has doubled, but what is unclear at present is whether these represent “deadweight” subsidies to existing workers and childcare places, or reflect new childcare places. But this is a subject on which the IR’s evaluation may throw more light.

### **B.3 Obstacles and constraints encountered**

The tax and benefit reforms have been implemented broadly as originally envisaged by the Government. We do not discuss here the internal process of transferring responsibility for in-work benefits from the DSS to the IR, so we only highlight one other point here: the estimated caseload of WFTC.

It is difficult to estimate take-up (i.e. the proportion of adults eligible for WFTC/FC who are receiving it) accurately, but the UK Government estimated that take-up of FC was 71-76 in 1997/8, corresponding to 80-87% of total expenditure<sup>21</sup>. In 1998, the Government estimated that WFTC would benefit around 1.4 million families: as of May 2000, caseload was only 1.06 million. There are three reasons that could explain why caseload is below the Government forecast:

- the Government’s estimate of the take-up rate was too high;
- the Government’s estimate of the eligible population was too high, perhaps because earnings growth has been higher than expected at the bottom end of the distribution;
- the transition period is longer than 9 months.

Until data from the 2000/01 Family Resources Survey or the Government’s WFTC evaluation become available, it will not be possible to say much about which factor was the most important. IFS’ researchers hope to complete work shortly on the trends in and determinants of take-up of means-tested benefits in the UK over the 1990s.

<sup>20</sup> See Noble et al (1998) and Shaw et al (1996).

<sup>21</sup> DSS (2000a).

## Part C: The policy debate

### C.1 An assessment of the arguments of different interest groups

When the Government first announced that it was looking at the merits of an earned income tax credit to replace Family Credit, interest groups' reactions were not, on balance, favourable. This was partly out of fear that the UK would adopt something similar to the US Earned Income Tax Credit, the features of which were seen as undesirable in a UK context; and partly a doubt as to whether the substantial upheaval involved would be justified by a small improvement in work incentives<sup>22</sup>. But the eventual reaction of interest groups to the tax and benefit reforms has been more favourable, perhaps due to the unanticipated generosity of government financial support implied by the reforms. We highlight here some of the arguments put forward over certain design features of the WFTC<sup>23</sup>:

- from April 2000, couples receiving the WFTC can choose who receives the credit. This is a change from Family Credit where the mother (if present) always made the claim and received the benefit direct; it could affect around 400,000 couple families claiming WFTC where the man is the only earner. Some interest groups have argued that this “purse to wallet” shift will have negative effects on mothers' and children's well-being. This is backed up by research suggesting that children's well-being depends more upon their mother's own income than their father's.<sup>24</sup> The Government has argued that paying in-work benefits through the wage packet emphasises the message that work pays, and that it should reduce the “stigma” of claiming the WFTC, although there is little hard evidence to support either of these claims. The Government has also announced that the integrated child credit will partially reverse this policy, paying all child payments direct to the main carer (see below for discussion of the integrated child credit). This is a similar debate about whether the childcare credit should also be paid direct to the carer, as the person more likely to be responsible for the childcare<sup>25</sup>;
- pro-minimum wage interest groups and at least one trade union have argued that the Government should not use the presence of in-work benefits as a reason not to increase the minimum wage<sup>26</sup>. Some have argued that a decent salary should be one that is high enough to remove entitlement to the WFTC;
- some interest groups have argued that the WFTC should pay more to couples than lone parents on the same family income. Others have noted that, with the abolition of the married couple's allowance in April 2000, no part of the UK's tax and benefit system recognises the formal state of marriage<sup>27</sup>;
- the Childcare Tax Credit is only available to families who use childcare that is registered with the local authority. It is argued that families in deprived areas have limited access to registered childcare: in these areas, informal childcare (whether paid or unpaid) is far more common;

<sup>22</sup> See Walker and Wiseman (1997), and various appendices to House of Commons Social Security Committee (1997), particularly those by Child Poverty Action Group, Low Pay Unit, the Trade Union Congress,

<sup>23</sup> It has not been possible to produce a comprehensive study, but we have looked at trade unions and the main lobby groups who campaign for families and children or low-wage workers.

<sup>24</sup> See, for example, appendices by Child Poverty Action Group and Ruth Lister in House of Commons Social Security Committee (1997); Rake (2000).

<sup>25</sup> See Rake (2000).

<sup>26</sup> See Low Pay Unit (2000) and UNISON (1999).

<sup>27</sup> See, for example, CARE (2000).

- some interest groups have argued that the design of the WFTC and Childcare Tax Credit show an inconsistency in the Government's approach to the economic value of childcare. A mother who spends all her time caring for her children is not considered to be in work by the tax or benefit system. Yet the Government is prepared effectively to pay other adults to look after her children.
- employers' organisations have complained about the costs they have incurred because the Inland Revenue have shifted some of the administrative costs of the WFTC from Government to employers.

There have been no substantial evaluations of the tax and benefit reforms by other interest groups.

## C.2 Future reforms

The introduction of the WFTC was opposed by the Conservative party (the main opposition party in the UK), and it has pledged to undo the reform to the WFTC by turning it back into a benefit, and making payments direct to carers, although it is not clear whether it proposes to reduce the generosity of the WFTC.

In March 2000, the Government announced the first details of its longer-term reform plan to create an integrated child credit out of the existing separate strands of financial support for children, and complement this with an employment tax credit payable to all workers with or without children<sup>28</sup>.

The integrated child credit is intended to bring together the separate strands of government financial support directed at families with children. Its primary objective is not to increase employment, but there may be some beneficial effects from ensuring a more seamless transition from welfare to work for parents. It will also give the Government the opportunity to answer some of the criticisms made by interest groups of the WFTC reform, notably by paying the integrated child credit direct to the main carer.

The employment tax credit for all workers could have more of an impact of employment, though, by increasing the gain to work of families without children. There has been little public analysis of this issue, but it has been suggested that workless families without children do not face a substantial financial disincentive to work. The Government would also need to restrict the employment tax credit to older workers to avoid the majority of the benefit going to young workers who are not living in low-income households<sup>29</sup>. The expansion of in-work benefits to more low-paid workers may increase the concerns that in-work benefits may have an impact on the wage distribution.

<sup>28</sup> HMT (2000b).

<sup>29</sup> See IFS (2000a).

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## Appendix A: The main tax and benefit reforms in the UK

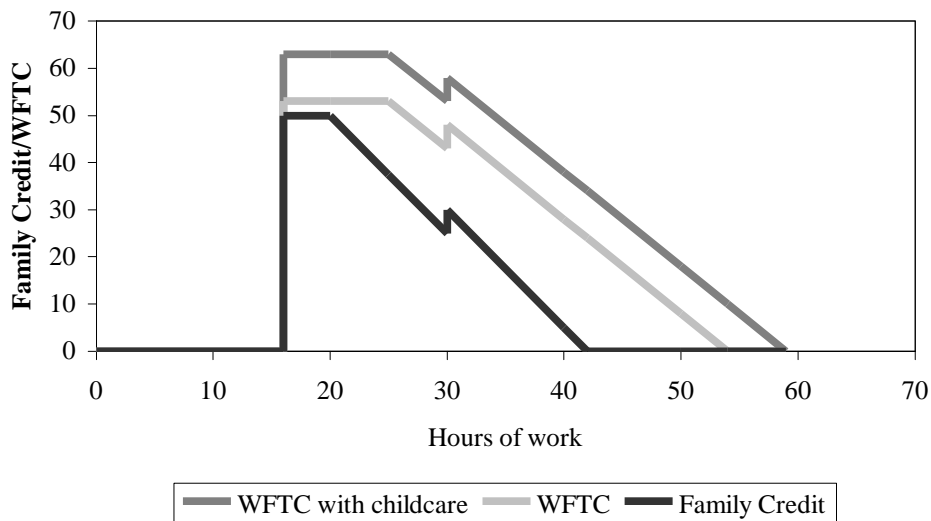
**The WFTC:** The UK also has a long history of in-work benefits, beginning with Family Income Supplement (FIS) in 1971. The present instrument, the Working Families' Tax Credit (WFTC) was first announced in 1998 as a replacement for Family Credit (FC). The WFTC started in October 1999, and was fully phased-in by April 2000. The WFTC is a refundable tax credit available to families working more than 16 hours a week. The amount of credit depends upon earnings, hours worked, the number of dependent children, and financial resources. Couples are assessed on their joint income and resources. There is no difference in the credit for lone parents and couples with otherwise identical characteristics. The credit is worth £105.95 a week to a family with two children, with an extra credit for families where someone works more than 30 hours a week. Beyond net incomes of £91.45 a week, the credit is tapered away at 55%. The credit is fully tapered away for a family with two children at a gross income of around £400 a week. The WFTC also changed the system of support for childcare costs for low-income working families. Under FC, childcare costs up to £60 (£100) a week for families with 1 (more than 1) children under 12 were disregarded when calculating the value of the credit. Under the WFTC, there is a separate Childcare Tax Credit, more generous than the FC childcare disregard in 2 ways:

- it provides a 70% subsidy to the parent on childcare costs up to £100 (£150) a week for families with 1 (more than 1) dependent children of any age;
- it is paid as a credit in addition to the WFTC, rather than being a earnings disregard, making it substantially more generous to those on low incomes.

