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Tax Credit Policy in the UK and its Lessons for Austria

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1. Introduction

The rationale of awarding tax credits to low income families is that it improves simultaneously incentives for work and the income situation of those on low wages. Tax credits are also often referred to as in-work benefits and they form a core element of 'Welfare to Work' strategies of many governments. The two objectives will be a top priority for countries where there is high non-employment and dependence on welfare benefits and/or there is a large segment of working population as low-wage workers. The motivations of such a policy initiative are therefore to redistribute in favour of low earners without increasing labour costs and also to move away from a passive and sometimes poorly targeted welfare system. Although the idea behind awarding such tax advantages is straightforward, nonetheless its design and implementation require careful preparation and planning within the context of the country in question. Undoubtedly, the biggest challenge lies in the public administration of such a system.

This Policy Brief summarises the policy experience of the tax credit system in the United Kingdom, with the aim to understand better the challenges underlying the tax credit policy to be initiated in Austria. The note has two parts. Firstly, it describes the historical evolution of the tax credit policy in the United Kingdom and also comments on its success and failure. Secondly, it provides some brief analyses of tax credit experience in other countries (the United States, Canada and Australia). Lastly, it provides some insights for the tax credit policy initiative to be introduced in Austria.

2. The tax credit policy in the United Kingdom

2.1 What challenges?

There are many challenges in introducing a tax credit system and they were all observed in the United Kingdom. A summary of these challenges is outlined here:

- The tax credit system has high IT requirements, so much so that the development of a comprehensive integrated tax credit policy in the United Kingdom was held back by lack of computerisation until 1970s;
- Taxes and benefits are separate functions of the government as they deal with different segments of the population: tax is collected from people who have enough income and the benefit is paid to those who don't. This limitation has also been observed in the United Kingdom and the disbursement of the tax credit has been moved from the department responsible for benefits to the tax department;
- Benefits are targeted towards families, while income tax is paid by individuals, and this generates additional complexities. The tax credit system in the United Kingdom has always been at the family level, but not without problems with respect to work (dis)incentives for a potential second earner within the family; and
- Taxes (including tax credits) are assessed on the basis of annual incomes, whereas benefit recipients' budgeting of personal expenses on the basis of their benefit income (and credits) is often done on weekly basis. Thus, it is important to somehow capture the variations in income within a single year and adjust tax credit payments promptly so that beneficiaries do not run into financial hardships. The United Kingdom's policy during different phases offers experiences of different degrees of responsiveness in adjusting tax credits due to sub-annual income variations.

Despite these challenges, there was a great motivation and political will in reforming the welfare system so as to make work pay at the bottom end of the earnings and induce people out of welfare into workfare. Behind these motivations, the tax credit system in the United Kingdom took various forms and came in different phases. They are described below, with a specific attention to the evolution of this policy and to draw lessons from the experience in each phase[1].

[1] These analyses are drawn from William Davies (2007) "Tax credits: the success and failure", *Prospect*, June.

2.2 Various phases of the British tax credit system

In 1971, the Family Income Supplement (FIS) was introduced, with a stated objective 'to top up the earnings of low earners and thus help to beat the unemployment trap'. As for most other benefits, the FIS was paid via the Department for Social Services (DSS). The parameters of this policy were such that it applied to a small proportion of low wage workers, and its take-up rate was less than 50%. Two critics of this policy stand out:

- there was a sharp fall in benefits as income from work rose, so it is often said that 'the FIS replaced the unemployment trap with a poverty trap'; and
- In the absence of a minimum wage, the policy was seen as subsidising employers offering low-wage work.

In 1988, the FIS was significantly expanded and re-titled as 'Family Credit' (FC). It continued as a benefit payment for working families, still administered by the DSS. This system was in place at the time the Labour party took over from the Conservatives in 1997, by which time it was paying out £2.3 billion a year. It was widely believed that the tax credit system that existed was 'inadequate to the challenge of getting more people into work'. The salient issues identified in reforming the system had been:

- to reform the system to get more single mothers into work;
- to address the issue of non-employment (where either disability or dependent children induce individuals out of the labour force); and
- to improve the take-up rate (the take-up rate of the FC was low: at about 70% in 1998, though considerably higher than 57% in 1988).
- Also, the payments and the income threshold were too low to make work significantly more attractive than benefits, especially the loss of housing benefits acted as a major disincentive to take on employment.

