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The Demise of Tax Credits

Of the many spending cuts announced by Chancellor George Osborne in the 'emergency' budget of 8th July 2015 it is arguably those to the UK's system of tax credits that are the most significant. In part, this is for reasons of scale. Together, the three largest changes to tax credits – removing additional support for third and subsequent children; abolishing the family element of Child Tax Credit; and reducing the value of the income thresholds/work allowances – will eventually generate an estimated £8.4 billion savings annuallyⁱ. They alone deliver much of the pledge to reduce welfare expenditure by £12 billion per year that was the subject of such controversy during the general election campaign.

As eye-watering as the scale of losses being imposed is, even more remarkable is the section of the population on whom they are being visited. The brunt of these cuts will be borne not by the jobless, but by working households with children – the 'hard working families' so beloved of speechwriters from across the political spectrum. The UK's extremely extensive system of cash support for low-income working households that had grown up under Labour governments after 1997 will be pared back greatly. If the tortuous roll-out of the new Universal Credit system introduced under the Coalition government is subject to no further delays, by 2019 the rump of tax credits will furthermore have been fully absorbed back into the mainstream social security system. The experiment in generously supporting the working poor through cash transfers untainted by association with 'welfare' will be over, only 20 years after it began.

Tax credits were explicitly built to last, however. Targeted on the working poor, they were meant to reconcile redistribution and poverty reduction with goals more valued on the political right, such as limiting burdens on employers, improving incentives for participation in paid work and combating 'dependency'. They thus seemed to rest on a broad and solid political support coalition. Delivering this support through the tax rather than the benefit system was, moreover, meant not only to boost the status of claimants but also reassure taxpayers that it was somehow different from and better than traditional pro-poor measures. This should have bolstered the popularity of tax credits yet further. So what went wrong?

The Rise of Tax Credits

The UK has a history of subsidising the incomes of low-earning families through dedicated targeted support that dates back to the early 1970s. Before Labour's return to government in the late 1990s, however, this policy had always been delivered through distinct in-work social security benefits. Though Family Credit, introduced in 1988, was somewhat more generous than its predecessor Family Income Supplement, the level of support provided was modest and in-work benefits represented a tiny fraction of total social expenditure.

There was nothing in Labour's manifesto for the 1997 elections about in-work support, save a vague pledge to 'examine the interaction of the tax and benefit systems so that they can be streamlined and modernised, so as to fulfil our objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening community and family life'. Within weeks of their landslide victory, though, it was announced that a task force had been established to consider the possible lessons for the UK of the American Earned Income Tax Credit (EITC), a refundable tax credit for working families administered by the federal tax authorities. And long before this task force was due

to report Chancellor Gordon Brown had already used his November 1997 budget statement to announce the replacement of Family Credit with a more generous tax credit for working families.

Working Families Tax Credit (WFTC), which came into operation in October 1999, actually still had much in common with Family Credit. The two key differences were in generosity and the mode of administration. Due to more generous earnings disregards and a lower withdrawal rate, WFTC immediately increased expenditure on in-work support by some 75 per cent, and in addition to providing more money to existing Family Credit recipients entitled 400,000 new families to support. WFTC also saw administrative responsibility for this area of policy move from the Department of Social Security (DSS) Benefits Agency to the Inland Revenue, under control of the Treasury. Tax-benefit integration on EITC lines was in reality limited, not least due to the impossibility of folding a household-based income support measure into an individualised system of income taxation, a key contrast between the UK and the US. There was however an option for WFTC to be paid through the wage packet, that is to say directly by employers as an addition to the salary of the main earner in the claimant household.

It is easy enough to understand why 'new' Labour opted for a sharp expansion in the generosity of targeted in-work support. Though committed to tackling poverty, especially among children, they were desperate to avoid being portrayed either as reckless with public expenditure or as favouring 'welfare' over 'hard work'. The first consideration precluded more generous universal benefits funded by higher taxes, the second the substantial improvement of means-tested support for families headed by someone out of work due to unemployment, sickness or caring responsibilities. A convenient *via media*, greater help for the working poor could also be presented, alongside the introduction of a national minimum wage, as an attempt 'make work pay' relative to out-of-work benefit receipt. It was a transfer to the poor that was simultaneously mobilised as evidence that the party had turned its back on its supposed welfarist vices.