The combined effect is that families receiving the Childcare Tax Credit can still receive some support from the WFTC at middle incomes: a family with two children claiming the maximum Childcare Tax Credit will have the WFTC fully tapered away at a gross weekly income of £660.

The two other key differences between the WFTC and FC are its **generosity** and the **payment mechanism**<sup>30</sup>. It is more generous than FC because: it has higher credits, particularly those for young children, families can earn more before the credit is phased out, and it has a lower withdrawal rate (see **Figure 1**). The change in the **Payment mechanism** is that, from April 2000, employees receive the WFTC paid through the wage packet, although couples with only one earner can elect to have the credit paid as a traditional welfare payment.

<sup>30</sup> See Blundell et al (2000) and Dilnot and McCrae (1999) for more details of the WFTC/ FC comparison.  
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**Figure 1: Increased generosity of in-work support**

*Note:* shows effect of increasing basic credit and reducing taper only.

**Income tax.** Over two years, the UK moved from having a 20% starting band over £4,500 of taxable income and then a 23p basic rate band, to having a 10% band over £1,500 and then a 22p band.

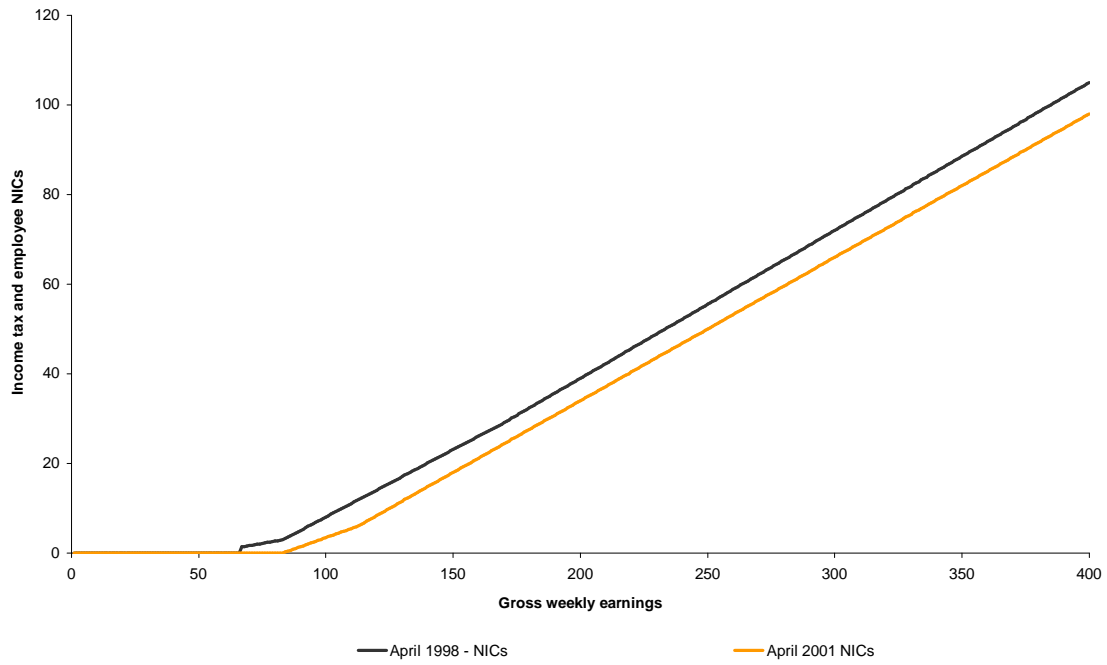
**The Children's Tax Credit:** the UK income tax system is based on individual taxation, with no allowances for dependents or partners/spouses, although families will be able to claim a £442 non-refundable children's tax credit from April 2001, phased out where there is a higher-rate taxpayer in the family (incomes over £32,785 in 2000-01). The married couple's allowance and additional person's allowance (claimed, respectively, by married couples with or without children and all non-married adults with children) were abolished in April 2000 to pay for this reform.

**National Insurance contributions (NICs):** NICs is the UK's social security contributions paid by both employees and employers. Employee NICs is paid on all earnings above a lower earnings limit (LEL) and below an upper earnings limit. The two main reforms to employee NICs that were designed to increase employment were<sup>31</sup>:

- to remove the "entry fee", whereby anyone who earned more than the LEL had to pay NICs on all earnings below and beyond the LEL. This led to marginal deduction rates of over 100% at this point in the budget constraint;
- the LEL was increased to align it with the point where a person begins to pay income tax.

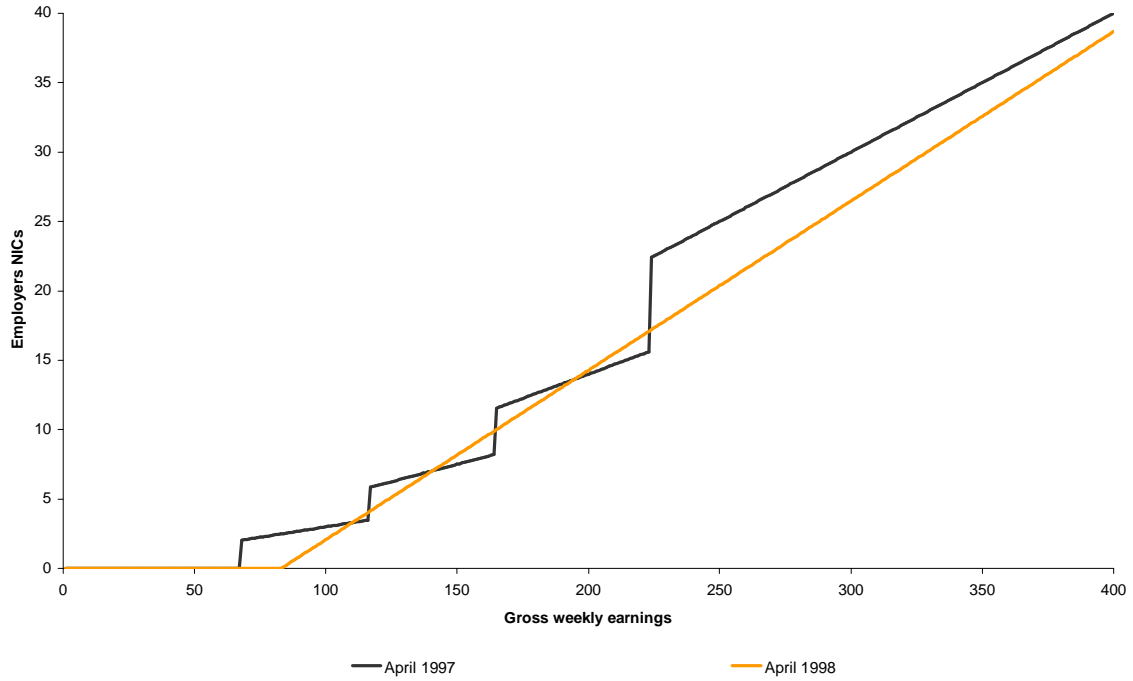
<sup>31</sup> See Chart 4.3 in HMT (1999a).  
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**Figure 2: The reforms to employee NICs and income tax**



Parallel reforms to employers NICs removed the steps in the budget constraint.

**Figure 3: The reforms to employer NICs**



## Other features of the UK's tax and benefit system

Low-income households can receive help with rental housing costs through Housing Benefit (HB), and help for the local tax in the UK (through Council Tax Benefit). About four-fifths of lone parents and around two-thirds of couples on out-of-work benefits are also receiving Housing Benefit, but working families are less likely to be on HB: around a third of the total Family Credit caseload were also on Housing Benefit in 1998, and it is estimated that around 12% of all families on WFTC will also be on Housing Benefit<sup>32</sup>.