In 1999, the Labour government introduced their first wave of tax credit policies. It consisted of the Working Families Tax Credit (WFTC) and the Disabled Persons Tax Credit (DPTC). The conditions for the WFTC were practically identical to the FC: eligibility was restricted to parents in work; beneficiaries had to work for a minimum 16 hours per week; and the payment was calculated on a 6-month basis. The supporting childcare costs were one of the main elements in making it easier for parents with small children to work. More importantly, the unit responsible for the disbursement of the tax credit was transferred from the DSS to the Inland Revenue. In government's view, this change helped WFTC to be associated with work and not benefits, to the extent that WFTC expenses were often presented as tax revenue lost rather than public spending on welfare. Government spent £6 billion a year on the WFTC, more than double of what has been spent previously on the FC. By several criteria, the WFTC can be considered a success:

- In absolute numbers, far more families were receiving the tax credit (although the take up rate remained low – around 65%);
- Employment amongst single parent started to rise;
- Recipients of the WFTC were familiar with the system as it closely resembled the previous one and there was very little additional complexity; and
- One challenge has been that the WFTC made significant overpayments: 10-14% a year. But, this was not seen as arising out of system's complexity but mainly as a result of claimant error and fraud.

In 2003, the latest system of the tax credit policy came into existence, and at this point the system's complexity and IT problems raised serious administration problems. The WFTC was now split into two new types: the **Working Tax Credit** (WTC) and the **Child Tax Credit** (CTC). The WTC pays tax credit to low earners, and it also contains an element of paying for childcare costs. The CTC is payable to families with children, irrespective of whether the parents are working or not. These changes have made more people eligible to the tax credit scheme: in 2006/07, close to 6 million families were claiming either the WTC, CTC or both. Around 4.2 million in work families with children got tax credits. The average annual award in 2005/06 was £3,200. [2]

[2] Child and Working Tax Credit Statistics: finalised annual awards 2005/06, HM Revenue and Customs (HMRC).

Box 1:
Tax credit system introduced in April 2003

Child Tax Credit (CTC) goes to families with children, in addition to their existing Child Benefit, irrespective of whether the parents are in work or not. People on lower incomes get more, with a maximum annual credit available to those having income below £14,155 per year (2006/07). The maximum CTC award is €3,520 for a family with one child, €6,240 for a family with two children and €8,950 for a family with three children. The CTC is paid until the child reaches a certain age.

Working Tax Credit (WTC) goes to low-income working individuals, including those without children if aged over 25 and working at least 30 hours.
A family with children, persons with disabilities, and persons aged 50+ can qualify with less than 30 hours requirement (at least 16 hours a week requirement will still apply). It is a means-tested benefit and it reduces with rising income. The annual maximum is paid to anyone having income below £5,220 per year (2006/07) and it is €2,540 for single persons and €5,040 for single parents and couples (extra payments are also paid to those whose working capacity is restricted due to disability and those who work more than 30 hours per week). The maximum amount of WTC is reduced at the taper rate of 37% as income rises above £5,220 per year (2006/07); i.e. in case of income above the threshold, the maximum award is reduced by 37p for every pound of income above the threshold.

Eligibility new tax credits are initially assessed on the basis of the previous year's income. If actual income in the year of payment is very different, an adjustment is made promptly, and also feeding into the following year's tax liabilities/credits. Alternatively, if the recipient chooses to notify the Inland Revenue of expected income change, adjustments can be made in year of payment (upwards as well downward). A new application can be made at anytime during a year and by any member of the family.

What is it worth? Valid claims and the amount paid depend upon the household income and family composition. Extra payments are available for lone parents, disabled people, or people aged 50 or over, who are returning to work after a period on benefit. A typical example is that a lone parent with one child, working for 20 hours a week earning the minimum wage and paying £80 per week for childcare would be entitled to over £8,000 a year in tax credits. Higher income families receive about £500 a year (e.g. a family with an income of £25,000 a year would receive £545 a year).

