Reforming the UK Family Tax and Benefits System

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Executive summary

British society has gone through a 'Great Disruption' in the last 40 years, and changes in family life have been at the heart of it. Marriage rates have fallen, cohabitation outside marriage has become the norm, divorce has risen, fertility rates have plummeted, ex-nuptial births have multiplied, and the number of children being raised by sole parents has escalated. The traditional male breadwinner pattern has also disintegrated as women have increased their level of workforce participation.

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These changes have undermined the system of family support that was put in place by Beveridge after the War. At that time, the vast majority of children were raised by married parents who usually stayed together and who commonly lived on a single wage. Apart from helping a tiny number of widowed families who lost their main breadwinner, the main task for family policy was to ensure that husbands' earnings were adequate for them to support their dependents. This was achieved by giving married men tax allowances in respect of their wives and children, thereby reducing the amount of income tax they had to pay, and by giving their wives a weekly cash benefit – the 'Family Allowance' – to supplement the housekeeping.

Following the 'Great Disruption', however, these arrangements were called into question, for increasing numbers of households had only one parent and no breadwinner. Today, only 5% of couples with dependent children have no adult worker, but 40% of lone parents do not work, and of those that do, few earn enough to cover the full costs of maintaining themselves and raising their children. For many sole parent families, government benefits have replaced the financial support that used to be provided by husbands. The result has been a huge increase in government spending.

Even though birth rates have been falling for much of the last 30 years, government spending on families with children has risen strongly – a 143% increase in real terms since the 1970s. In part, this is because New Labour has followed a deliberate policy of increasing financial support for families with children, but most of the increase – 60% of it – has been caused by the rise in the number of sole parent families. Most of the increased spending is not therefore making families any better off than they used to be; it is simply compensating for the absence of husband-fathers who used to support their families and no longer do.

It is right that people with children should be helped with the costs of raising them, but the way taxes and benefits for families have changed to accommodate the radical shifts that have occurred in family life has created many new problems. We have ended up with a system that is very costly, often unfair, and which undermines the independence and self-reliance of families rather than promoting it.

The case for assisting families with the costs of raising their children rests on the principle of 'horizontal equity.' This recognises that children have a claim on a portion of their parents' income, which means that a worker with children is earning less for him or herself than a comparable worker on the same wage with no dependents. Equitable taxation requires that his or her earnings should be taxed less (e.g. by giving children and dependent partners their own tax-free income allowances and permitting them to transfer these to the person who earns the income on their behalf).

> "We have ended up with a system that is very costly, often unfair, and which undermines the independence and self-reliance of families rather than promoting it"

Recent family policy has neglected this horizontal equity principle. So much emphasis has been placed on redistributing incomes vertically (from richer to poorer families) that equitable tax treatment of non-parents and parents at each level of income has been forgotten. The result is that middle-income families have lost out in comparison with single people, and families relying on just one income have been particularly hard-hit. Britain ranks high in international league tables measuring the generosity of family support for lower income families, but because we have neglected the horizontal equity principle, families on average earnings have gone backwards.

One of the biggest mistakes in UK family policy was scrapping tax allowances for spouses and dependent children. They have been replaced with 'tax credits' which are now costing £20 billion per year (up from £2.3 billon in 1997) and which in most cases are little more than glorified welfare benefits. Instead of spending their own money raising their children, as they used to do, many parents now pay higher taxes to the government, and then have to apply to get their money back as fortnightly hand-outs. The average middle-income family today pays £6,016 in tax and NI contributions, but gets back £5,383 as social security and family payments. This unnecessary churning has undermined family independence and self-reliance and turned four-fifths of the nation's families (5.5 million households) into welfare claimants.

This report proposes the following changes:

- Tax allowances for dependent children and for non-working spouses should be restored. This would allow working parents to keep more of what they earn, rather than going to the state for top-ups, and it would reduce wasteful churning and 'middle class welfare'.
- Tax credits should be retained, but cut back so they are only claimed by low-income working families (the group for whom they were originally intended). The purpose of tax credits has become confused because the

government has been using them to reduce poverty as well as to reward work. Families now qualify for tax credits even if they do not have a job, and this has undermined work incentives rather than strengthening them. Tax credits should have only one purpose, which is to boost the income of low-income families who work. Families where nobody is employed should not be eligible for tax credits (they should get welfare supplements for their children, as used to be the case before 2003).

- The tax credits system should also be overhauled. There should be a single family tax credit, normally payable annually in arrears so as to eliminate the overpayments problem and reduce fraud. The so-called 'couple penalty' should be ended by taking account of partners when calculating tax credit payments. Tax credits should reflect the number of hours work people do. It is unfair that part-time employment of just 16 hours per week can be topped up to almost the equivalent of a full-time take-home wage. To ensure that people who work more hours get more support than those who work fewer hours, tax credits should be calculated on hourly rates, not total wages.
- There should also be changes to Child Benefit, child care subsidies and parental leave. Evidence suggests that children up to two years of age benefit from being raised at home, but for older children, formal child care can generate significant benefits. It therefore makes sense to enable those parents who want to stay home to look after their children to do so for the first three years, but after that, there is no reason why taxpayers should subsidise parents to stay at home rather than go to work. Child Benefit could be 'front-loaded' onto the first three years to help defray the cost of lost wages when a parent stays home. Current child care subsidies could be replaced by a 'Parenting Care Allowance' for the first three years, which could be used by parents to buy child care or to offset lost wages, whichever they prefer. A new 'Life Course Savings' scheme could also enable prospective parents to build up tax-free savings to replace lost earnings during periods of extended parental leave.
- Once their youngest child turns three, parents who cannot support themselves should be expected to work rather than claim welfare. This should apply to all families: sole parents as well as couple families should be expected to achieve self-reliance after their children turn 3, and welfare should play only a secondary role in their family finances. Absent fathers should help pay for the upkeep of their children, just as other fathers are expected to do, and those who fail to maintain child support payments should be prosecuted.

In the current economic climate there is no scope for additional government spending, so the proposals outlined in this report are intended to be broadly 'revenue-neutral.' There should be no additional spending, just a different pattern of spending. In particular, the aim should be to shift families from relying on government hand-outs to greater reliance on their own earnings, aided by more generous, family-based, tax allowances.

1

What is the Family For?

The 'Great Disruption'

The American political analyst, Francis Fukuyama, has described the period of the 1960s through the 1990s as marking 'a Great Disruption' in western societies.[1] In addition to declining levels of trust, weakening community ties and spiralling crime rates, this disruption was manifested in a dramatic shift in the norms and values governing family life. In the last 40 years, western family patterns have been transformed.

It is a sociological truism that the family is the core institution of any society. In addition to providing adults with emotional gratification and economic security, families play a crucial role in raising the young and therefore in transmitting the culture of the society from one generation to the next. If family life changes, the socialisation process is almost certain to be affected, and the effects will be felt across the board: in schools, in places of employment, in levels of crime and anti-social behaviour in local communities, and in patterns of government social expenditure.

The indicators of the upheaval that has occurred in family life in Britain over the last 40 years are all now wearily familiar:[2]

- **Marriage rates have plummeted:** The annual number of marriages in England and Wales increased steadily (other than during the two World Wars) from 1838 (when civil registration began) until 1970. Since then, the number of couples getting married each year has fallen by one-third, to just 236,980 in 2006.
- **Cohabitation outside marriage has become normal and widely accepted:** Married couples still outnumber cohabiting couples (11.6 million against 2.2 million), but more than 10% of working-age people today cohabit, and this represents a five-fold increase in 30 years. More than half of cohabiting couples later marry (the proportion of couples who live together before getting married has risen from 2% in 1960 to 75% today), but these marriages are less likely to last.
- **Divorce has increased:** There were 24,000 divorces in Britain in 1958. This rose to 56,000 in 1969 and reached 125,000 in 1972 following the reform of the divorce laws. Today, there are 155,000 divorces each year, and about four in ten marriages now end in divorce. Although the divorce rate has been fairly stable (at around 12 divorces per annum for every 1000 married people) since peaking in the mid-1980s, Britain's rate is one of the highest in the EU and is significantly above the EU average.

1 Fukuyama F (1999), *The Great Disruption*, Simon & Schuster.

2 The following statistics are taken from: Centre for Social Justice, *Family Law Review, Interim Report*, November 2008; Cabinet Office Strategy Unit and Department for Children Schools and Families, *Families in Britain: An evidence paper*, December 2008; OECD, *Babies and Bosses*, 2007, Table 2.2; Smallwood S (2004), 'Characteristics of sole registered births and the mothers who register them' in Population Trends, no.117; Kirby J (2005), *The price of parenthood* , Centre for Policy Studies; Department of Health, *Abortion statistics England and Wales 2007*, Statistical Bulletin, Table 1.

- **Fertility rates have dropped:** In 1970, the total fertility rate (the number of children born to an average woman over her lifetime) stood at 2.43 in the UK. This was comfortably above the 2.1 required to replace the population each generation. By 2001, it had fallen to 1.63 – significantly below replacement rate – although it has since recovered to 1.9 in 2007. The fall in fertility in Britain has not been as great as in many other countries. In the OECD as a whole, the total fertility rate fell from 2.70 in 1970 to 1.63 in 2005. Part of the explanation lies in delayed childbirth (women are having babies later, and many leave it too late to have the size of family they had hoped for). But the rise in abortions has also been a major factor (up from 55,000 – five per thousand fertile women – in England and Wales in 1969 to over 200,000 – nearly 19 per thousand fertile women – today).
- **Births outside of marriage have multiplied:** Fewer than 10% of all live births in 1971 were to unmarried parents. Today the figure is over 40%. This increase is partly accounted for by the switch from marriage to cohabitation, but in only one-quarter of ex-nuptial births is the father living at the same address as the mother. Of the remainder, half have a father living at a different address, and half have no father named on the birth certificate. Substantial numbers of children are today born to unmarried mothers who have little or no contact with the father.
- **The number of children raised by sole parents has escalated:** The rise in ex-nuptial births has combined with the increase in divorces and cohabitation break-ups to produce an increasing number of children being raised in sole parent (normally fatherless) households. In 1975, 10% of families with children were headed by a sole parent. Today it is 27%. There has also been an increase in the number of children being raised in step and 'blended' (two sets of children from earlier relationships) families (up from 1 in 15 in 1990 to 1 in 10 in 2001). A recent government report describes step families as "one of the fastest growing family form [sic] in the UK".[3]
- **Female workforce participation has risen:** As a result the traditional 'male breadwinner' model of family life has disintegrated. In particular, part-time employment of women with dependent children has become increasingly common, and demands for pre-school and out-of-school-hours care has escalated as increasing numbers of families try to reconcile the demands of two jobs with the responsibilities of raising young children.