**Table 2. WFTC/FC statistics**

	<b>May 2000</b>	<b>May 1999</b>
Caseload	1,060,800	821,300
<i>lone parents</i>	547,700 (52%)	417,600 (51%)
<i>couples</i>	513,100 (48%)	403,700 (49%)
Children in families receiving WFTC/FC	2,079,500	1,578,000 <sup>33</sup>
Average weekly award	£73.28	£62.99
<i>lone parents</i>	£76.40	£63.55
<i>couples</i>	£69.94	£62.45
Average gross earnings	£153	£119
<i>lone parents</i>	£137	£108
<i>couples</i>	£169	£129
Help with childcare costs	110,700	43,200
<i>lone parents</i>	100,500 (91%)	41,600 (96%)
<i>couples</i>	10,200 (9%)	1,700 (4%)
Average amount of help	£32.14	£21.87
<b>Parameters</b>	<b>June 2000</b>	<b>April 1999</b>
Basic Credit	£53.15	£49.80
Child credit (under 11)	£25.60	£15.15
Child credit (over 11, under 16)	£25.60	£15.15
Applicable amount (highest income where full credit is payable)	£91.45	£80.65
Taper rate	55%	70%

Source: WFTC QSE May 2000, FC QSE May 1999. All financial values in cash terms.

<sup>32</sup> See DSS (HB and IS QSEs) for out-of-work families, and Hansard (2000) for WFTC claimants, but note that the latter estimate assumes that all families newly-eligible for the WFTC – very few of whom would be eligible for HB – claim the WFTC.

<sup>33</sup> February 99.

**Appendix B: The effect of the reforms on budget constraints and work incentives.**

Figure 5 presents the change in the budget constraint of a lone parent with two children. It is clear that the reform unambiguously improves the gain to work, although the increase in net income is small below 25 hours of work, and is smaller for those on HB. Above this point, the reduction in the WFTC taper starts to increase the gains to working. For those already working, the incentives depend upon gross earnings.

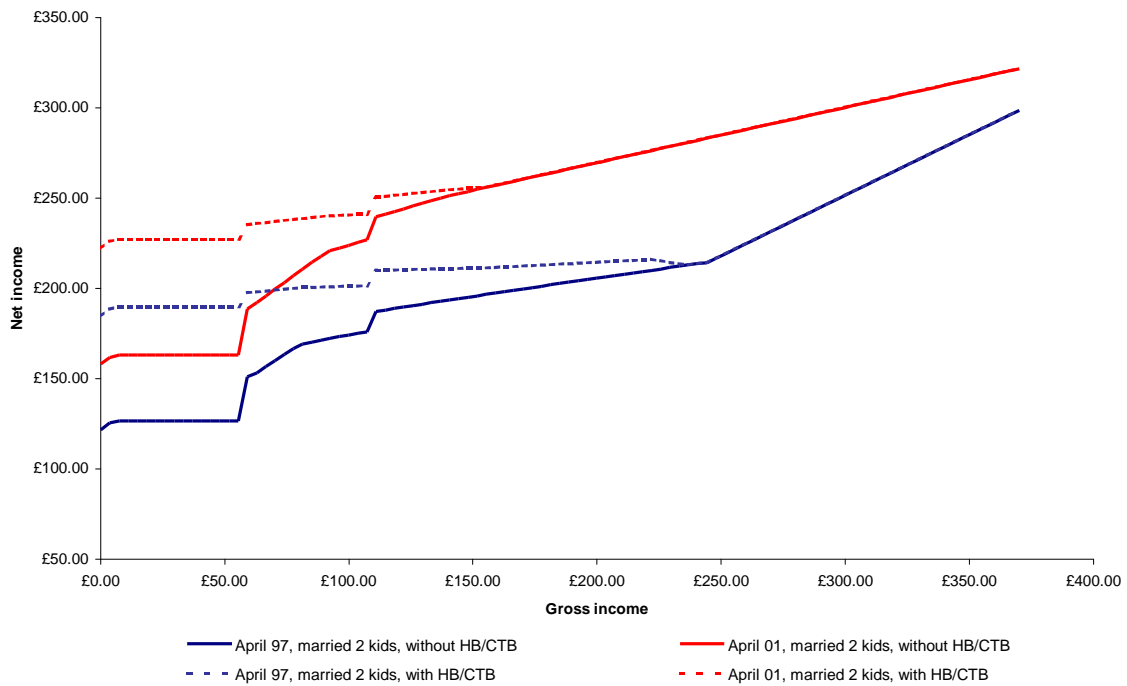
Figure 4 shows the effect of the WFTC reform on an adult in a single-earner couple. The gain to work increases at all income levels; again, the gains are smaller for those on HB. The incentives to change hours of work for those already in work depend upon gross earnings.

Increasing in-work means-tested benefits can lead to incentives to move out of work altogether. Figure 6 shows the budget constraint for the partner of the adult in Figure 4, conditional on the first earner working 35 hours a week. Income at all hours of work has increased through the effect of the reforms on the first earner's net income, giving an incentive to reduce hours or move out of work altogether. The marginal withdrawal rate has increased for families newly-eligible for in-work benefits. The situation would change slightly if we allowed for childcare costs - couples need to have both adults working more than 16 hours per week to qualify - giving a small incentive for the second earner to work 16 or more hours. The reforms have had a much greater effect on families with children than those without children, as is shown in Figure 7, showing the budget constraint for couples without children (those for single adults without children would be qualitatively similar). These families benefit from the tax reforms alone, which make a much smaller difference to the budget constraint.

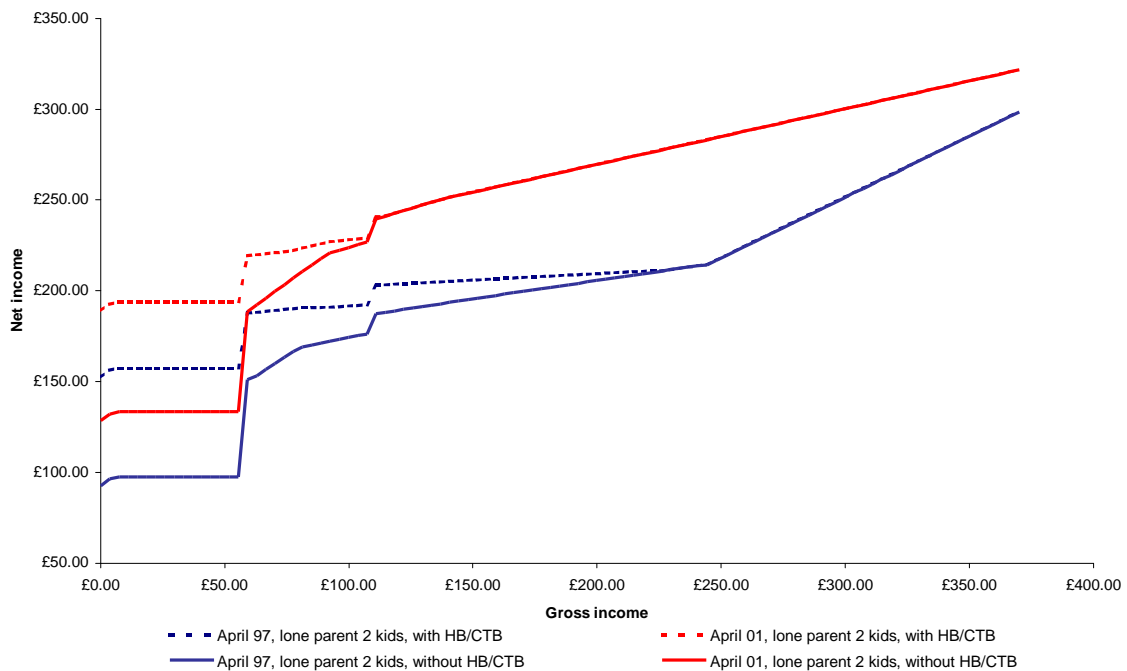
To illustrate the comparative generosity of the UK's tax and benefit system, Figure 8 directly compares the WFTC with the EITC on an annual basis, and Figure 9 shows the budget constraints faced by a lone mother with 2 children in both the US and the UK at various proportions of median male earnings.