The new system also made other changes, which lead to complexities for claimants and also resulted in serious problems in administering the system. Two changes of note are:

- The first change was to the way tax credit payments were made. Payments were administered by the tax collection agency (Her Majesty Revenue and Customs, HMRC)[3] instead of the benefit agency (formerly DSS, now known as the DWP).

- Under WFTC, tax credit awards were calculated every 6 months and then fixed for the whole of this period. The WTC, on the other hand, aimed to be more responsive to changes in personal circumstances. For these reasons, the new system calculates entitlements for the whole year on the basis of the previous year's income. The adjustments are made throughout the year based on claimants' self-assessment of changes in their family's circumstances (earnings, childcare requirements, marital association, etc.). The system led to an in-built system of overpayments and underpayments, which were settled at the end of the year.

[3] Until 2006, employers were responsible for paying tax credits through the payroll. From April 2006, tax credit payments are made directly by the HMRC. For more details, see L. Leppick (2006), In-work benefits: literature review, Centre for Policy Studies.(HMRC).

There were serious problems in building an IT system that can cope with such a complex system: an estimated £100 million of overpayments were made during the first year due to IT problems alone. Altogether the system pays out £17 billion per year, and almost £2.5 billion are considered to be 'misdirected' (amounting to wastage of almost 15% per year). The biggest flaw of the system was linked to government underestimation in the degree of variations in income of low earners which lead to a systematic bias towards overpayments. The government faced serious challenges in collecting overpayments from individuals who were reluctant to return what they thought is rightfully theirs. The problem of the overpayment will be overcome through a recent change in the system (announced in the 2005 pre-budget report): the earnings rise disregard during a year has been increased from £2,500 to £25,000. This change alone will cost the Treasury £500m a year, but it will reduce the chance of overpayments for a large number of families. It will also reduce, albeit partly, the disincentives inherent in the system for the second earner to enter labour market.

More critically, there is also the issue that the existence of disregard for the earnings rise implies that not everyone with the same income and circumstances in the current year ends up with the same award. The impact on work incentives is difficult to predict. It could be positive in that the disregard means that some increase in earnings is protected from a reduction in the tax credit award. On the other hand, the system is not very transparent and if people cannot understand the system they may be reluctant to risk their awards by increasing their earnings.

Also, a worker's participation in the so-called 'salary sacrifice scheme' (in which the worker agrees to accept a reduced wage from the employer in return for a non-cash benefit) may actually increase his/her entitlement to the WTC as the income on which they are assessed is lower. Moreover, employers' experience suggests that the tax credit recipients are quite inflexible towards their working hours and thus they are less employable than others.

Brewer (2005)[4] outlines the case that the CTC is more effective in reducing poverty than the WTC. His conclusion is that no single measure can affordably cut poverty without reducing work incentives, thereby underlining the trade-off inherent in the double aim of tax credit programs: to simultaneously improve work incentives and reduce poverty.
The new system had nonetheless some notable achievements:

- It has a high take-up rate, at 82% overall and 97% for families earning less than £10,000 a year.
- There is a notable rise in the employment of single parent families: from 42% in 1997 to 57% in 2007.
- The percentage of 'workless' families (i.e. those with no member of the family in employment) has also gone down.
- Tax credits are one of the main reasons that the net effect of tax and benefit changes since 1997 has been to raise incomes for the poorest 20% of families by 12%. Four out of ten families now do not pay any net tax.

Despite all its flaws, the tax credit policy has played a vital role in lifting many families with children out of poverty, in preventing inequality from rising far more sharply and in improving work incentives.

[4] Brewer, M. (2005). Tax Credits: Time to stop weakening work incentives? Presentation given at the Institute for Fiscal Studies, 15 September 2005 (quoted in L. Leppick (2006)).

2.3 Conclusions

Taking the long-term view, the problems encountered in the tax credit policy in the UK were worth the pain. Despite all its flaws, tax credit policy has played an important role in the outcome that, during the last decade, 600,000 children had been lifted out of poverty, (compared to the doubling of child poverty that occurred over the previous 20 years). The question is whether it was necessary to use a system with an almost 15% inaccuracy rate to achieve this, perhaps not. If Austria were to introduce such a policy, it has to measure how such wastage could be avoided or kept to a minimum.