Why it was believed expedient to shift responsibility for in-work support from DSS to the Treasury is more perplexing, not least given the similarities between WFTC and Family Credit and the impediments to true tax-benefit integration, which were well-known at the timeⁱⁱ. At one level, the turn to tax credits no doubt owed something to Brown's desire to make the Treasury a launch-pad for his own Prime Ministerial ambitions. The extremely rapid introduction of WFTC allowed Brown's team to wrestle control of important parts of the welfare reform agenda and turn the Treasury into a major spending department. In the process they pre-empted and neutralised the work of Frank Field, who had been appointed Minister of State in DSS with a remit to 'think the unthinkable' on welfare reform, but was considered a potentially dangerous maverick by many, especially in the Treasury.

Beyond these inter-personal and inter-departmental power struggles, the choice of tax credits was also a conscious act of political communication. A variety of audiences were being targeted. For claimants, receiving support through a different channel than they would use if on out-of-work benefits was meant to be a further manifestation of the rewards of working; making work pay was about administrative status as well as money. Tax credits were also intended to make the expansion of cash transfers targeted on household income from look like something other than a straightforward extension of means testing, to which considerable opposition still existed in the wider Labour Party.

Last but not least, it was seemingly thought that tax credits would be more acceptable to the broader community of UK taxpayers than any expanded social security benefit. Even without full tax-benefit integration, tax credits appeared capable of harnessing some of the fundamental ambiguity that helps insulate many forms of fiscal welfare from opprobrium, particularly in anti-state political cultures. When WFTC was unveiled Brown described it as a ‘tax cut for hundreds and thousands of men and women’, while the 2001 Labour election manifesto boasted that WFTC had ‘meant a tax cut averaging £31 a week for 1.1 million families’. Initially the government even tried to record tax credits as revenue forgone in the national accounts, which was crucial in allowing them to respect their pledge of remaining within Conservative spending plans for their first two years in government.

The belief in the political power of working tax credits was in large part based on reasoning by analogy with the example of EITC. In the 1998 report of his task force to the Treasury, Martin Taylor marvelled at EITC’s ‘widespread political support ... at a time when the US welfare budget more generally has been under remorseless attack’. Like a number of American political scientists writing at this timeⁱⁱⁱ, Labour seemingly believed that pro-poor redistribution would be inherently more popular and durable if directed to workers and organised through the tax system. While the existing structure of the UK tax and benefit system made it impossible to import EITC as a policy, they clearly hoped to import its politics.

Sand in the Machine

Plans were being laid to expand and improve WFTC even before the measure had been fully implemented. Significant changes eventually came early in Labour’s second term in office, with the 2002 Tax Credits Act. This removed some family support elements from WFTC and rolled them into a new integrated Child Tax Credit (CTC) payable to lower-income households with children irrespective of work status. WFTC was at the same time rebranded Working Tax Credit (WTC) and its eligibility extended to childless working households, albeit on more restrictive terms. Capital limits for entitlement were abandoned and the new tax credits calculated on gross rather than net income. Approximately half a million extra households were drawn into the system by the changes, which also saw tax credit expenditure jump, on 2014/15 prices, from £13.7 billion in 2002/03 to £22.1 billion the following year.

An additional significant change with the new tax credits was in assessment of eligibility. Awards were henceforth to be made annually, based on a household’s income from the previous tax year. Claimants were at the same time given new responsibilities to inform the Inland Revenue of in-year changes in their family circumstances, income, hours of work or childcare costs. Adjustments could then be made to existing awards to account for any under-payments and – beyond a write-off amount initially set at £2500 per annum – over-payments. The aim of this change was to make tax credit administration less onerous and align it better with the operation of the income tax data collection system, while at the same time preserving the system’s responsiveness to need.