The real-time work incentives are slightly different from those suggested by the traditional budget constraint. The WFTC is assessed on income over an assessment period of 7 – 17 weeks (exact length depends on the frequency with which the employee is paid). Once set, the credit is paid at a fixed amount for 6 months, regardless of changes in income. In 6 months time, the credit is re-assessed over another 7 – 17 week assessment period. The credit is non-cumulative: any apparent “under”- or “over”-payment during the previous 6 month period is ignored. There is some preliminary evidence that this dichotomy between the assessment period and the non-assessment period under Family Credit caused a distortion in the labour supply behaviour of couple families.

**Figure 4: Budget constraint, couples with two children**



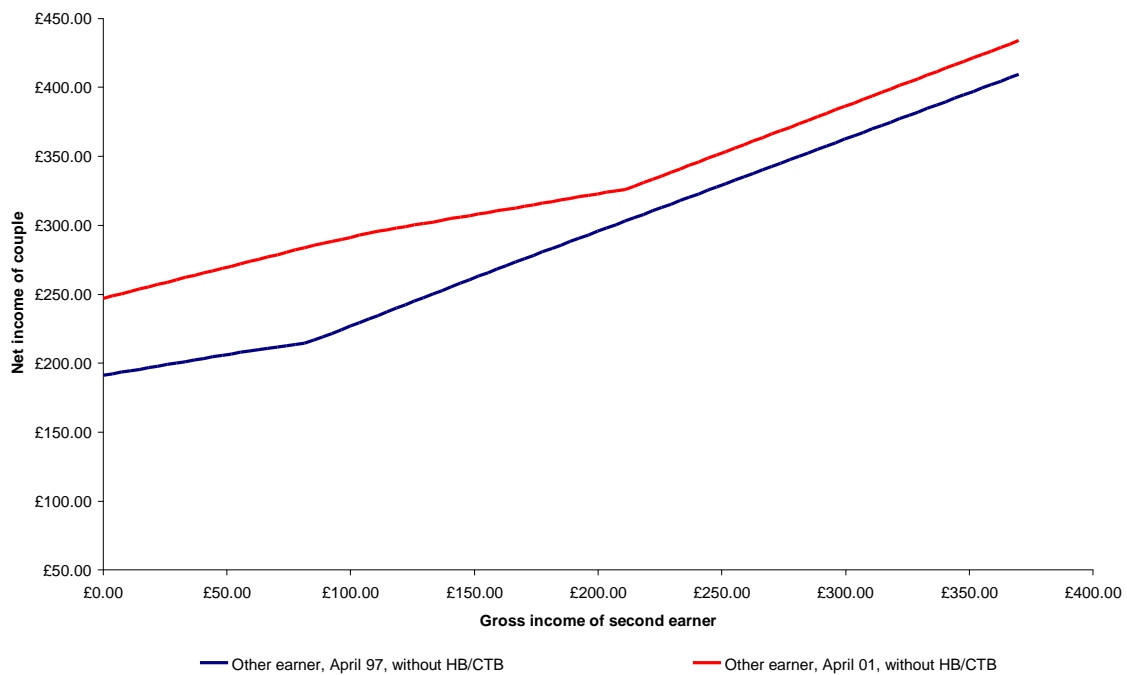
**Figure 5: Budget constraint, lone parents with two children**



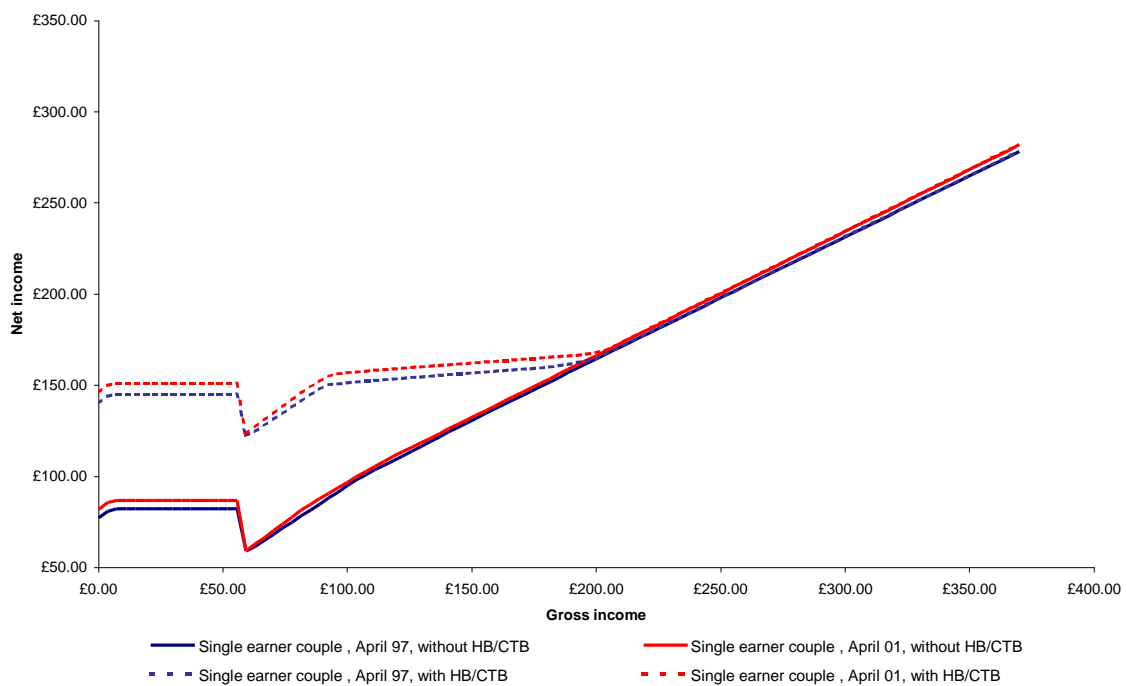
Source: Authors' calculations from TAXBEN.

Notes: The chart compares the tax and benefit system as of April 2001 with that of April 1997 if it had uprated in successive years. Assumes hourly wage of £3.70, no childcare costs, rent of £50 a week, Council Tax of £13 a week.

**Figure 6: Budget constraint, second earner in couple with two children**



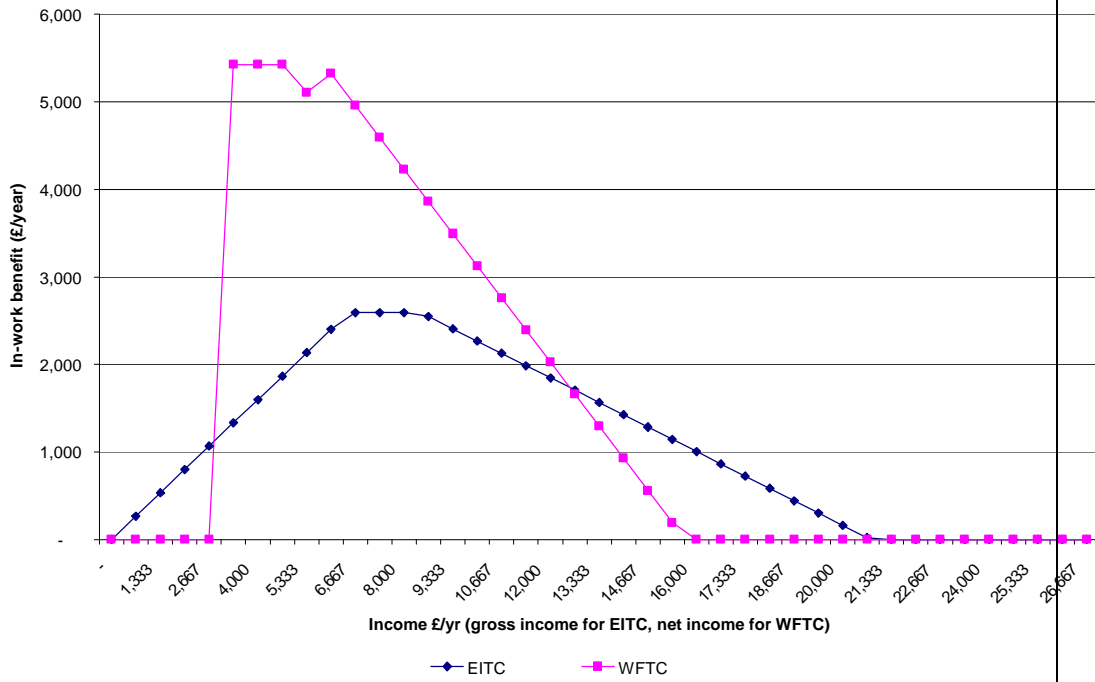
**Figure 7: Budget constraint, couple with no children**