All of this is well-known, and many reports have been written attacking or defending the impact of these changes on family wellbeing. While some of these changes have been associated with improvements in people's lives (e.g. we can now escape from unhappy marriages more easily, and women who want to develop careers outside the home now have more opportunity to do so), others have undoubtedly diminished overall levels of happiness and life satisfaction.

We know, for example, that married couples are richer, happier and more satisfied with life than cohabiting couples,[4] yet marriage has been declining while cohabitation has been increasing. For children, too, the overall balance sheet appears more negative than positive, for children raised in sole parent, step or 'blended' families tend on average to be disadvantaged on a wide range of measures as compared with those raised by natural parents in a stable marriage, yet

3 Cabinet Office Strategy Unit and Dept for Children Schools and Families, *Families in Britain: An evidence paper* London, December 2008, p.26

4 Ibid, p.85.

marriage has been declining while sole parent and step families have been growing rapidly.[5]

This report does not attempt yet another analysis of how changes in family life have affected children's wellbeing. Our focus is more limited than that. It has to do with the shifts in public policy that the 'Great Disruption' has triggered.

More specifically, we shall trace the way government financial support for families has changed in response to the shifts that have occurred in family life since World War II. We shall ask why governments spend so much money supporting the nation's families, what they are trying to achieve, what effects their expenditure is actually having, and whether the current policy mix is appropriate given the changed context of family life in the contemporary period. In this way, we shall try to work from first principles to identify ways in which the government might secure better outcomes by changing some of the ways it provides financial support for families.

The post-war legacy of family support policies

When Beveridge put in place the foundations of Britain's modern welfare state in the 1940s, the overwhelming majority of children were raised by their two natural parents. These parents were almost invariably married to each other, and were unlikely to separate.

The public policy problem which Beveridge had to address was simple: how to ensure that these married couples had sufficient income to cover the costs of raising their children.

Most families at that time relied for their income on one, full-time, male wage. There was a complementary (though in some views, unequal) division of labour between husband and wife whereby the man worked outside the home for a wage, while the woman worked inside the home, bringing up the children and managing the domestic budget.[6]

The normal pattern was that part of the man's wage would go to his wife to cover 'housekeeping,' which included personal items for herself and the children (some families regarded the housekeeping money as the wife's 'wage').[7] There was an implicit understanding that he would continue to provide financially for her throughout their lives, so she could sacrifice her own future career knowing that her husband had made a binding commitment through marriage to provide for her, even after the children had grown up and left home.

Two kinds of problems could arise in these arrangements. One was if a man died, for his dependents might then be left with no source of income. This eventuality was covered in some cases by insurance, or by membership of a friendly society or other mutual aid association offering widows' and orphans' benefits.[8] In other cases, bereaved women had to rely on Poor Law assistance until the government introduced Widows' and Orphans' benefits in 1925.[9]

The second kind of problem arose when men were working, but did not earn high enough wages to cover the essential costs of supporting their children and a dependent spouse. Because the level of a man's wage was determined by the value

5 Much of the evidence on child wellbeing in sole parent, step and 'blended' families is reviewed in Dennis N and Erdos G (1993), *Families without fatherhood*, Institute of Economic Affairs, London, 2nd edition; Morgan P (1999), *Farewell to the family?*, Institute of Economic Affairs, London, 2nd edition; Maley B (2001), *Family and Marriage in Australia*, Centre for Independent Studies, Sydney; Social Justice Policy Group, *Breakthrough Britain, vol.1: Family Breakdown*, Centre for Social Justice, July 2007; Layard R and Dunn J (2009), *A Good Childhood*, The Children's Society, London.

6 Differentiation of roles between husband and wife does not necessarily indicate inequality of power or status between them. Some thinking seems to imply that men and women cannot be equal unless they both share equally in all family functions, including paid work and child nurturing. Not only do many couples not wish to adopt such a pattern (see Hakim C (1996), *Key Issues in Women's Work*, London: Athlone Press), but there are longstanding sociological arguments that families might function most effectively when one specialises in 'external' and 'instrumental' activities while the other focuses more on 'internal' and 'expressive' ones (e.g. Parsons T and Bales R (1955), *Family, socialization and interaction process*, Illinois: Free Press).

7 Pahl J (1980), 'Patterns of money management within marriage' in *Journal of Social Policy*, vol 9, pp.313-335.

8 Green D and Cromwell L (1984), *Mutual Aid or Welfare State*, Allen & Unwin.

9 For a history, see Strickland P and Vidler G (1998), *Widows' Benefits*, Research Paper 98/100, House of Commons Library.

of his labour to an employer, without reference to his domestic circumstances, there was no guarantee that a man with a large family would earn enough to pay the rent and put food on the table, particularly if he was low-skilled. There was also the possibility that a man earning an adequate wage may nevertheless fail to hand over a large enough proportion of his earnings for his wife to be able to look after herself and their children adequately.

Public policy responded to this problem of how to support the living standards of dependents of employed men in two ways.

First, governments tried to keep low-paid men with family commitments out of the income tax system. From before the First World War, there was a policy to give family men additional tax allowances which were not available to other workers who did not have family responsibilities, in order to reduce their tax liabilities.

The principle that underpinned these concessions was the more people who depended on a single wage, the less tax should be deducted from it. A single man was given a tax-free allowance which effectively recognised that he should not be taxed until he had earned a subsistence income from which he could maintain himself. A married man with a wife and children to support was therefore given a higher tax-free allowance so that he could not only afford to feed, clothe and house himself, but he could also secure the subsistence of the other family members who depended upon his wage.

This was done by giving family men a 'Married Man's' allowance (to help with their wives' needs), and child tax allowances (to help cover the needs of their dependent children) in addition to their own personal tax-free allowance. With more mouths to feed, they were allowed to earn more money before incurring income tax liabilities.

The second way the government responded to the problem of inadequate family incomes was to give families with dependent children a flat-rate top-up. This was done by a 'Family Allowance' (later changed to the 'Child Benefit'), which was introduced by Beveridge in 1943.

Family Allowance boosted the income of every family in the country, irrespective of their circumstances. It was originally limited to families with two or more children, for Beveridge believed that a working man's full-time wage was adequate to provide for a spouse and one child, but it was subsequently extended to cover the first child as well. Today, Child benefit actually pays more for the first than for subsequent children.

The Family Allowance introduced by Beveridge had two key features. First, it was a universal, flat-rate payment which did not vary according to people's financial circumstances. From the richest family to the poorest, everyone qualified for the same amount.

This may seem inefficient from an economic point of view, for many families were clearly earning enough without needing additional government assistance. But by insisting on flat-rate universalism, rather than targeting the most needy, Beveridge was attempting to minimise the negative impact that receipt of government payments can have on people's willingness to work.[10]

Beveridge understood that when the government tops-up people's incomes, there will always be some workers who respond by reducing the amount of work

10 Nolan P (2006), 'Tax relief for breadwinners or caregivers?' in *Journal of Comparative Policy Analysis*, vol.8, No.2, pp.167-183.

they do (this is what economists call a 'substitution effect') because they can achieve the same living standard with less effort than before.

In addition to this substitution effect, government payments that are targeted specifically on the poor can also have a serious, negative impact on work incentives for those who want to improve their incomes. This is because 'means tested' benefits effectively 'reward' those with least money and penalise people as their earnings rise. For as long as you remain poor, you are eligible for a benefit, but once your earnings start to rise, government help tapers off, which means you can find yourself working longer hours or doing more difficult work for very little extra net income.

It was this disincentive effect created by means testing that Beveridge wanted to avoid by insisting that Family Allowances should be universal and flat-rate . By giving everyone the same amount per child, there would be no penalty on those who worked harder to increase their incomes, and no penalty on people moving from unemployment or sickness back into paid work. Work disincentives would not be avoided completely (there would still be some substitution effect), but they would be minimised.

The second, key feature of Beveridge's Family Allowance was that it was a cash payment made on a regular basis to the person who was caring for the children (almost always the mother). This effectively gave wives their own source of funds, independent of any money handed over by their husbands.

Unlike tax allowances, which benefited the husband and which may or may not be handed on to the wife and children, the Family Allowance went directly to the 'principal carer', which (it was assumed) increased the likelihood that the money would be spent to the benefit of the children.

Of course, the social reforms introduced in the 1940s went much further than just introducing Family Allowances. A new system of National Insurance was set up to strengthen people's protection against poverty in the event of sickness, widowhood, old age or unemployment; and the National Health Service offered health and dental care on the basis of 'need' rather than capacity to pay. All of this impacted on the nation's families.

But in terms of direct financial assistance, the crucial elements of family policy after World War II were tax allowances for workers with families (to reduce the tax levied on incomes which had to be shared among several family members), and a universal family payment (to top-up the incomes of all families, irrespective of their financial circumstances).

This system of financial support reflected a society where children were almost all being raised in two-parent families, where most families had one adult in paid employment and one at home raising the children, and where divorces were rare and unemployment was low.

By the time the 'Great Disruption' had run its course, however, none of this held true any longer. Over the last 40 years, family life has been turned upside down, and successive governments have been struggling to develop new policies which more adequately reflect the very different circumstances in which many people in Britain now live.[11] This has resulted (among other things) in an explosion of government spending which has spectacularly gathered pace in the last few years.

11 This is true in most developed countries, not just in Britain. Shirley Gabel and Sheila Kamerman review family policies in 21 countries and conclude: "Whereas the primary goal of family benefits at the close of the 1970s was to supplement the income of families with children, the current goals of family policies have expanded to include balancing work and family responsibilities; providing incentives to work; enhancing and strengthening the development of young children; targeting help to families considered most vulnerable…" ('Investing in children' in *Social Service Review*, June 2006, p.260-1). This expansion of aims directly reflects changes in family form and structure.