The conclusions with respect to work incentives of the British schemes are mixed. There is definitely a strong incentive for single parents to return to work. One particular area of weakness is the work incentives for 'second' earner in the family: the eligibility conditions for a couple are the same as for a single (even though the poverty line is 30 per cent higher for couples). There are also weaknesses in providing incentives to increase working hours beyond what ensures entitlement, and this is mainly for the fact that other benefits (particularly Housing Benefits) are withdrawn rather quickly once income from work starts to rise. The CTC is paid irrespective of employment status of parents, and this could also be partly a disincentive towards work.

The main challenge to the WTC in the United Kingdom has been its administrative difficulties towards responsiveness to income changes. Below, in Section 3, we provide a brief review on experiences of other countries with respect to tax credit responsiveness to changes in income within a year, so as to put the UK's policy in an international perspective.

3. International experiences on tax credit responsiveness within a year

The WTC of the United Kingdom has been seen very responsive to changes in the variations of the individual income situation, and this has generated some serious administrative issues. However, the UK system is not unique as some complexity is inevitable in benefit systems that allocate tax credits based on changeable personal circumstances during the year. It will be interesting to see how other countries have dealt with this issue.

3.1 The United States

In the United States, working families file a tax return at the end of the year, and when their income is below a given threshold they receive a 'tax credit', typically as a single lump sum. Thus, the system only rewards after the full assessment of the income situation during the year in question, and this may raise questions about whether the work incentive signal is strong in such a system. In the US, the signal may still be strong because the culture of filing tax returns is more common amongst the Americans (since the overpayment of tax is quite common in the US) than the British.

3.2 Australia

In Australia, the tax credit is usually paid as a fortnightly payment, with a possibility to opt for a reduction in regular tax instalments or a lump-sum payment after the end of the tax year. Claimants are expected to estimate their taxable income for the year ahead. At the end of that year, entitlements are adjusted to reflect actual income: people who have already received their credits through fortnightly payments must pay some of it back if they earned more than estimated, or receive more if they earned less. This claw back of overpayment had therefore a similar problem as in the UK. The Australian government waived off the first A$1000 of any debt owed, reducing the number with repayment debts to about 10 per cent of claimants.[5]

[5] For more discussion, see Whiteford, P., Mendelson, M., and Millar, J. (2003) *Timing is Right? Tax credits and how to respond to income changes*, York: Joseph Rowntree Foundation, England

The unexpectedly high level of overpayments indicates the risk of a system based on advance estimates. Most often overpayments were due to individuals having jobs with fluctuating earnings or second earners increasing their pay/hours of work. In addition, it seems that families were more likely to underestimate their income than they were to overestimate – indeed most families did not get their estimates right. In the second year of the system, there appeared to be some reduction of overpayments, but these still affected an estimated 33 per cent of families (compared with 39 per cent in the first year). One remedial measure has been to allow families to vary the amount they receive over the year and so reduce the likelihood that they will be overpaid.

3.3 Canada

In Canada, the amount to be paid is based on net family income in the calendar year before the time a tax return is filed (in April), which determines benefits for the year (from July to June) ahead. There are no mid-year adjustments due to changes in income, although mid-year corrections are required for changes in family composition. Families experiencing sharp drops of income during the year may claim provincial social assistance to top up their incomes, providing the drop takes them below thresholds of eligibility for such schemes. Other than this emergency assistance for people who find themselves in dire straits, there is no adjustment once the year's tax-benefit levels have been set: income falls are not compensated for in the current year, and nor do income rises trigger in-year reductions or repayments. This failure to make adjustments means monthly payments can in some cases be based on income received up to two years previously. However, this lack of responsiveness has not been an issue in Canada. This may be because the level of the benefits is lower than in Australia or the UK. Alternatively, it may be because the simplicity of the system is much more valued by recipients than responsiveness to mid-year income changes.