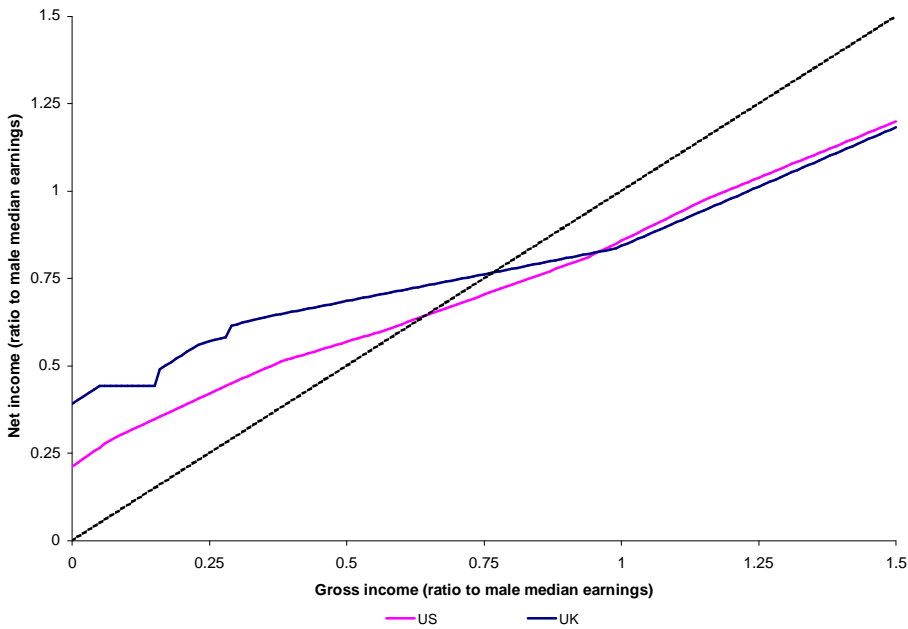
Source: Authors' calculations from TAXBEN.

Notes: Assume hourly wage of £3.70, no childcare costs, rent of £50 a week, Council Tax of £13 a week and first earner with gross earnings of £130 a week.

**Figure 8. Annual WFTC and EITC payments, 2 WFTC claims in a year (£1/\$1.50)**



**Figure 9. US and UK budget constraints for lone parent, 2 children as % male median earnings**



Notes: Assumes hourly wage of £3.60 so WFTC eligibility reached at around £3,000.  
Source: Brewer (2000).

Appendix C: Key labour market statistics

Figure 10: Employment rates

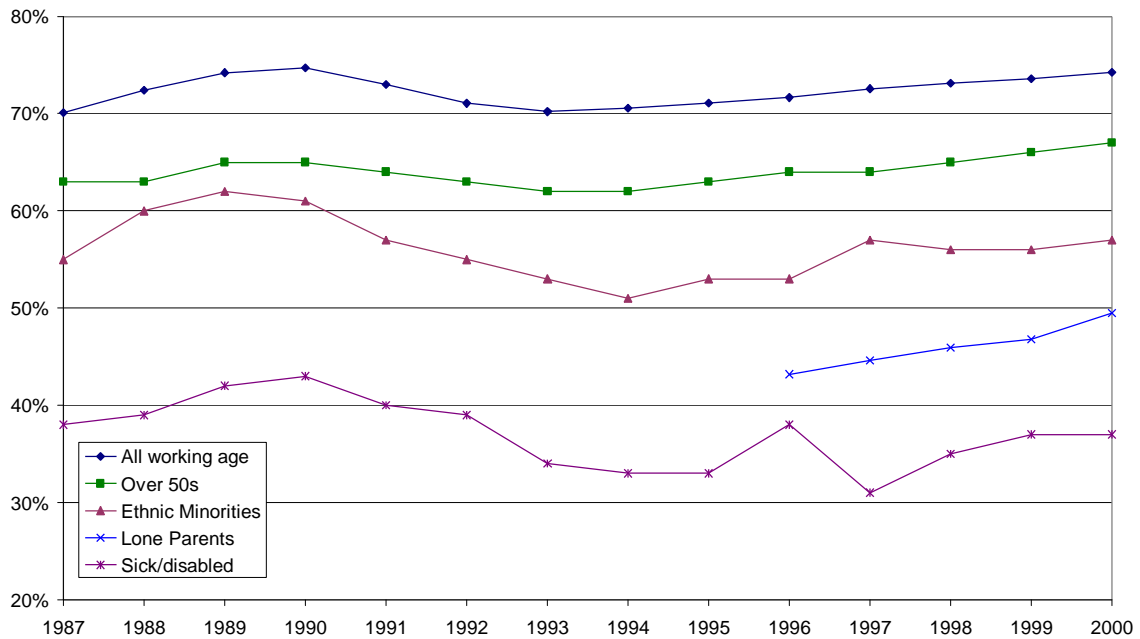
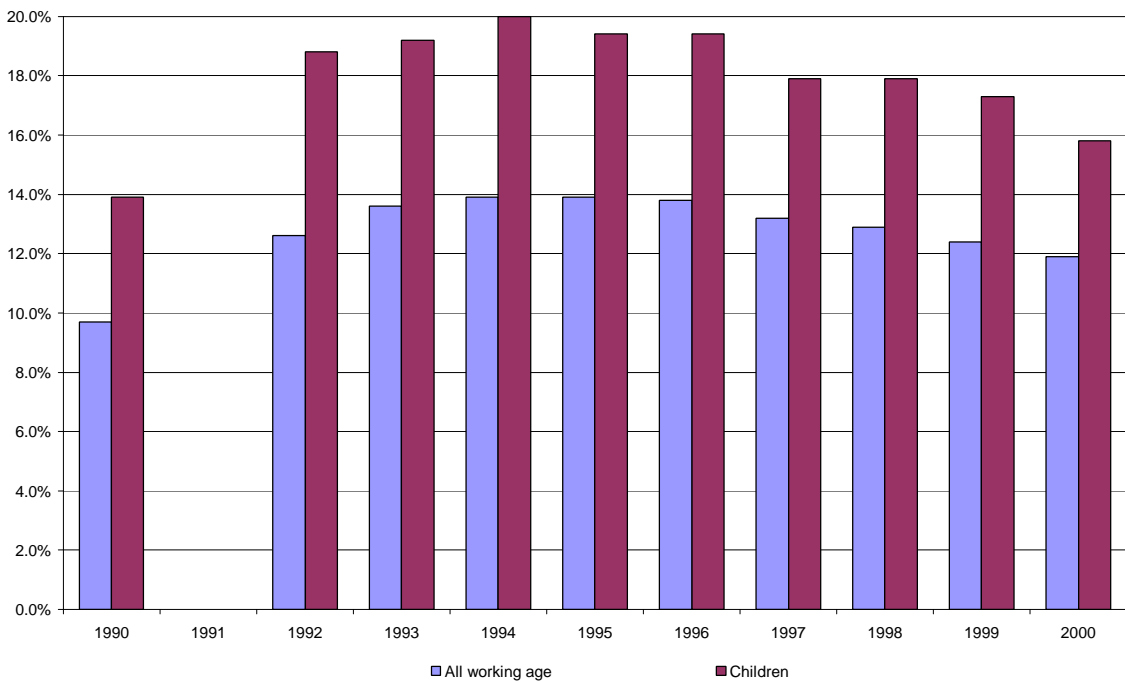


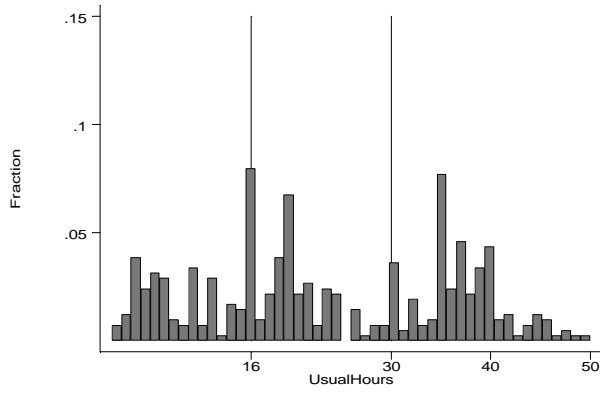
Figure 11: The proportion of children and adults living in worklessness households



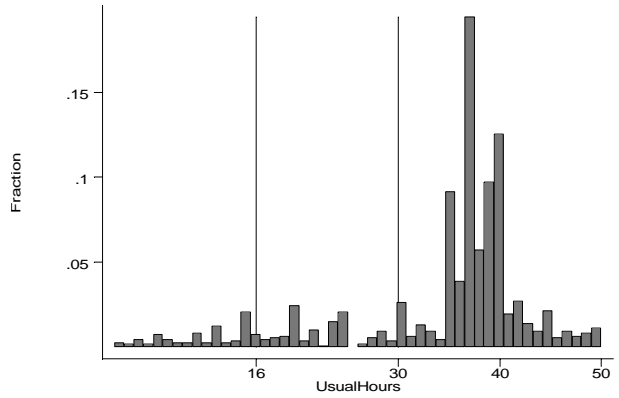
Source: DSS (2000b).