The rising cost of family support

The level of government financial support for families hardly changed in Britain between 1975 and 1990. Real spending rose from £10 billion in 1975 to £12 billion in 1984, and then fell back again. But after 1990, spending began to accelerate rapidly, and it has risen markedly since 1997, when New Labour came to power.

It has been estimated that government spending on 'child-contingent support' for families (i.e. financial assistance paid only to people with children) rose by more than 50% in real terms between 1997 and 2003, reaching £22 billion by 2003.[12]

In 2003, the UK government spent an average of £32.57 per week in cash payments and tax allowances for every child in the country. This represented about 15% of the average UK household's disposable income. Although this was comparable with the level of support offered in many other European countries,[13] it represented a huge jump on previous levels of support in the UK. Back in 1975, each child got only £13.41 (expressed in 2003 prices).

> "The fact that spending has continued to go up means that smaller numbers of children are now attracting much higher per capita levels of expenditure than they did in the past"

Indexed to prices, government-financed family support rose by 143% from 1975 to 2003 (indexed to earnings, it rose by 62%). Most families have benefited, but the lion's share of this increase has gone to sole parent families. The average couple with one child saw its child-contingent receipts from government rise from 3.4% to 5.7% of their combined total disposable earnings between 1975 and 2003, but the average sole parent with one child saw her/his child-contingent government payments increase from 14.7% of disposable income in 1975 to 32.7% in 2003.[14]

All this increased spending means financial support for families with children now absorbs a greater slice of the government's budget than ever before (up from 3.4% to 4.7% of total government spending since 1975). Expressed as a proportion of GDP, government family spending is up from 1.5% to 2.0%.[15]

On the face of it, this huge rise in government spending on children seems odd, for economic growth means that average real incomes have been rising over time. We might therefore have expected people's need for government aid to have fallen rather than increased. Moreover, declining fertility rates mean that the number of children in the country has been shrinking. Fewer children should have led to less government spending, not more. The fact that spending has continued to go up means that smaller numbers of children are now attracting much higher per capita levels of expenditure than they did in the past.

Part of the explanation for this apparent paradox lies in a change in political priorities. Since 1999, Labour governments have set as a major policy target the reduction of child poverty rates. They have pursued this aim by increasing the flow of cash transfers to lower-income families (particularly sole parents). One reason why a smaller number of children is having much more money spent on them is that policy has shifted towards a more aggressive income redistribution agenda.

12 Adam S and Brewer M (2004), *Supporting Families*, Bristol: Policy Press. Brewer M, Ratcliffe A and Smith S (2008), *Does welfare reform affect fertility?*, Institute for Fiscal Studies, *Working paper* 08/09.

13 This is about the same level of spending as in Ireland, France, Germany and Denmark, but is rather more than in Sweden, Italy, Spain and the Netherlands. See Corak M, Lietz C and Sutherland H (2005), 'The impact of tax and transfer systems on children in the European Union', *Innocenti Working Paper*, Florence: UNICEF, p.20.

14 Adam and Brewer (2004), p.15.

15 Ibid, p.54.

A bigger part of the explanation, however, lies in the fallout from the 'Great Disruption'. Before the 1960s, almost all families with children had their own source of earnings (the adult male worker). The government's task was therefore relatively manageable: to top up the earnings of the poorest and biggest families, and support the few families where the death of the principal breadwinner threatened penury.

Today, by contrast, many families have no earnings of their own – 1.7 million children are growing up in families where nobody has a job.[16] Changes in the labour market over the last 30 years have driven up the number of couples with children where neither adult has a job. And changes in family life have led to increased numbers of single-parent families where it is often difficult for one adult to combine full-time paid employment with child-rearing responsibilities. Where a husband used to be principal provider, the government now has to step in.

Table 1: Dependency on government financial support by different types of households, 2006

Household type	No state support %	50% or more of income from government %
One adult working age		
Male	63	26
Female	69	22
Two adults working age	77	6
Sole parents		
One child	2	54
2 children	1	63
3+ children	–	76
Couple families		
One child	5	10
2 children	2	8
3 children	1	19
All households	30	29

Source: Department for Work and Pensions, *Family Resources Survey 2006-07* Office of National Statistics 2007, Table 3.9. 'State support' includes child benefit and state pension as well as means-tested welfare benefits and tax credits.

Table 1 shows that almost all families with children receive some financial assistance from the government today, but heavy dependency on government (defined as receiving half or more of total income from the state) is concentrated among sole parents. Fewer than one-in-ten couple families with children have to rely on government to provide them with half or more of their weekly income, but more than half of sole parents do so.

16 Department for Work and Pensions, *In work, Better off*, Cm 7130, 2007.

The reason for this high level of state dependency among sole parents is that they tend either not to work at all, or only to work part-time. In 2008, only 5% of couples with dependent children did no paid work, as compared with 40% of sole parents.[17]

The result can be seen in Table 2, which identifies the proportion of household income that comes from their own activities (paid employment, self-employment or investments), as against the proportion that comes from government payments (including tax credits). Couples with children on average generate 90% of their household income from their own earnings, and in this they differ hardly at all from childless couples. Indeed, couples with children are more self-reliant on average than single people without children. Sole parents, by contrast, rely on government for 50% of their income and generate only 42% from their own earnings.

Table 2: Proportion of weekly income sourced from own earnings and from government payments, 2006

Household type	Household earnings %	Government payments %
One adult working age		
Male	86	10
Female	83	10
Two adults working age	91	7
Sole parents	42	50
Couple with children	90	8
All households	76	21

Source: Department for Work and Pensions, *Family Resources Survey 2006-07* Office of National Statistics 2007, Table 3.12

Government assistance for families has therefore increased in the last 30 years mainly because of the huge increase in the number of sole parent families, most of which cannot support themselves unaided. It has been estimated that 60% of the increased per capita government spending on supporting children between 1978 and 1999 came about because of the changes in family patterns that occurred during that period. Only 40% is explained by more generous policies.[18]

Why should we support the cost of other people's children?

With so much public money now being directed at people with children, it is important to ask why the government should be involved at all in the family support business.

Most people who have children choose to become parents. Presumably they anticipate that the pleasures of having children will outweigh the costs they incur. This means the money they spend on parenthood raises their overall levels of

17 Office for National Statistics, *Work and worklessness among households*, ONS, August 2008, Table 1.

18 Adam and Brewer (2004), pp.13-14.

happiness and wellbeing (what economists call their 'welfare'). This being the case, why should the rest of us be required to compensate them for the expenses they incur in pursuing this greater happiness?

A recent survey undertaken by Policy Exchange and Ipsos-MORI asked parents and non-parents whether people who choose to have children should get help from other taxpayers with the cost of raising them.[19] Given that British governments have given parents tax concessions for more than one hundred years, and that family allowances (Child Benefit) have been given to parents for more than sixty years, we anticipated strong public support for family assistance. In fact, however, opinion is surprisingly polarised (Table 3).

Table 3: Views of parents and non-parents regarding taxpayer support for families with children

Which of these statements comes closest to your view?	Parent %	Non-parent %	Total %
People who choose to have children should not expect other taxpayers to help with the cost of raising them	43	49	47
All taxpayers should contribute something to help parents with the cost of raising their children	47	41	43
Total	29	71	100

N (weighted) = 2035. P<0.05
Source: 2009 Policy Exchange/IPSOS-MORI Family Priorities Survey

Public opinion appears to be almost equally divided. If anything, slightly more people believe taxpayers should *not* be expected to contribute than believe that they should (47% against 43%). Not surprisingly, this pattern reverses among parents (parents are more likely to favour taxpayer support than non-parents). But even here, opinion is still quite evenly split, and although the relationship between parental status and belief in taxpayer support for families is statistically significant, it is certainly not strong.

With levels of ambivalence like this in the population as a whole, and even among parents, it should not just be assumed that family assistance is a 'good thing' which governments should continue to offer indefinitely. Just because people with children have received support in the past does not mean they should continue to receive support in the future. People are more affluent than they were one hundred or even 50 years ago, and we have seen that family life has also changed dramatically. Perhaps the case for supporting parents was strong in the past, but has weakened over time. The arguments should certainly be examined afresh.

Whenever the question is explicitly raised of why parents with dependent children should receive financial support from the rest of society, three kinds of answers are commonly offered. Only one is ultimately convincing:

19 Fieldwork conducted 9-15 January 2009. Stratified sample comprising 573 parents and 1,454 others (total sample size = 2,027). Data reweighted to be representative of population as a whole (weighted N=2035).

i. Alleviate child poverty and suffering

One possible reason for supporting families is to improve the quality of children's lives. Unlike adults, who can be held responsible for their own actions, children are at the mercy of their parents when it comes to their standard of living. Wider society therefore has a responsibility to safeguard their welfare.

A child being raised in a poor or deprived family bears no responsibility for his or her plight; nor is it in his or her power to change their circumstances, for they are very much dependent on the actions of their parent(s) or guardian(s). The wider community might therefore be thought to have a duty to intervene to ensure that children enjoy a minimum acceptable level of welfare.

There is also a powerful, longer-term argument for safeguarding children's welfare, for a blighted childhood often results in a blighted adulthood. We know that the early years of a child's life crucially influence both cognitive and behavioural development. If all individuals are to have the opportunity to fulfil their potential, it is important to ensure that young children are not deprived of the material and emotional supports they need in their formative years.

It can also be argued that it is in all our interests that other people's children get a decent start in life, for those who grow up in more deprived homes are more likely to get involved in crime and anti-social behaviour later on, as well as being more vulnerable to unemployment, ill-health and teenage pregnancy. All such behaviours impose a financial burden on taxpayers, so there is a simple economic efficiency argument in favour of preventive intervention early in children's lives.[20]

For all of these reasons, it makes sense for governments to act to try to reduce childhood deprivation.