It was administrative issues that were to quickly appear as the Achilles heel of the new system in the following years, however. Indeed, tax credit administration became a major public policy fiasco^{iv}. One cause of the problems was the inability of the private company that held the government contract to provide IT services to put in place a system that could accurately process tax credit claims. The underlying systems were therefore not ready when the new tax credits were launched,

meaning many claimants had no idea of the value of their award (or even if their claim had been processed), a large number of payments were delayed and an enormous backlog developed.

Moreover, it quickly became apparent that reconciling responsiveness and a light-touch annualised assessment and award system was basically impossible. The extent and frequency of major changes in personal and professional circumstances among recipients of in-work support had been grossly under-estimated. Claimants struggled with the heavy compliance burden the administrative arrangements placed on them, and large overpayments and underpayments were endemic in the operation of the system.

The attempted recovery of overpayments by the Inland Revenue (HMRC from 2005) was particularly controversial. Households asked to pay back part of their tax credit awards often had no idea that they had been receiving too much money and, with low incomes and usually few savings, no immediate way to pay it back. The Parliamentary Ombudsman received record numbers of complaints from victims of tax credit maladministration, and the government faced widespread accusations of punitiveness in the media. Faced with the political storm, a large proportion of overpaid money was eventually written-off, and in 2005 the income rise disregard was increased to £25,000 per annum. The tax credit system increasingly came to be seen as both inhumane and profligate, at total odds with the images of Labour's social policy it had been intended to project.

On the back foot, Labour's resolve to defend its tax credit vision weakened. Symptomatic was the fate of the possibility for tax credits to be paid through the wage packet. Intended to 'reinforce the distinction between the rewards of work and remaining on welfare', as Martin Taylor's report had put it, this payment mechanism was from the outset criticised both by the poverty lobby, concerned about privacy issues and implicit transfers 'from purse to wallet', and by employers, who baulked at the administrative burden. Downgraded from planned requirement to mere option when WFTC was introduced, in 2006 it was abandoned altogether. Belief in the importance of ensuring that in-work support looked distinct from other types of social assistance was seemingly on the wane.

Back to Benefits

There was little indication at the time that Labour's eviction from office in the 2010 general election signalled the beginning of the end of tax credits. While the Conservative election manifesto promised administrative changes to reduce fraud and overpayments, it stated clearly that the Conservatives 'support tax credits' and in government would 'continue to provide tax credits to a range of families'. There was also nothing in the coalition agreement eventually reached with the Liberal Democrats that presaged major structural changes to in-work support.

At the Conservative Party conference in October 2010, however, new Work and Pensions Secretary Iain Duncan Smith unveiled plans to merge tax credits and a range of existing means-tested benefits for those out of work in a new integrated measure, Universal Credit. This was closely modelled on a proposal in a 2009 report by the Centre for Social Justice, the think-tank he had co-founded. Following a White Paper published within barely a month of the conference announcement, a bill was introduced in Parliament early in 2011. Universal Credit was formally adopted as part of the Welfare Reform Act that received royal assent in March 2012, and is currently in a laboured and repeatedly delayed process of implementation. While the latter has been the object of much

criticism, political opposition to the principle of the reform has been conspicuous mainly by its absence.

Though the administrative problems that have bedevilled tax credits form part of the rationale for this disruptive change, the Centre for Social Justice's main argument for an integrated system of in-work and out-of-work support, now reprised by the government, relates to work incentives. The effect of the minimum hours requirements for tax credit eligibility combined with the modest earnings disregards for out-of-work benefits is criticised as providing limited incentives for people to take-up work of less than 16 hours per week, with little acknowledgement that this 'anomaly' was a quite deliberate aim of earlier policy^v. A single payment with a standard withdrawal rate over different earnings levels is also intended to make the rewards of increasing work intensity more transparent than under the extant system of overlapping benefits and tax credits with differing rates of withdrawal. Finally, it is argued that remaining on the same benefit when moving into (or indeed back out of) work will reduce both hassle and uncertainties over entitlement and therefore cash-flow, encouraging labour market transitions further.