**Figure 12: Weekly hours of work, single low-education women with and without children**

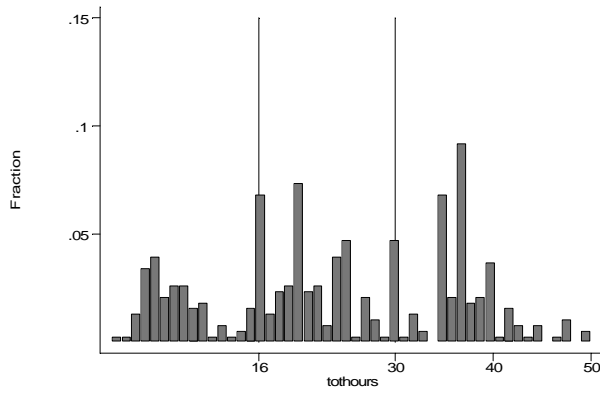
Lone mothers, low education, FRS 1994/95



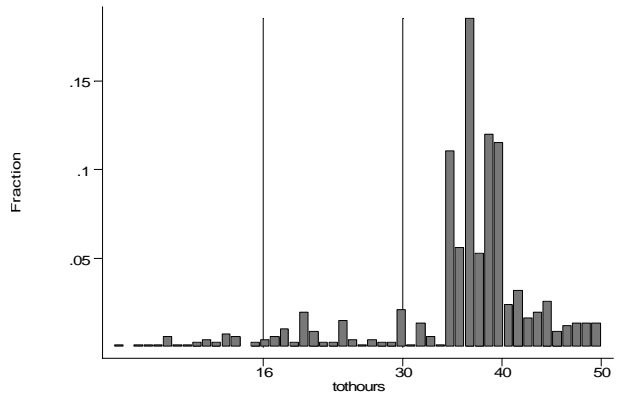
Single women, low education, FRS 1994/95



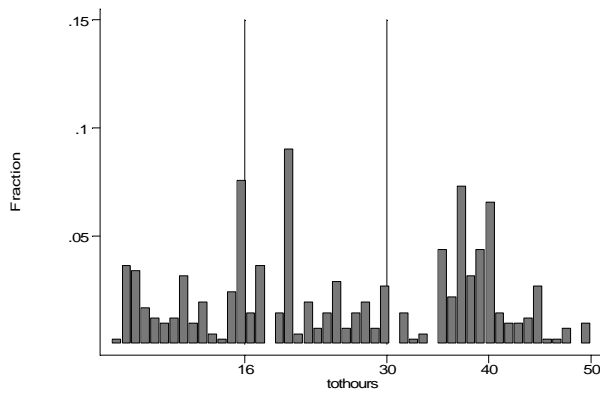
Lone mothers, low education, FRS 1995/96



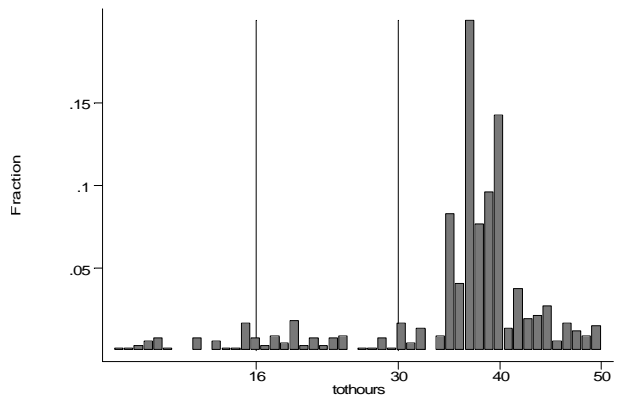
Single women, low education, FRS 1995/96



Lone mothers, low education, FRS 1996/97

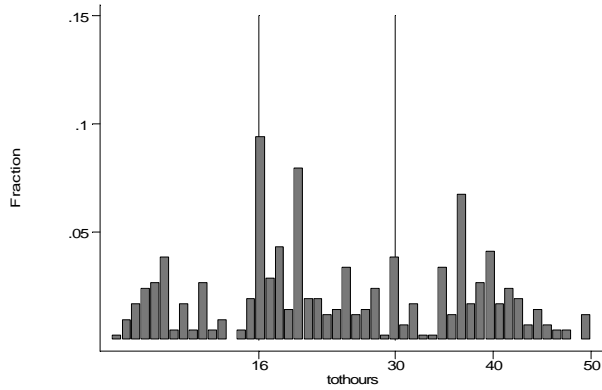


Single women, low education, FRS 1996/97

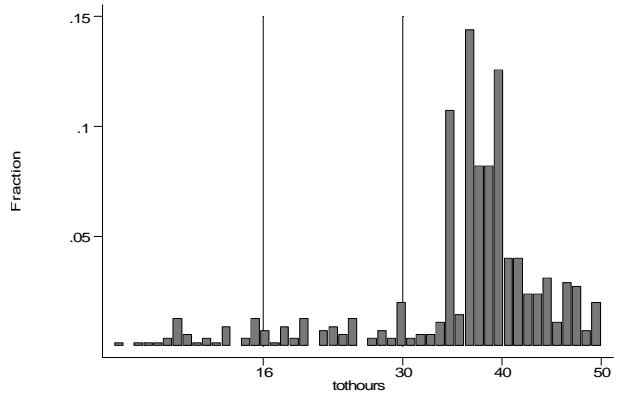


**Figure 12: Weekly hours of work, single low-education women with and without children (cont)**

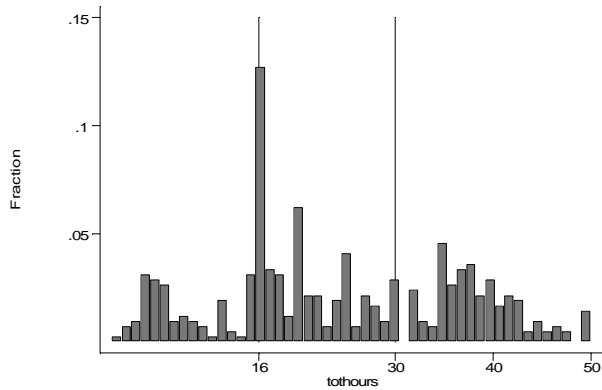
Lone mothers, low education, FRS 1997/98



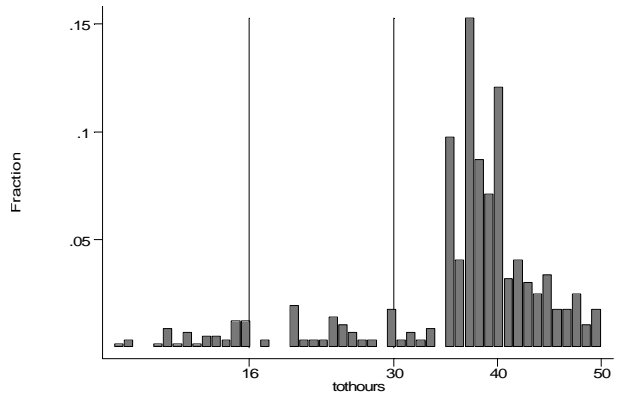
Single women, low education, FRS 1997/98