However, this makes the case for anti-poverty programmes, not for pro-family policies. If the concern is simply to keep children out of poverty, this can in principle be achieved by adopting policies that target poverty rather than policies that target families. As Stuart Adam and Mike Brewer observe: "This redistribution could be achieved by a tax and benefit system that did not recognise children at all: if households with children tend to be poor, a progressive or pro-poor transfer system will benefit them more in any case."[21]

Current family assistance programmes direct money to almost all families with children. Most of the children in these families are not poor. If we want a compelling argument in favour of general family assistance, therefore, we need to look elsewhere.

ii. Reduce free riding and compensate parents for the value of the public goods they create

A second argument in favour of government transfers to people with children is that children are not only 'private goods' who bring pleasure to their parents. They are also what economists call 'merit goods' who bring benefits to everyone else.[22] Seen in this way, it is not fair to expect parents to meet the full cost of raising their children, for everyone else is gaining from the 'positive externalities.' Unless we all make a financial contribution to the costs, non-parents will end up 'free-riding' on parents.

This is less an ethical argument than an economic one. It is an established principle in economics that, where possible, the value of 'externalities' should be built into the prices people pay and receive for goods and services. If your activities are creating negative externalities for other people then you should compensate them; if you are creating positive externalities, they should pay you. If the value of externalities is

20 Banks J and Brewer M (2002), *Understanding the relative generosity of government financial support to families with children*, Institute for Fiscal Studies, *Working Paper* 02/02 p.10.

21 Adam and Brewer (2004), p.4.

22 Greener K and Cracknell R (1998), 'Child Benefit', House of Commons, *Research Paper* 98/79, p.17.

not priced, producer behaviour will be distorted. In the case of positive externalities, producers might stop supplying merit goods altogether if they have to bear all the costs while strangers take a free ride enjoying the benefits.

Parents who produce children create benefits for everyone else. Most fundamentally, other people's children give us all a future. The 2006 film *Children of Men* explored what our world would be like if people suddenly became infertile and stopped having children. The result was a collapsing society of misery, hopelessness and terror as people faced the reality of their impending extinction as a society and a species.

> The key economic question is whether people really would stop having children if the subsidies were withdrawn

More directly and less dramatically, we also benefit from others choosing parenthood because children are the next generation of workers, consumers and taxpayers. We all need younger people growing up behind us to create the new wealth that will finance the health care and pensions that we expect to receive when we grow older and stop working. This is precisely why governments throughout the western world are so concerned about falling fertility rates, for as the population ages, a 'top-heavy' demographic structure will put extra burdens on a smaller working generation as they try to support an increasingly large cohort of retirees.

All of this is true, but the key economic question is whether people really would stop having children if the subsidies were withdrawn. This seems unlikely, in which case the economic argument for compensating them for the value of the public goods they are providing looks much weaker.

We shall see later that pro-natalist policies which offer financial inducements to people to have children can have some impact on birth rates, particularly at the lower end of the income distribution. However, it is almost certainly the case that most parents in Britain would still have children even if there were no government assistance available.[23]

If this is the case, then spending more than £20 billion a year on income transfers to families is economically irrational, for most people would still have children without this help. Subsidising parents to encourage them to have children is like subsidising a company to continue production when it would carry on even without government hand-outs. Much of this assistance seems to be unnecessary (what economists call a 'deadweight cost').

iii. Restore horizontal equity

The final argument for helping parents with the costs incurred in raising their children is rooted in the proposition that every individual citizen has a right to a subsistence income. Where possible, individuals are expected to earn this money for themselves, in which case the state should not tax them until they have achieved this minimum income level. Where they cannot earn an income for themselves, the community provides it, through the agency of the state.

This principle of a right to a basic, subsistence income logically applies to all individuals, be they children or adults. This is because a child needs a certain minimum income if it is to feed and clothe itself, just as an adult does. The only difference is that a child relies on its parents to provide this income until it is in a

23 Adam S, Brewer M and Reed H (2002), *The benefits of parenting*, Institute for Fiscal Studies, *Commentary* No.91.

position to generate an income for itself. This means that parents are required to supply a subsistence income, not only for themselves, but also for their children.

Once people become parents, we require them (by law, as well as by convention) to spend some of their money fulfilling various functions on behalf of their children. In the end, they have no choice in this, because the society invests children with certain enforceable rights over their parents (e.g. the right to be fed, clothed, housed and educated). A parent who fails to deliver on these services can be charged with neglect.

What does it cost parents to raise children?

There are three different ways analysts try to determine how much of their income parents have to sacrifice in order to meet the living costs of their children:

1. The 'budget standards' approach, which draws up a list of 'essential items' that have to be bought for a child of any given age, and adds up their total cost.
2. Surveys asking people how much they think children cost.
3. Comparing how much families with children actually spend as compared with childless households enjoying a comparable standard of living using surveys of household expenditure.

These different approaches produce different results. Methods based on actual expenditure are probably the most reliable, for they look at what families actually spend, rather than what people think they should spend.

One UK study based on expenditure comparisons estimates that a childless couple would need to increase their income by 14% to maintain their standard of living after having a child.[24] This figure rises to 25% if they have two children, and to 32% for three children. As children get older, so the cost burden rises. For children over the age of 12, this research estimates the additional income required would be 22% for one child and 44% for two.

These estimates correspond fairly closely with results found by other researchers in the USA, Australia and elsewhere. They suggest that a couple with two young children on the average household income (in 2006) of around £30,000 p.a. before tax and benefits would need about £7,500 more each year if they were to retain the standard of living that an equivalent childless couple was enjoying.[25] This would rise to more than £13,000 p.a. more if their children were teenagers.

But if we insist that parents should devote a certain slice of their income to their children, it follows that we should also recognise that part of their income is not, in this sense, theirs. It is earned by them on behalf of their child. This means that if two adults earn the same income, but one has children while the other does not, the former is earning less for him or herself than the latter, in which case he or she should be taxed less, or should be eligible for higher welfare payments. Peter MacDonald makes the point clearly:

> *"Taking two couples on the same level of income, the couple with children has considerably higher expenses than the couple without children, expenses that, by law, cannot be set aside. The principle of horizontal equity argues that, in recognition of the social value of children, the tax-transfer system should redress this discrepancy."*[26]

24 Discussed in D'Addio A and D'Ercloe M (2005), 'Trends and determinants of fertility rates in OECD countries' in *Social Employment and Migration Working Papers*, No.27, OECD, p.49.

25 National Statistics, *Household Income*, http://www.statistics.gov.uk/cci/nugget.asp?id=334

26 MacDonald P (2003), 'Reforming family support policy in Australia' in *People and Place* vol.11, no.2, p.3.

The crucial point about this principle is that it applies to all parents, irrespective of their income or economic circumstances.[27] We do not help with the cost of children because parents need financial assistance (although some might), nor because we benefit indirectly from their fecundity (although we do), but because we require parents to spend part of their income looking after other, junior, citizens. One person's income, therefore, has to be spread among several other people, and for this, the income earner should be compensated.

We saw earlier that the tax system in Britain used to recognise this core principle, for workers who had to share their wages with dependent family members paid less tax than equivalent workers who had only themselves to support.

Today, however, every worker earning up to £100,000 per year is entitled to the same annual tax-free earnings allowance (worth £6,035 in 2008/09), irrespective of whether or not they have family dependents. This tax-free allowance effectively represents a minimum subsistence income level – by allowing each worker to retain £500 per month before paying tax, the government is recognising that people need this amount just to keep body and soul together.

But workers with dependent children have to use their income to ensure the subsistence of their children as well as themselves. Once they have paid for the needs of their children, their net income remaining to cover their own subsistence is obviously a lot lower than that enjoyed by equivalent workers who have no family responsibilities.[28] Yet in Britain today, they pay exactly the same amount of tax (although if they qualify for welfare, the government compensates them with additional cash benefits).

One way the cost of raising children could be recognised is by giving children their own tax-free allowance, which their parents could then claim on their behalf. This would mean that working parents would pay less tax than equivalent workers who do not have to share their incomes in this way. This additional tax allowance would not represent an anti-poverty subsidy, nor a pro-natalist incentive, but an equitable adjustment to reflect the fact that several people depend on that one income:

> *"Looked at in this way, tax reliefs for spouses or children are not to be seen as subsidies or as incentives but as achieving a greater measure of equity as between one type of taxpayer and another."*[29]

As we have seen, the UK tax system used to recognise this horizontal equity principle. This is no longer the case, however, and later in this report we shall consider whether our current 'individually-based' income tax system needs revising to make it consistent with the horizontal equity condition.

Proposition 1

Although public opinion is evenly divided on whether taxpayers should assist parents with the costs of raising their children, the principle of horizontal equity requires that all parents should be compensated for having to share their income with additional dependents. This means that tax should be levied on incomes according to the number of family members who depend upon them for their sustenance.

27 Indeed, it could be argued that higher-earning families should receive *more* than lower earners, since they will pay more to raise each child than a poorer family will, so they will fall proportionately further behind an equivalent, childless household. See Adam, Brewer and Reed (2002), p.14.

28 Immervoll H, Kleven HJ, Kreiner C and Verdelin N (2008), *An evaluation of the tax-transfer treatment of married couples in European countries*, Unpublished paper, London School of Economics, p.1.

29 Draper D and Beighton L (2008), *Taxation of married families*, London: Care, p.29.

2
What Should Family Policy Do?

Should governments try to influence the way families behave?

If there is a strong case for helping parents meet the costs of raising their children, the next question to ask is whether or not this assistance should be given unconditionally. Is it appropriate for governments to use the financial leverage represented by expenditure of more than £20 billion every year to promote or deter certain kinds of parenting, or even certain patterns of relationships?

In a liberal society, there is a powerful argument in favour of governments remaining neutral when it comes to family policies. Governments that provide cash assistance to families should scrupulously avoid getting involved in the 'private realm' of family life, for different people have different ideas about how to live their lives, and none of us want politicians telling us how to go about it.

"It is one thing for governments to allow adults to live their lives at they see fit, but if this impacts negatively on the welfare of their children, there may be an overwhelming case for intervening to change what they are doing"

There are, however, two equally powerful arguments pointing the other way.

Firstly, family policy should have regard for the interests of children, who cannot make their own judgements about the best way to live, and who are generally at the mercy of the decisions made by their parents. It is one thing for governments to allow adults to live their lives at they see fit, but if this impacts negatively on the welfare of their children, there may be an overwhelming case for intervening to change what they are doing.