Though the differences between Universal Credit and the current system have been talked up by the government, it is perhaps truer to say that Universal Credit – at least under the legislation and regulations as adopted in 2012 – pursues some broadly similar aims to tax credits, but with a rather different emphasis. With respect to work incentives, it was always going to create winners (especially those moving into work at low hours) as well as losers (especially those already working part-time and second earners). Like tax credits before 2006, Universal Credit tries to make support from government look more like a wage than a traditional social security benefit, but does so through the tool of compulsory monthly payments that are meant to encourage good household budgeting. Universal Credit's 'real time information' system will also again try (and again fail?) to reconcile a certain administrative simplicity with responsiveness, and will ironically go further than the existing system in tax-benefit integration through its impact on the reporting of PAYE income taxation information for benefit purposes.

But Universal Credit is definitively a working-age social security benefit, and will be administered as such by the DSS' successor, the Department for Work and Pensions. This means that, except in some tightly specified circumstances, all adults in a household receiving support will be subject to a regime of work-related conditionality, with sanctions for non-compliance. The government has indeed taken the opportunity of the introduction of Universal Credit to toughen the conditionality regime compared to that for many of the working-age benefits it is replacing. In a novel move, conditionality under Universal Credit will also apply, in its strongest form, to members of working households should overall earnings fall below a threshold calculated with reference to full-time employment at the minimum wage per adult household member.

How 'in-work conditionality' will function in practice is at best unclear^{vi}. There is no real international or historical precedent for it, and it is open to doubt if the regulatory capacity of the modern state really stretches to dictating peoples' choice of jobs or hours of work. What is certain is the symbolic change from the liberal tax credit system. Though Labour escalated the political arms race over conditionality for out-of-work benefit claimants, tax credits for the working poor were quite explicitly spared. Indeed, the permissiveness (and generosity) of working tax credits was used to legitimate the increasing severity of behavioural controls on the jobless; carrots for 'doing the

right thing' (that is, working) justified the beating of those who were not with bigger sticks. But as in any arms race tougher conditionality for benefit claimants has gradually become self-justifying, and in the process the gentler and more humane administrative treatment of the working poor has lost much of its political *raison d'être*.

From One Make Work Pay Consensus to Another

Alongside this structural reform that will take a number of years to phase in, in-work support was also subject to immediate and significant cuts as part of the coalition government's austerity drive. Indeed, several of the cost-containing changes to tax credits – such as freezing the basic and 30 hour elements of WTC, withdrawing it more rapidly with increasing earnings and increasing the minimum hours requirement for couples from 16 to 24 – each delivered considerably bigger savings than much more high-profile measures such as the benefit cap or the so-called bedroom tax.

The restrictions to tax credits and Universal Credit announced by George Osborne in his first budget as Chancellor in a majority Conservative government build on these earlier cuts, but also dwarf them. As well as making working households reliant on in-work support sizeably worse off, many of the changes will considerably reduce incentives to both enter and progress in work^{vii}. Design features of Universal Credit that were central to its ambition to make work pay, such as the relatively generous earned income disregards offered by the work allowances, have been significantly diluted.

And yet Osborne still presented his emergency budget as one for working people in which a central aim was to make work pay. This seemingly incongruous claim was linked to two other announcements in the budget, an increase in the threshold for the payment of basic rate income tax and, especially, a sharp increase in the minimum wage for workers aged 25 or more, branded as the introduction of a 'national living wage'. This 'higher wage, lower tax, lower welfare' route to making work pay, as David Cameron characterised it in a speech ahead of the budget, distinctly shifts the British model of supporting the incomes of workers away from redistribution and towards regulation. While the Conservatives' belated conversion to the merits of a minimum wage was known, few expected a 40 per cent rise in its value for some workers to be announced on their watch.

The monomaniacal pursuit of deficit reduction by the current government of course explains much of this changed approach. In-work support has come to represent a very significant share of social expenditure, with overall tax credits now the second largest social programme in the UK after the state pension. Part of their growth reflects the increased generosity of the Labour years, but some too is the consequence of wage stagnation and a growth in part-time employment, especially since the onset of the recession. When social programmes become large, however, they also become choice prey for governments interested in restraining public expenditure, unless they can benefit from energetic political support. The minimum wage announcement did much to head that off at the pass.