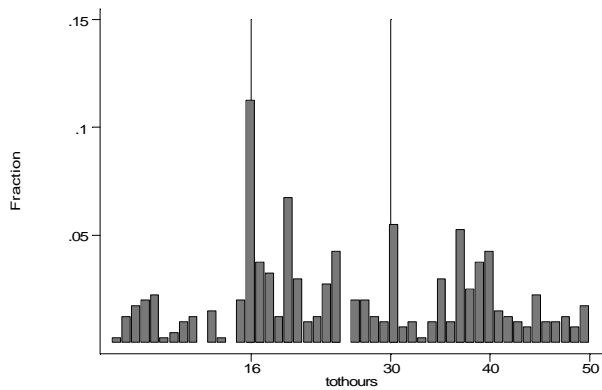
Lone mothers, low education, FRS 1998/99



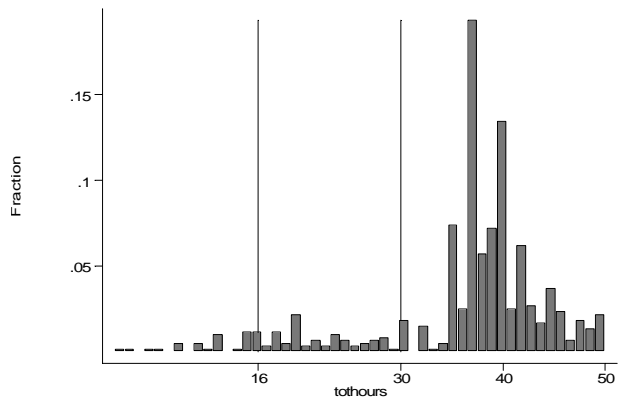
Single women, low education, FRS 1998/99



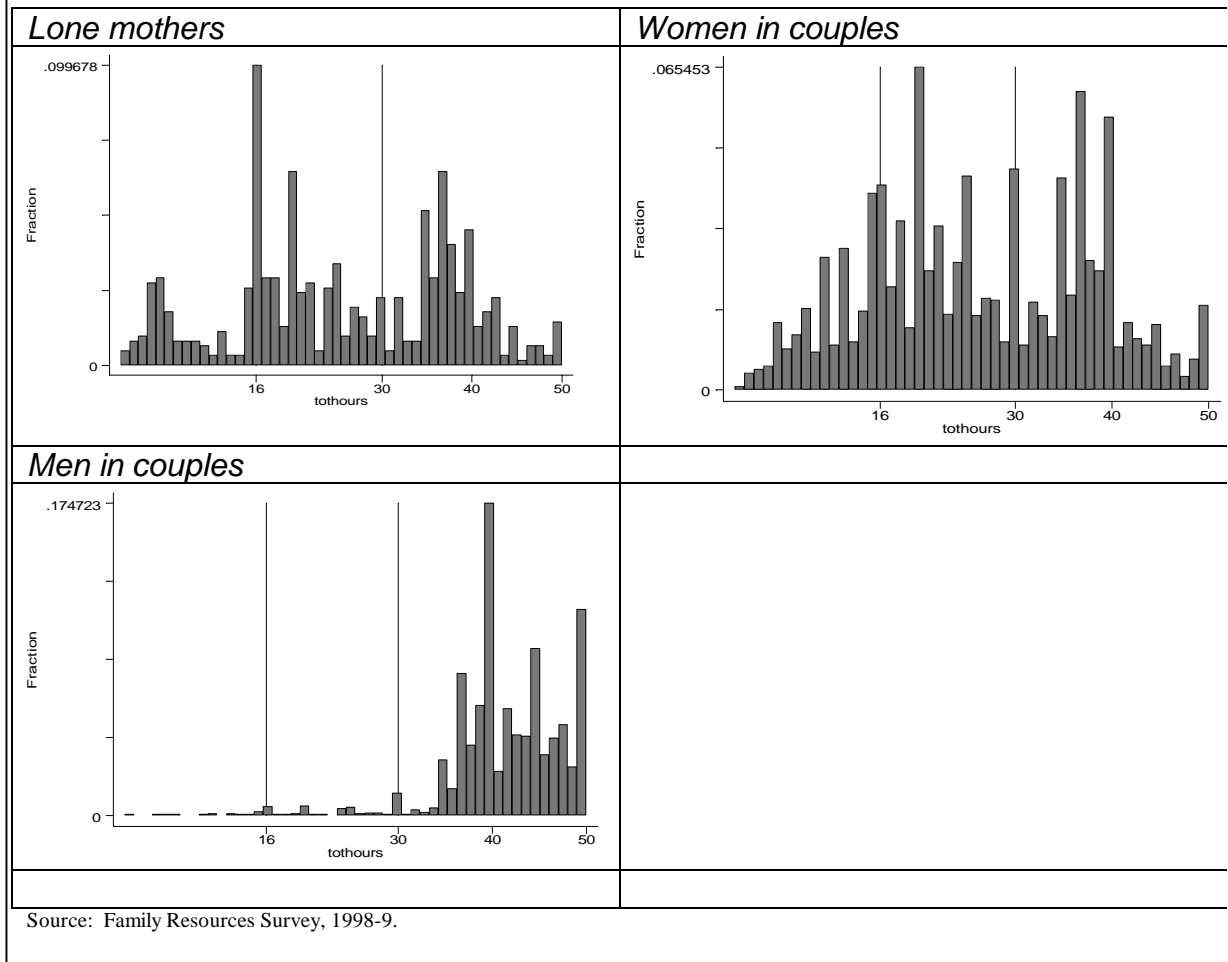
Lone mothers, low education, FRS 1999/00



Single women, low education, FRS 1999/00



**Figure 13: Hours of work by family types**



**Table 3. Mothers' employment rates by age of youngest child**

Employment rate by age of youngest child	Lone mother	Mothers in couples	Mothers with working partner	Mothers with non-working partner
0 to 1	21	56	56	26
2 to 4	33	61	64	28
5 to 10	49	74	78	34
11 to 15	59	78	84	42
<b>All</b>	<b>44</b>	<b>69</b>	<b>73</b>	<b>35</b>

Source: Household LFS, Spring 1998, cited in HMT (1999b).

Appendix D: Low-income families and benefit/tax credit flows

Figure 14: Caseload of lone parents on Income Support and all families on FC/WFTC, 1996-2000

Figure 15: Families on WFTC: where were they 12 months ago ?

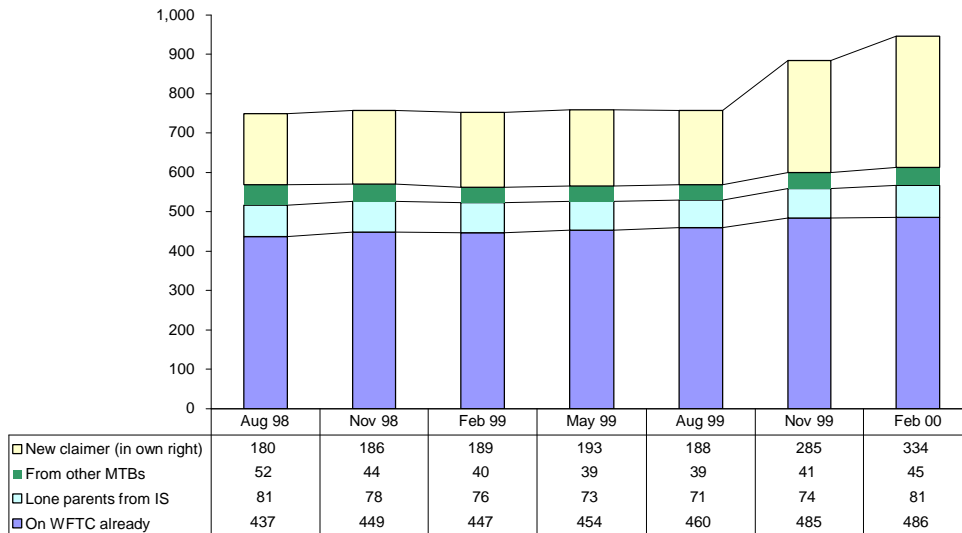
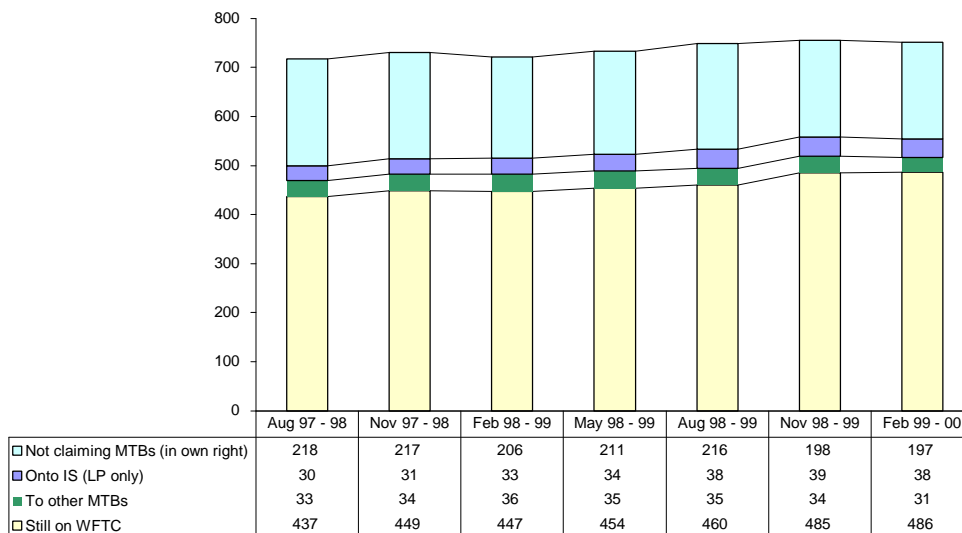