Secondly, achieving policy neutrality is easier said than done, for whenever governments take money away from one set of people and direct it to another, they inevitably send out signals about 'appropriate' and 'inappropriate' behaviour. Family policies will always end up influencing people's behaviour in one way or another, even if they do not intend to. It is simply not possible to spend more than £20 billion a year on family transfers and not influence people's behaviour.

Failing to impose conditions on receipt of money is no more 'neutral' than imposing conditions. If a government gives money indiscriminately to 'irresponsible' parents as well as to 'responsible' ones, then it is making a moral statement just as much as if it laid down strict rules of eligibility which excluded certain kinds of parents from receiving payments. Tolerating bad parenting is no more 'neutral' than penalising it. And just as conditionality is likely to promote one kind of behaviour, so unconditionality is likely to promote another. Patricia Morgan makes the point clearly:

> *"By rewarding some behaviours and penalising others, tax and welfare systems affect the preference and behaviour of individuals not just through hard cash calculations but by (unavoidably) embodying and promoting certain values and assumptions. In other words, they send out messages where something that pays a penalty is perceived as unworthy and that which receives a bonus is to be approved and emulated."*[30]

We have already encountered one example of how government payments can unintentionally promote undesirable behaviour in our discussion of the 'moral hazard' problem encountered by attempts to boost the incomes of poorer people. Offered an income supplement, some people will simply reduce the amount of paid work they do. This leaves them no better off financially, reduces levels of economic activity in the economy as a whole, and increases the burden on taxpayers. Over time, it might also encourage others to follow this example.

This is a seemingly intractable problem encountered by policies aimed at boosting the incomes of the poor.[31] The OECD calculates that for every 1% increase in poverty reduction achieved by welfare states in the advanced countries, the number of jobless families increases by 0.63%, yet we know that joblessness is itself a major cause of poverty. In the UK, this problem is even worse: here, a 1 point reduction in poverty increases the proportion of jobless families by 0.92 of a point. The OECD concludes: "More generous support to poor families is associated with higher levels of family joblessness."[32]

Benefits targeted at particular groups such as sole parents encounter similar problems. More spending increases the attractiveness of these benefits and swells the number of people applying for them. It also legitimises and normalises the behaviour to which they attach, so over time, the number of claimants multiplies and policies intended to reduce neediness end up increasing it. International comparisons suggest, for example, that for every €1000 above the European average a country spends supporting sole parents, the probability of a woman in that country becoming a single mother increases by 2%.[33]

This 'signalling' process works in reverse, as well. Introducing targeted benefits encourages the behaviour in question; removing them discourages it. Scrapping tax allowances for married couples, for example, signifies that marriage is no longer officially favoured, and the result is likely to depress the marriage rate as cohabitation or sole parenting become more 'normal' and accepted.

It is therefore difficult for governments to devise 'neutral' family expenditure policies. This being the case, if any spending policy is likely to influence the way people behave, why not at least try to influence behaviour in a desirable rather than undesirable direction? If we know that certain practices are beneficial to the wellbeing of children, for example, why not use family policies to promote and encourage them?

One problem with this is that governments do not necessarily know what the best practices are. Experts may believe today that a particular kind of parenting is beneficial and should be promoted, but later research may lead to a change of mind. The history of British public policy is littered with examples of grand designs promoted by governments at huge cost but which were later found to have been ill-advised, or even disastrous.

30 Morgan P (2007), *The war between the state and the family,* Institute of Economic Affairs, p.124. See also Social Justice Policy Group, *Breakthrough Britain, vol.1: Family Breakdown*, Centre for Social Justice, July 2007, p.85.

31 The trade-off between poverty relief and work incentives is unavoidable outside of a universal payments system: "No miraculous solution can be advanced short of paying benefit to everybody or nobody" (Taylor M (1998), 'Modernisation of Britain's tax and benefit system', *Budget paper no.2*). Mike Brewer finds that the UK Labour Government's desire to reduce child poverty has compromised financial work incentives: *Welfare reform in the UK,* Institute for Fiscal Studies, *Working Paper* No.20/07, 2007, p.27.

32 See Whiteford P and Adema W (2007), *What works best in reducing child poverty: A benefit of work strategy?*, OECD Social employment and migration *Working Paper* No.51, p.37.

33 This estimate controls for inter-country variations in age, education, unemployment, wages and tolerance of sole parenthood. Morgan (2007), p.109-10.

There is also the problem of unintended and unanticipated consequences. The more government sets its mind to promoting a particular outcome, the more certain we can be that it will also generate many other results, at least some of which are likely to be harmful.

What is more, family policy is an area where governments are likely to have incompatible objectives. As we shall see, some of the outcomes governments might want to pursue through family policies can only be achieved by undermining other, equally desirable, ones. Politicians talk about 'balancing' the demands of work and family, for example, but this rhetoric often disguises some uncomfortable and unavoidable dilemmas. For example:

- We cannot strengthen women's participation in the labour market and at the same time enable mothers to stay at home to nurture their young children. We know that women who stay off work for more than four or five months after having a baby begin to jeopardise their future careers,[34] but we also know that children in their first year of life develop much better if they are looked after at home than if they are placed in formal childcare.
- We cannot make the tax system fairer for single-earner couples without reducing the rewards to those partners who want to engage in paid work, for helping those who live off one income inevitably means reducing the relative rewards that come from having two.

We shall consider these and other similar dilemmas in more detail later in this report.

Proposition 2

Any attempt to redistribute income among different kinds of families and households will end up encouraging some kinds of lifestyle choices over others. There is no neutral policy. Governments should ensure that family support expenditures do not encourage or sustain ill-advised patterns of family life among those who receive them.

What might family policy try to achieve?

If, cautiously, we accept that governments might try to 'nudge' people in certain desirable directions through their family support policies, then what are the appropriate outcomes it should be aiming to promote?

Should family policy promote marriage?

There is overwhelming social scientific evidence that, other things being equal, children are better off in all sorts of ways if they are raised by their two natural parents, rather than by one parent, or in a reconstituted step or 'blended' family.[35] Should governments therefore use family policy to promote married parenthood, or at least to try to support stable coupled parenting?

Children of sole parents are on average born with lower birth weights than those brought up by both of their natural parents. They are also more prone to Sudden Infant Death Syndrome, are more likely to be neglected or abused, expe-

34 Even providing more generous child payments appears to depress women's labour force participation, for the extra cash reduces their need to earn money: Dex S and Joshi H (1999), 'Careers and motherhood: policies for compatibility' in *Cambridge Journal of Economics* vol.23, pp.641-59.

35 A 'blended' family is one where both adult partners bring children from a previous relationship into the new household. For sources reviewing the evidence on sole parents, step and 'blended' families, see footnote 5.

rience more academic problems at school, have lower average reading and maths scores, have worse truancy records, are more likely to drink, smoke and take drugs in adolescence, are more prone to depression and mental illness as they grow older, report more long-term emotional and behavioural problems, are more likely to suffer unemployment as adults, have higher rates of poverty and homelessness as adults, are more likely to break the law and to end up in prison by the age of 30, and are more likely to become parents at a young age and to repeat the cycle they have gone through by themselves having children without a resident partner.

“Children are likely to fare better if their parents stay together, and their parents are more likely to stay together if they are married”

In many cases, these outcomes are even worse for children raised in step or ‘blended’ families.

It is sometimes argued that these problems simply reflect lack of money. Sole parents tend to have lower incomes than couple families, and a low income can itself result in adverse social and psychological outcomes for children. But the evidence indicates that the parental situation exerts an additional, independent effect on child wellbeing, over and above the effect attributable to the income of the parent. Topping up the incomes of sole parents is not going to make the differences in child wellbeing measures disappear.

There is also clear evidence that parents are more likely to stay together if they are married than if they merely co-habit. Nearly one-third of parents who are cohabiting or are ‘closely involved’ separate before their child’s third birthday, and 43% split by the time the child turns five. These proportions compare with just 6% and 8% respectively of married parents.[36]

There is an element of self-selection here, of course: more committed couples are more likely to marry, and more committed couples tend to stay together more successfully. But the pattern is not entirely explained by self-selection – it appears that the very fact of marrying itself contributes to the success and longevity of a relationship.[37]

So children are likely to fare better if their parents stay together, and their parents are more likely to stay together if they are married. Put the two pieces of information together and we have a seemingly compelling argument for the government to adopt family support policies which favour married parents.

Despite this, New Labour in particular has been loath to draw any value judgements about family forms, and it has explicitly distanced itself from supporting what it calls the “nuclear family ideal advocated by some”. It seeks to normalise sole parenting by assuring us that sole parent rates today are similar to those in the fifteenth century, and it problematises married parenting by insisting that “the nuclear family ideal” peaked in the 1950s and is now in retreat.[38] It insists that families should be supported “regardless of form or structure.”[39]

Britain’s Labour government acknowledges that children raised in sole parent and step and ‘blended’ families tend to do worse on a wide range of outcomes than children raised by their two natural parents, but it immediately insists that “increased pluralism of family structures need not lead to poorer outcomes”.[40] It claims that the problem is mainly financial, and that what damages children

36 Social Justice Policy Group, *Breakthrough Britain, vol.1: Family Breakdown*, 2007, p.9; Social Justice Policy Group, *Family Law Interim Report*, November 2008, p.7.

37 Social Justice Policy Group, *Family Law Interim Report*, November 2008, p.12,21.

38 Cabinet Office Strategy Unit and Department for Children Schools and Families, *Families in Britain: An evidence paper*, December 2008, p.18.

39 Ibid, p.108.

40 Ibid, p.84.

is not the absence of one parent, but the souring of the relationship between parents.

The Conservatives, by contrast, have recently suggested that married couples should once again be favoured by the tax system.[41] They are likely to find strong public support for such a policy, for a poll conducted in April and May 2007 found 80% of people agreeing that the tax and benefits system should offer extra support for people who are married.[42] The problem, though, is that those who miss out as a result of such a policy are likely to be more vociferous than the majority who approve of it.

Should family policy try to promote higher fertility?