In summary, the UK and Australian systems are quite similar, except that Australia uses prospective and the UK retrospective income for the initial assessment. Each then seeks to respond to some changes as they happen and the rest in an annual end-of-the-year settlement. These changes make these systems quite complex, especially in administration. These systems involve more intrusiveness for recipients than Canada's system. This is especially true in the UK, where there are several tax credits and in-work benefits.

4. Lessons for Austria

Unlike the United Kingdom, Austria does not have high numbers of low wage workers, high incidence of workless families where no family member is in employment, or high levels of child poverty. There are other contextual factors that are also different in Austria in comparison to the UK (minimum wage settings, levels of the out-of-work social assistance and housing benefits on offer, etc.). Yet, the policy experience of the UK offers some useful lessons for the tax credit policy to be introduced in Austria. Perhaps the strongest message from the review of the British policy has been "keep it simple", as the benefit simplicity will help to effectively implement and evaluate the experience of the tax credit policy. It is also imperative that a good and tested IT system is put in place before introducing the policy.

More specifically, the following recommendations arise out of the study of the British system:

- Austria should consider introducing a WTC type policy initiative in which the tax credit can be limited in time. Such a policy will serve as a push for people to enter labour market or those already on low wages to benefit from extra income. The advantage of the time limited form of the tax credit lies in its clear message: the cash assistance is transitional and the beneficiaries should focus on reaching self-sufficiency during the time the credit is available. However, the 'time out' beneficiaries will have to be carefully monitored to evaluate whether the credits have indeed lead to a permanent effect of self-sufficiency and in moving them out of poverty.

- As for responsiveness to changes in income and family circumstances, it is recommended that Austria follows a system similar to the one in Canada. Such a system will fix tax credit benefits for a limited time in advance (say, 2 years), and with no sub-period adjustments due to changes in income or family composition. It can be recommended that, in the first instance, the policy should be introduced for specific subgroups that are at a big disadvantage, either in terms of high non-employment or in having low wage incomes. These groups can be lone parent families and persons with disabilities. Once entitled to the tax credit, individuals will be required to continue to work a specified minimum number of working hours (say, at least 20 hours per week). Families entitled to the tax credit and experiencing sharp drops in their income should re-apply for extra tax credit to top up their incomes.

- The UK's experience shows clearly that the challenges underlying the administration should not be underestimated. The overloading of the tax system and their offices has been the main negative factor behind the problems encountered in the WTC. Austria will have to decide whether the tax collection agency, the employment agencies or the benefit awarding agencies are more appropriate for the administration of the tax credit system. It appears to be the case that the employment offices will be more effective in administering the system in Austria, mainly for the fact that they are already in contact with many of the potential clients and they can carry out 'better-off' calculations more effectively.

- A good understanding of the interaction with other benefits is crucial at the early stage. This is particularly true for an interaction with the housing benefit, irrespective of however complex Austrian housing benefit system is. An interaction with the provincial social assistance policy should also be carefully evaluated. The benefit simplicity objective must be given lots of importance, and a high quality of explanatory material should be prepared so that claimants could understand their entitlements. Good access to advice and information, preferably face-to-face but also over the telephone, will be essential.

- The sheer force of political will was the cornerstone of Brown's policy in The United Kingdom. Austrian policymakers would also need a strong commitment to pursue this policy initiative (and it seems that the Federal Minister Dr. Erwin Buchinger is right behind such a policy initiative in Austria). Austria also needs to stick with the policy for some time. A good evaluation after the initial years of this policy will allow them to revisit to the design of the policy best suited for Austria.

The success or failure of the tax credit policy in the United Kingdom offers no assurances that it will work the same way in Austria. A lot depends on the contextual factors, such as the interplay with other tax and benefit policies, other labour market policies and wage setting arrangements. Another important element will be the behavioural response of those who are potential beneficiaries; the cultural factors will also come into play such as any social stigma associated with such a benefit and the work ethics. The tax credit policy stands out as a potentially useful policy for Austria, although it will be imperative to do more background research on the effect of the contextual factors. Austria, or any other country considering introducing tax credit policy, will have to learn not just from experiences of other countries but also from their own so as to modify the policy design and its implementation with time.

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