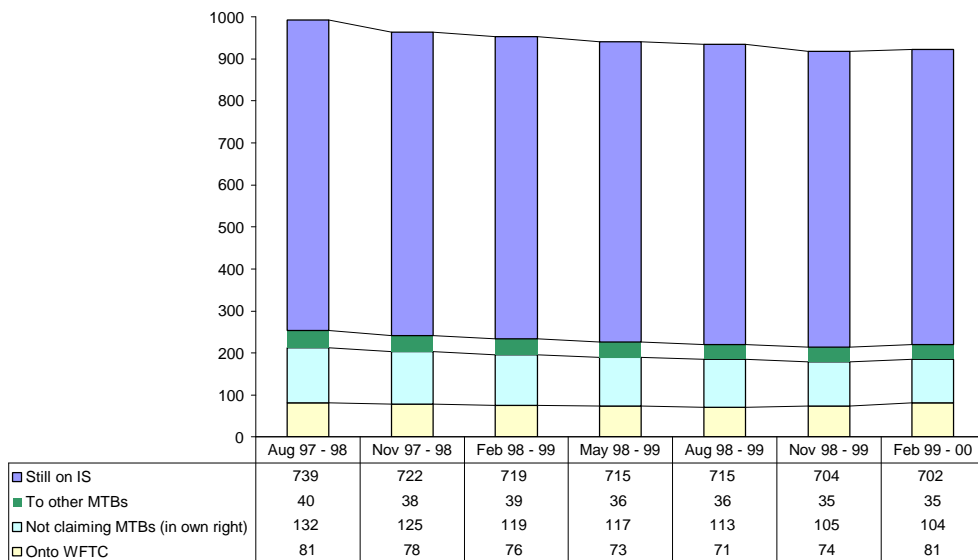
Figure 16: WFTC claimants: where do they go ?



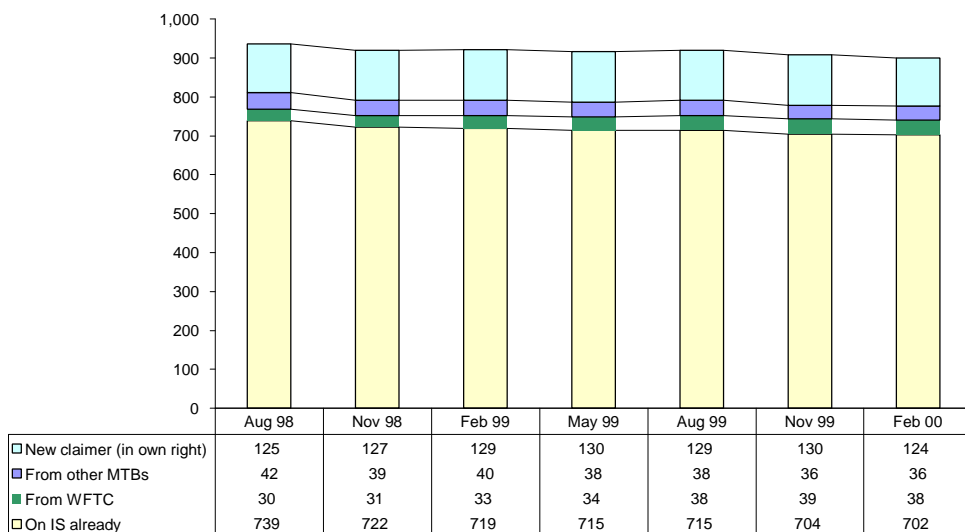
Source: DSS (Client Group Analysis – Working Age).

Notes: “New claimer (in own right)” includes (an unknown number of) people claiming in their own right who were previously partners of claimants – see endnote 14.

**Figure 17: Lone parents on Income Support: where are they in 12 months time ?**



**Figure 18: Lone parents on IS: what were they doing 12 months ago ?**



Source: DSS (Client Group Analysis – Working Age).

Notes: “Not claiming MTBs (in own right)” includes (an unknown number of) lone parents with a new partner who are still receiving MTBs.

**Appendix E: cost of the reforms****Table 4. Cost of the reforms**

<b>Measure</b>	<b>Cost (£m, 2001/2 financial year)</b>
WFTC	2,300 (real difference between 2001/2 and 1998/8, in 1999/0 prices).
NICs reforms	3,300
10p starting rate of income tax	1,800
22p basic rate of income tax	2,900
Children's Tax Credit	1,600
Abolition of married couple's allowance	1,850
Employment tax credit	An "illustrative" employment tax credit could cost around £300m benefiting 300-400,000 families without children.
Integrated child credit	Would depend upon policy decisions

Source: Various Budgets; HMT (2000b) for employment tax credit.

Notes: NICs reforms included are: abolition of "entry fee" and increases in LEL for employee NICs. There have been other, smaller, changes to NICs that have increased revenue. Employers' NICs will be lowered by 0.3% in 2001 and 0.1% in 2002 to offset introduction of new climate change levy and aggregates levy.

**Appendix : Terms of Reference.**

“In October 1999, the UK Government took the first step in its strategy to make work pay and to tackle poverty, by replacing Family Credit by the Working Families Tax Credit. It also proposed to introduce a new Children’s Tax Credit from 2001. The 1999 Budget set out further changes, including an integrated child credit, paid to the main carer, and an employment tax credit, payable through the wage packet. Families with children as well as groups without children would be eligible for the employment tax credit, which, with the National Minimum Wage, will serve to make it financially worthwhile to undertake work.

“In Spring 1999, 4.5 million adults of working age and 2 million children in the UK lived in households without any-one in work. Worklessness is not just a feature of poor households with children; rates of unemployment are even higher for working-age households without children. While the introduction of the National Minimum Wage in April 1999 provided, for the first time in the UK, a statutory level beneath which pay cannot fall, a minimum wage alone is considered not to be able to generate adequate in-work income to meet the needs of varying family structures. Moreover, fixing the minimum wage at a level sufficient to generate an income equal to half-average income could have adverse effects on employment opportunities of low-skilled workers, particularly the young. Together with the New Deal (an active labour market programme for unemployed people), the minimum wage and the employment tax credit should provide a comprehensive strategy to move people from welfare and into work. The tax and benefit reform is one of the UK Government’s instruments for improving employability (Pillar 1 of the UK Employment Action Plan for 2000; Pillar 1, Guideline 2 of proposed EU Employment Guidelines for 2001). The Government has argued that the Working Families Tax Credit (WFTC) will have important labour market effects, although official estimates of its likely scale have not been made. Estimates by the UK Institute of Fiscal Studies, for the Monetary Policy Committee of the Bank of England, suggest between 10,000 and 45,000 additional labour market participants. The participation rate for single parents was estimated to rise from 39.8% to 42%, and for women with unemployed partners from 41.9% to 43.2%, while for women with employed partners the participation rate was estimated to fall from 57.6% to 57%. Another study, carried out by senior researchers for the Joseph Rowntree Foundation, suggests a maximum increase in participation of around 90,000”.