Although the UK government is concerned about the impact of falling birth rates on the ageing of the population, promoting increased fertility is not an explicit objective of family policy in this country. This is partly because Britain's fertility rate is not plummeting as much as the rates in many other OECD countries (see Table 4). It may also have something to do with the continuing association in many people's minds between pro-natalist policies and the rhetoric of German Nazism and Italian fascism.

Table 4: Fertility rates, women's employment and child poverty, comparing UK with other OECD countries

	Total fertility rate	Employment/population ratio		Child poverty
		All women	*Sole parents*	%
UK	1.80	66.8	56.2	16.2
OECD	1.63	56.8	70.6	12.0

Source: OECD, Babies and Bosses (2007), Table 1.1.

Britain's total fertility rate (given as 1.8 in Table 4, but now a little higher at 1.9) is considerably below replacement level, but it is in countries like Japan and Korea, where women of childbearing age are now having an average of just 1.3 children each, that the fertility issue is dominating the family policy agenda. In Korea, a 'Master Plan' has been introduced which aims to raise fertility by increasing support for childcare, expanding maternity leave and introducing pension scheme credits for workers who have children.[43] Similarly in Japan, the 'Angel Plan' has tried to raise fertility by improving access to child care and making workplaces more family-friendly.[44]

Interestingly, some of the policies introduced in these countries are not dissimilar from the family policies pursued in recent years in the UK. The professed rationale is, however, very different. Here, the explicit aim of policies like subsidised childcare and family tax credits is not to encourage women to have children, but is to tackle high levels of child poverty and to raise the employment rate of sole parents. On both of these measures, Britain compares poorly with most other countries.[45]

41 The proposal is for a married couple's allowance that would raise couples' incomes by £32 per week. See Brewer M, Francesconi M, Gregg P and Grogger J (2009), 'In-work benefit reform in a cross-national perspective' in *The Economic Journal,* vol.119, p.F2.

42 Social Justice Policy Group, *Breakthrough Britain, vol.1: Family Breakdown*, 2007, p.6.

43 OECD, *Facing the future: Korea's family, pension and health policy challenges,* 2007.

44 National Institute of Population and Social Security Research, *Child related policies in Japan*, 2004. Japan also pays a modest Child Allowance to families, and offers tax allowances for dependents.

45 OECD. *Babies and Bosses*, 2007, p.13.

Even though the British government has not made increased fertility one of its priorities, there is some evidence that the increasing generosity of family payments since 1999 has contributed to a small increase in the birth rate. This effect has been concentrated on poorly-educated women, for they were the main beneficiaries of the new tax credits which are targeted at poorer, and therefore generally less well-educated, families. Poorly-educated women received an average 46% increase in family benefits, and they responded by producing 45,000 more children than they otherwise would have done.[46] Better-educated women, by contrast, have received much less of the government's cash, and they are anyway unlikely to have more children simply because the government starts providing more generous benefits.[47]

Most research around the world claims to find little effect of government family expenditure on overall fertility levels, although the evidence is mixed.[48] Some North American studies have found that tax breaks can have some impact, but the OECD finds little association between the amount of horizontal redistribution taking place through a country's tax and benefit system and its total fertility rate.[49] Commentators have often linked France's increased fertility rate since 1995 to its increasingly generous child cash benefits, but some analysts suggest the changes in government family payments there played almost no part in raising the birth rate.[50]

It is much the same picture with other kinds of family help, such as subsidised childcare or enhanced parental leave. Although help with childcare costs might make parenting more attractive to career women, there is no evidence of a strong relationship between the cost of childcare in a country and its fertility rate.[51] Indeed, the UK has one of the most expensive childcare systems in Europe (as a percentage of household income), but as we have seen, our fertility rate is above the European average.

The OECD has attempted to model the combined effect of family tax and benefits, parental leave and childcare policies on international fertility rates. It predicts that the UK could increase its fertility rate to replacement level (2.1 per woman) if it increased its tax/benefit subsidies to families and reduced childcare costs. But the authors of the OECD report warn that their findings should be treated "with caution", and even if their modelling is reliable, the cost of such a policy would be huge if it were to reach its target. On the OECD's estimates, it would take a 25% increase in the value of tax/benefit transfers to families just to raise the fertility rate in the UK by 0.05 children per woman.[52]

The conclusion from all of this research is that the impact of family policies on fertility rates is generally fairly weak, and research evidence linking the two is often inconclusive or even contradictory.[53] In the case of parental leave, the association actually runs the 'wrong' way (i.e. fertility falls as parental leave becomes more generous).[54] However, economic incentives do seem to have some impact on fertility levels among lower-income groups.

Should family policy promote female labour market participation?

The entry of more women into the labour force has been one of the main social changes to have occurred in Britain in the last 50 years. Full-time female employment rates have actually remained fairly stable ever since the mid-nineteenth century (the percentage of women of working age employed full-time fell from 42%

46 Brewer M, Ratcliffe A and Smith S (2008), 'Does welfare reform affect fertility? *Institute for Fiscal Studies Working Paper* 08/09.

47 Kirby J (2005), *The price of parenthood*, Centre for Policy Studies.

48 Similar policies also often have different effects in different countries. In the UK and the Netherlands, for example, families have adopted a 'one and a half breadwinner' model which means their fertility decisions are unlikely to be influenced by policy changes (like subsidised long-hours child care, or more generous maternity leave). In other countries (like France, Denmark or Belgium), by contrast, such policies might have a bigger effect. Fukuda N (2003), *Three worlds of pronatalism?*, Tokyo: National Institute of Population and Social Security Research, *Working Paper Series* (E), no.18.

49 Review by Sleebos J (2003), 'Low fertility rates in OECD countries' in *OECD Labour Market and Social Policy Occasional papers*, No.15, p.44. However, Anna d'Addio and Marco d'Ercole ('Trends and determinants of fertility rates in OECD countries' *Social, Employment and Migration Working Paper* 2005, OECD) find little effect, and the National Institute of Population and Social Security Research report, *Child related policies in Japan*, finds no correlation between levels of government spending on families and national fertility rates, comparing 13 different countries.

50 The Allocation Parentale d'Éducation, worth €500 per month for three years to parents of newborn children, was extended from three- to two-child families in 1994, but the belief that this helped raise fertility "should be taken with a grain of salt" (Laroque G and Salanie B (2004), 'Fertility and financial incentives in France' in *CESifo Economic Studies* vol.50, p.448).

51 D'Addio A and D'Ercole M (2005). Sleebos (2003) reports a "positive" but "small" effect (p.44).

52 D'Addio A and D'Ercole M (2005), p.65.

53 Even Sleebos, who offers the 'subjective' judgement that family policies do have some positive effect on fertility, admits that: "Findings are often inconclusive and contradictory" and that "few generalisations can be drawn" (p.48).

54 D'Addio A and D'Ercole M (2005).

in 1851 to 32% in 1901, hit 30% in 1951, and then rose to 36% in 1994).[55] Part-time female employment has, however, expanded significantly since the 1950s, rising from 11% in 1951 to 44% in 1995, and this has helped push Britain's overall rate of female workforce participation to well above the OECD average (Table 4).

Since the 1970s, government policies have been strongly supportive of women working. Equal pay and equal opportunity laws, rights to maternity leave, the move to individual rather than family taxation, and increased childcare support have all been important in supporting women who want to combine family and career. The single-earner family, where the husband works for a wage while the wife stays home to raise the children, has become an exception. Even among couples whose children are below school age, only 33% now have a full-time working father with the mother at home; 32% combine a male full-time wage with female part-time employment, and 25% have both partners working full-time.[56]

As the number of households containing two adult earners has increased, so it has become more difficult for single earner families to keep their heads above water. House prices, for example, have been partly driven up by the enhanced spending power of dual earner households. The move to dual earner families is thus self-reinforcing: the more of them there are, the harder it becomes not to join them.

Two principal factors account for governments' enthusiasm in promoting female employment. One is the ageing population, for the impact of falling birth rates on economic output can be countered by expanding the size of the workforce by drawing on other pools of potential labour. This can be done by encouraging existing workers to delay retirement, by raising employment levels among groups like the disabled, or by sponsoring increased immigration by young, overseas workers; but the biggest pool of unused labour waiting to be tapped has been women with family responsibilities.

According to the OECD: "In all countries, increasing female employment is emphasised as being crucial for maintaining economic growth and/or affordable pension systems."[57] The report goes on to suggest that this has been a particularly important consideration in Britain, but we are not alone in this. Concern about future output has led the EU to set its member states a formal target of a 60% female employment rate by 2010 (a figure Britain has already passed).[58]

The other reason governments have wanted to increase female workforce participation is a concern to promote 'gender equity'. For women to achieve equality with men, it is assumed that they must participate in paid labour to the same extent as men do.

Research by the UK Cabinet Office Women's Unit actually shows that many women in Britain have no desire to work in full-time careers. Women are evenly divided over whether they believe being a housewife is less fulfilling than paid work, while one-third think that home and family should be a woman's major focus in life. Full-time mothers generally tell researchers that it is their choice to remain home and raise their children, and only 5% of mothers say they would choose to work full-time if there was no financial need to do so.[59]

Overseas, too, research has found that many women do not want to work full-time while they are raising their children. In France, when child benefits became more generous, women responded by reducing their participation in paid work.[60]

55 Hakim C (1996), *Key Issues in Women's Work*.

56 Jaumotte F (2003), 'Female labour force participation', *OECD Economics Department Working Papers* No.376, Table 1.

57 *Facing the future*, OECD, 2007, p.28.

58 *Babies and Bosses* (2007), p.14.

59 Hakim C, Bradley K, Price E and Mitchell L (2008), *Little Britons: Financing Childcare Choice*, Policy Exchange.

60 Dex and Joshi (1999), p.645.

In Sweden, women with young children deserted the state nursery system in droves once they were offered the alternative of extended parental leave that allowed them to stay at home and look after their infant children themselves.[61]

Despite what women say they want, however, academics and policy-makers throughout the western world have been on a mission for the last 30 years to 'free' them from domestic labour, uncouple their dependency on a male wage, and get them into full-time careers of their own. As an earlier Policy Exchange report concluded:

> *"The Government talks about providing choice for women, but in practice its policy is designed to encourage mothers to choose paid work in preference to full-time motherhood, even if that is what they prefer."*[62]

This can only be done, of course, if some way is found to look after young children for extended periods while both their parents are at work. The drive to raise female employment rates thus necessarily entails policies designed to increase the supply of affordable childcare.