Even so, it has been striking how few newspaper column inches have been devoted to restrictions to in-work support by comparison with other welfare changes that are less significant, certainly in expenditure terms. It seems that if the complexity and opacity of tax credits facilitated their expansion 'by stealth', it has equally made them very vulnerable, under different political conditions,

to retrenchment. It has also ultimately proved rather easy for a government that is so-minded to reframe tax credits, at least in their British form, as part of 'welfare'. Nobody has suggested that any of the cuts to in-work support that have been announced are a tax hike.

The Labour Party has been a largely passive spectator as the in-work support system it built up in office has been first qualitatively and then quantitatively dismantled. But when the deep-seated ambivalence that also exists on the left to the principle of supplementing labour incomes through the socio-fiscal system is recalled, this is perhaps not so surprising. Nor is this an especially 'old Labour' posture. It should be remembered that while it was almost totally silent on any plans for working tax credits, the 1997 Labour manifesto already railed against the 'massive ... benefits bill by which the taxpayer subsidises companies that pay very low wages'.

More recently, some of the most vocal criticisms of the 'Byzantine tax credit economy' have been aired by figures from the impeccably Blairite think tank Policy Network^{viii}. They have been at the forefront in pressing Labour to embrace 'predistribution' – in large part just a less threatening term for regulating markets – as part of a more fiscally responsible approach to the promotion of social justice. They even called for 'a higher 'living' minimum wage', long before any similar misnomer ever crossed George Osborne's lips.

What becomes clear is that the broad coalition behind tax credits was only ever contingently solid. Policies sustained by ambiguous agreements between political parties representing very different interests have weaknesses that are symmetrical to their strengths; the sources of cross-party appeal can quite quickly become the reasons for cross-party disdain. The emergence of the deficit as the central issue in British political debate was the main catalyst for such a transformation in the fortunes of extensive cash transfers for the working poor. But a shared belief on the right and the left that the generalised subsidisation of wages is an undesirable aberration has a much longer political pedigree, whatever its economic merits.

The considerable technical challenge of calibrating extensive in-work support policies to meet their multiple goals is likely also partly responsible for their waning political support. The problems that dogged the administration of tax credits certainly made it harder for Labour to defend the system when it came under attack. And the otherwise bizarre sight of Iain Duncan Smith punching the air with delight on the floor of the House as his flagship programme was gutted might be explained by the changes limiting the scale and impact of the operational problems that Universal Credit will inevitably confront. Not so long ago targeted in-work support looked like smart policy and smart politics. Today it looks much less like either.

Conclusion

Until recently tax credits for the working poor appeared to be a central pillar of an emerging transatlantic 'Anglo-social' model. Their rapid fall from grace in the UK is multi-factorial. Though America's experience with EITC was beguiling politically, tax credits were an odd import for the UK, where they fitted neither with the operation of the taxation system nor with the stronger tradition of highly targeted anti-poverty policies. Attempting to meet too many goals concurrently led to administrative problems and some political discredit that partly obscured other achievements of the tax credit system.

This has been exploited by the Conservatives, who in coalition recast in-work support in a far less liberal guise through Universal Credit. But with this new policy likely to raise even greater problems of regulatory capacity and the projected cost of in-work support still spiralling, in a deficit conscious post-crisis environment the whole principle of supplementing labour incomes through cash transfers has now been challenged. In the process the fragility of the political coalition on which it rested has been clearly revealed.

Tax credits were however central to the success of Labour governments in substantially reducing poverty during their terms in office, especially among children and working-age families with children. However much the scheduled increase in the minimum wage will be welcomed by low-paid people over the age of 25, it is no simple functional equivalent to in-work support distributively, and will not prevent these gains in combating poverty being undone. This policy reversal may also compromise the UK's impressive performance over the last two decades in reducing reliance on out-of-work benefits and promoting employment growth, particularly among groups such as lone parents.

While there are social models elsewhere in Europe that combine high employment and low poverty without recourse to extensive in-work support, the UK's political economy shares few of their institutional characteristics, and a selective increase in the minimum wage won't change that. The current government believes that the centre of UK politics has shifted, and it may be right. But if the demise of tax credits is definitive, those competing for the new centre who still care about solving the problems they were introduced to address will soon enough be forced to present a credible menu of alternative policies.

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