There is a lot of evidence that young children – particularly those in their first year of life – are best looked after by a parent or family carer, rather than in institutions. Common sense wisdom concurs: 80% of Britons think young children should be looked after at home by a parent rather than being placed with a childminder or a day nursery.[63]

Older children, from around age three onwards, do seem to benefit from time spent outside the home in nurseries or pre-school: they learn to socialise with other children, they benefit from exposure to new learning environments, and those from more deprived backgrounds in particular can make real cognitive, social and emotional gains as a result of the additional stimuli and structured play opportunities they encounter.[64]

But at one – or even two – years of age, children's emotional and intellectual development can easily be impaired if they are left on a regular basis in long-hours institutional care. This is the time when the 'emotional brain' is being formed (created in the first 18 months) and when synapse formation in the visual cortex is occurring (completed by age two).[65] Young children exposed to long and sustained periods of institutional care generate higher levels of stress hormone which can damage brain development. They reveal more social and behavioural problems, both at the time and later, as a result.[66]

Modern neuroscience is clear that, in the first year or two of life "intimate, loving, one-to-one interaction" is an "essential input to the child's emotional, physical and cognitive development."[67] This cannot be delivered by long hours institutional care, no matter how well it is financed or how professionally it is managed.[68] Even childcare advocates now admit that removing infants from their parents and putting them into institutional care in the first year of life is probably harmful.[69]

Faced with this evidence, those pushing for higher levels of female workforce participation have started to advocate more generous leave entitlements for parents in the first year of their child's life, so that parents can stay at home to look after their babies without leaving the labour market. A well-publicised report by UNICEF, for example, recently drew attention to the deleterious effects of childcare

61 Adamson P (2008), *The Childcare Transition*, UNICEF, Innocenti Research Centre, Report No.8, p.15.

62 Hakim et al (2008), *Little Britons*, p.19.

63 Social Justice Policy Group, *Breakthrough Britain Vol.1: Family Breakdown*, (2007) p.6.

64 *Babies and Bosses* (2007), chapter 6; Kamerman S et al (2003), 'Social Policies, family types and child outcomes in selected OECD countries', *OECD Social, Employment and Migration Working Papers* No.6; Hansen K and Hawkes D (2009), 'Early childcare and child development' in *Journal of Social Policy* vol 38, p.211-39.

65 Social Justice Policy Group, *Breakthrough Britain Vol.1: Family Breakdown* (2007), p.16.

66 Social Justice Policy Group, *Breakthrough Britain Vol.1: Family Breakdown*, p.76.

67 Adamson P (2008), *The Childcare Transition*, p.6.

68 It is sometimes argued that the problems with childcare could be resolved if the government spent more money on providing a higher level of care with higher levels of staffing and better training. This would still fail to match the quality of interaction between a full-time parent and her/his infant, however. It would also be hugely expensive. As Patricia Morgan points out: "'High quality, low-cost childcare' is a contradiction in terms. Its expense (even if the personnel could be found to provide it) would outweigh the worth of the mother's labour elsewhere" (*Family policy, family changes*, p.109).

69 "Child development is negatively affected when an infant does not receive full-time personal care...for at least the first 6 to 12 months of his/her life" (*Babies and Bosses*, (2007) p.109).

on infants and argued that countries like Britain should provide all mothers with twelve months of paid leave entitlement so they do not have to use institutional care.[70]

The problem with this solution (apart from the cost) is that long periods of maternity leave are known to weaken women's attachment to the workforce. Leave periods of up to four months seem to have no detrimental impact, but beyond about 20 weeks, skills begin to deteriorate and the motivation to return to work declines. Generous maternity leave is therefore the enemy of enhanced female workforce participation – around five months is thought to be optimal.[71]

> "Young children exposed to long and sustained periods of institutional care generate higher levels of stress hormone which can damage brain development, and they reveal more social and behavioural problems, at the time, and later, as a result"

But five months is nowhere near long enough to meet the child development concerns about extended use of institutional child care. From the point of view of the child, it is probably best for one parent to stay home (or for two parents to alternate) for the first two years. From the point of view of women's workforce participation, however, it is best for a parent to return to full-time work after four or five months. There is a tension here which cannot be resolved and which many advocates of greater female workforce participation therefore try to ignore.[72]

Should family policy promote good parenting?

The principle of conditional welfare rights is now established in the UK benefits system, although in practice its application can be less obvious. Not only the jobless, but also some non-employed sole parent and disabled claimants, are now expected to fulfil certain activity requirements, such as work or training, in order to qualify for government payments. The idea that anyone in need has an unconditional right to support has been replaced to a degree by the idea of reciprocity: people are expected to do something to help themselves in return for receiving financial help from the state.

Thus far, this principle has not been extended to family payments, but there seems no good reason why it should not be. Indeed, the logic of conditionality is even stronger in the case of family support, for these payments are not made directly to the intended beneficiaries (the children), but to their agents (their parents or guardians). We argued earlier that the whole point of family payments is that the wider community expects and requires parents to raise their children according to certain minimum standards, so it offers financial help to assist in this. It therefore seems appropriate that these payments should be reduced or withheld in cases where parents do not meet these standards.

Other countries have no problem with this idea. In Mexico, for example, cash payments for poor families were introduced in 1997 with the proviso that recipients keep their children in school and take them for regular health checks.[73] The result has been a marked improvement in school attendance and in childhood malnutrition.

70 Adamson P (2008), *The Childcare Transition*.

71 Beyond a maximum of 4 to 6 months, mothers' labour market position can be "permanently damaged" as they withdraw from work and secure lower earnings – *Babies and Bosses*, p.21. "Taking parental leave for an extended period of time may deteriorate labour market skills and damage future career paths and earnings. Beyond 20 weeks, the marginal effect of additional parental leave on female participation becomes negative'" (Jaumotte, p.25).

72 Hakim C et al (2008), *Little Britons*, p.23.

73 *Babies and Bosses* (2007), p.78.

In Australia, receipt of the lump-sum maternity payment is conditional on having one's child vaccinated. More controversially, pilot programmes have been taking place in various remote Aboriginal communities where there are serious problems of child abuse, drug taking and alcohol bingeing. Both welfare and family payments have been tied to fulfilling conditions around school attendance, child abuse, substance abuse and housing tenancy, and similar, larger-scale trials in eight localities across the country are now under way.[74]

In Britain, the Blair government proposed in 2002 that Child Benefit should be taken away from parents whose children were persistently truanting from school, but the proposal met with fierce resistance from lobby groups which argued that this would be detrimental to the welfare of the children and would punish parents who might be blameless. A former director of the Child Poverty Action Group pointed out that, "The many objectives of Child Benefit have never included the inculcation of good behaviour", and the government backed off.[75]

This response points to an inherent problem in conditional schemes like this: that money is often withdrawn from very needy families, and the children can end up suffering. In Australia, the introduction of work requirements for sole parents with older children hit precisely this problem. Those who failed to participate had their payments stopped, and the federal government had then to enlist the help of the third sector to monitor the impact on their children and to make emergency payments where necessary.[76]

There is, it seems, a choice between two evils. On the one hand, it seems heartless to withhold payments from families where parents fall short of required standards, particularly as this may well mean their children suffer. But on the other, it is clearly wrong and counter-productive to continue handing out family payments to parents who manifestly are failing to meet the minimum parenting standards the rest of us expect and demand, and to do so sends the wrong kinds of messages to the rest of the community.

In his book *Neighbours from Hell*, the former Minister for Welfare Reform, Frank Field, suggests that 200 years of progress in building civility in Britain has been unraveling as a result of the growth of unconditional welfare rights:

> *"The unconditionality of much welfare has severed the connection between a person's actions and accepting the consequences of that pattern of behaviour…The idea that welfare should be received free of conditions is a very recent development. For most of the last 400 years the receipt of welfare has been dependent on fulfilling a series of conditions. Only since the 1960s did an opposing idea gain ground…[the] damaging belief that no matter how badly a person behaves the right to welfare is inviolate."*[77]

Our failure to attach any requirements to receipt of public funds has undermined the people who seek to maintain traditional standards of behaviour, and has fuelled the growth of dysfunctional, anti-social behaviour. Field concludes:

> *"Unconditional welfare declares that no behaviour is so out of bounds that the right to a minimum income is foregone. Taking away the assumption that welfare will always be paid irrespective of a claimant's behaviour is a crucial part of any successful strategy to re-establish common decencies."*[78]

74 Saunders P (2008), 'From entitlement to employment' in Kay L and Hartwich O (eds), *When hassle means help*, Policy Exchange.

75 Quoted in Bennett F and Dornan P (2006), *Child Benefit: Fit for the future*, Child Poverty Action Group, p.16.

76 Saunders P (2008), 'From entitlement to employment'.

77 Field F (2003), *Neighbours from hell*, Politico's 2003, pp.33,95,98.

78 Field F (2006), *The ethic of respect: A left-wing cause*, Centre for Independent Studies, Occasional Paper 102, pp.40-42.

A substantial proportion of the British public appears to agree with this (Table 5). In the 2009 Policy Exchange-Ipsos MORI survey, 49% backed the idea that family payments should be conditional, and only 27% opposed it. Parents were just as supportive of making family payments conditional as non-parents.

Table 5: Public support for conditional family payments

How strongly would you support or oppose the following: "Parents who fail to bring up their children properly should lose eligibility for family payments"

	Parents	Non-parents	Total
	%	%	%
Strongly support	25	23	23
Tend to support	27	26	26
Neither support nor oppose	17	18	18
Tend to oppose	17	15	16
Strongly oppose	10	11	11

N (weighted) = 2035.
Source: 2009 Policy Exchange/IPSOS-MORI Family Priorities Survey

Of course, this leaves open the question of what conditions should be imposed, how they should be monitored, and what should happen in those cases where parents fail to meet these conditions and their children lose out as a result of the withdrawal of payments (in focus group discussions, many of those who supported conditionality in principle had difficulty in practice squaring their support for financial sanctions with their concern to safeguard the wellbeing of the children in these families).[79] But in principle, it seems desirable that certain minimum standards which are known to impact on children's wellbeing – things like ensuring the children attend school, preventing them from getting involved in anti-social or criminal behaviour, and avoiding exposing them in the home to illegal drug use – should be attached to parents' continuing receipt of family payments.

Proposition 3

The rules governing tax concessions and benefits for families should wherever possible reward positive parenting, and should not encourage behaviour known to be potentially harmful to children's development. This means: (a) care must be taken to minimise, and if possible eliminate, work disincentives following from receipt of payments; (b) there should be tax concessions for married couples with children, because marriage provides the most reliable platform for raising children; (c) one parent should be encouraged to remain at home for at least the first year of a child's life; and (d) receipt of family payments should be conditional on meeting certain minimum standards while raising children.

79 See *Families in Britain*, Ipsos-MORI and Policy Exchange, May 2009.

3

How Should Assistance be Delivered?

We have now clarified what the overall purpose of a family tax and benefits system should be (increased horizontal equity); and we have identified some of the objectives it might usefully set for itself (strengthening work incentives, supporting married parenthood, encouraging parental nurturing of infants, and improving standards of parenting). The next question to ask is how these aims and objectives might best be delivered.

There are four, basic sets of dilemmas to consider here:

- should assistance be targeted on the poorest families or provided on a universal basis?;
- should it mainly involve benefit payments or tax reductions?;
- should it be made in cash or in kind?; and
- should it be weighted towards younger or older children?

Targeted or universal payments?

If the key aim of family-based cash transfers is to increase horizontal equity, entitlement has to be universal. The principle is simple: the more people there are in a family living off any one income, the less that income should be taxed (or the more it should be supplemented) – no matter how large or small it may be.

Prosperous parents are obliged to share their income with their children, just as less well-off parents are. In relative terms, their children probably cost them just as big a slice of their income, and in absolute terms, they sacrifice a much larger sum of money to raising their children than poorer parents do. Seen in this light, it does not follow that prosperous parents should be compensated less:

> *"The horizontal equity arguments for supporting families with children do not immediately suggest that child-contingent support should be higher for families with lower incomes... Horizontal equity may even suggest that child-contingent support should be higher for better-off families, because of the extra costs that they face to maintain a higher material living standard... Even if notions of inverse means testing are unacceptable, there is no reason to suppose that costs of children are higher in absolute terms for poorer families than for richer ones, and this again points to universal child benefits, with redistribution goals being achieved through the non-child-contingent transfer system."*[80]

80 Adam S, Brewer M and Reed H (2002), *The Benefits of Parenting*, IFS Commentary 91, Institute for Fiscal Studies, pp.14-5.

Some countries recognise this argument for universal assistance in their family support systems (Table 6). In Germany and Belgium, for example, family assistance ensures that couples with two children get about 10% more income than equivalent couples without children, and this holds right across the income distribution, from poor families to rich ones. In the Netherlands, the top-up is worth less (between 5 and 7%), and in Ireland it is worth more (between 12 and 16%), but in both countries, it is given to families right across the income scale.

Elsewhere, however, the supplement to the income of parents with children (relative to childless couples on the same earnings) falls as family incomes rise. In the USA, couples with no earnings get 30% more if they have two children than if they have none, but by the time they reach the average wage, this top-up has been reduced to 10%. In Denmark, the top-up falls from 22% for couples with no earnings to 8% for those on twice average earnings. In Australia, Canada and Japan, the drop-off is even greater, so by the time families in these countries achieve twice average earnings, their net income hardly varies whether they have children or not.

Table 6: Additional financial support for couples with children compared with childless couples at different levels of earnings in different OECD countries

	Earnings as % of average wage				
	0	**50**	**100**	**50**	**200**
Strong horizontal equity:					
Belgium	11	10	10	10	10
Germany	9	9	9	10	10
Ireland	16	18	13	13	13
Netherlands	5	7	5	5	5
Weak horizontal equity:					
Australia	19	16	15	8	3
Canada	17	21	9	5	3
Denmark	22	22	11	6	6
Japan	19	19	4	2	4
UK	**19**	**24**	**12**	**7**	**7**
USA	30	25	11	11	11
OECD average	15	14	9	8	7

Source: OECD, *Babies and Bosses* (2007), Table 4.2.
Assistance at each level of earnings is expressed as the difference between the net incomes of a single-income couple without children and a single-income couple with two children.

In the UK, two-child couples on low earnings boost their income by more than 20% relative to childless couples as a result of family payments, but this enhancement falls to just 7% once they get above average earnings. Britain ranks high in league tables measuring the generosity of family support for lower income families, but performs less well when comparing families on average earnings.[81]

The principle of horizontal equity is not wholly neglected in Britain, for Child Benefit is a universal payment. Child tax credits, however, are means tested, and in recent years their importance has grown relative to the universal benefit.[82] As a proportion of total financial support for children, Child Benefit fell from 79 to 42% between 1979 and 2003.[83]

Table 6 indicates that in the UK (as in a number of other OECD countries), the principle of horizontal equity has been sacrificed to the principle of vertical equity. In other words, as families with children get richer, the government becomes less concerned to help them maintain their living standards vis-a-vis comparable earners without children.

But the family support system was never intended to be an instrument of vertical redistribution. Vertical equity can be pursued through a progressive income tax system (a high earner pays proportionately more tax than a low earner) and through a redistributive welfare benefits system (poor households qualify for assistance for which more affluent households are ineligible). Family transfers are intended for a different purpose, to compensate parents for part of the cost incurred in raising children. To achieve this, they should either allow adults with dependent children to pay less tax, or make them eligible to receive higher payments, so they end up with a higher net income than single adults *on the same income*.

This is what the German, Belgian, Dutch and Irish systems achieve, but what the UK system fails to.

A significant proportion of the British public appears to understand and agree with the idea that family assistance should be used to increase horizontal, rather than vertical, equity. Asked whether government assistance to people with children should be restricted to poorer families or made available to all parents, half of the respondents to a recent survey said that support should be universal, while only 40% thought it should be targeted (Table 7). Among parents, support for universalism was even higher, at 58%.[84]

Table 7: Support for universal family assistance

Which of these statements comes closest to your view?	Parent %	Non-parent %	Total %
Anybody with a dependent child should get some government help towards the cost of raising it.	58	47	50
Only poor parents should get government help towards the costs of raising their children.	33	43	40
Don't know	9	10	10

N (weighted) = 2035. $p<0.05$
Source: 2009 Policy Exchange/IPSOS-MORI Family Priorities Survey

81 Bradshaw J and Finch N (2002), 'A comparison of child benefit packages in 22 countries', Department of Work and Pensions, *Research Report* No.174. Britain ranks 7th overall out of 22 nations.

82 Commission on Families and the Wellbeing of Children, *Families and the State.* Bristol: Policy Press, 2005, p.63.

83 Child Poverty Action Group (2006), *Child Benefit.*

84 The survey also asked whether child benefit should be restricted to lower income families. Only 30% of respondents (and 25% of parents) thought that it should.

Horizontal equity is not the only reason for supporting universal family assistance. We saw earlier that a major problem with targeting is that it penalises any family whose members make an effort to improve their income. The more hours they work, and the more they train and study to improve their earning capacity, the less help they get from the government.

This disincentive effect is inherent to means testing. Government can try to minimise it by flattening the income taper, so that benefits are withdrawn more gradually as family incomes rise, but the problem never goes away. The more we try to restrict assistance to those most in need, the more vicious the work disincentives are likely to be. Advocates of universalism also point to the stigmatising effects that can arise in targeted systems.[85] These are generally avoided in universal payments.

The obvious problem with universalism, however, is that it is expensive. The UK government is spending more on family assistance today than ever before. If the extra benefits to families that have been introduced in the last ten years were to be spread out more evenly among all families with children, the cost would be crippling. A key question, therefore, is not whether we should compensate all families for the costs they incur in raising their children, but whether we can afford to.

Benefits or tax cuts?: The importance of reducing churning

Thus far, we have discussed government 'financial assistance' to families without specifying what form it takes. We saw at the start of this chapter that it has traditionally taken two forms:

- Government payments to families with children (e.g. the universal Child Benefit, the successor to the 'family allowance' introduced after World War II).
- Allowing families with children to retain a bigger slice of their own earnings before they start paying tax (e.g. the dependents' tax allowances, introduced before World War I).

We shall see later that the new tax credits system muddies these waters somewhat, but in essence, tax credits also fall into one of these two categories: despite their rather misleading name, child tax credits are always payments.

There are two main problems with delivering family assistance through tax reductions rather than through direct payments:

- Firstly, families have to be earning in order to take advantage of tax-free earnings allowances. Tax breaks for families do not benefit those where nobody is in paid work, and they may only be of limited help to those (e.g. families relying on one part-time earner) with very low earnings. If the tax-free allowance exceeds the total amount earned, the surplus allowance will not be used.
- Secondly, assistance through tax deductions is directed to the family's principal earner, who may not be the main carer. If the intention of family assistance is to help families with the cost of raising their children, it makes more sense if it goes to the adult who is directly responsible for looking after the children – which normally means putting money into the mother's purse rather than the father's pay packet.

85 Commission on Families and the Wellbeing of Children, *Families and the State*. Bristol: Policy Press, 2005.

But reliance on payments rather than tax deductions brings its own problems which arguably outweigh the difficulties attached to tax-based assistance. Perhaps the key one is that receipt of government payments will over time erode families' sense of their own self-reliance and promote in its place a culture of dependency.

A pound earned has a very different meaning than a pound received in benefits. The first signifies independence and points to an ability to care for oneself and one's family through one's own efforts; the second signifies dependence on others and promotes a mentality that looks to the government to resolve one's problems whenever difficulties arise.

If we want to strengthen family life, we should not be encouraging greater dependency on government hand-outs. Yet this is exactly what the new tax credits system has been doing.

In Britain today, not only is every family with children eligible to receive Child Benefit, but the majority also qualify for the child tax credit (which, despite its name, is a cash benefit, not a tax reduction).

All families earning up to £58,000 a year are eligible to claim the child tax credit and 82% of them do so.[86] 5.5 million households, most of whom had never claimed welfare benefits before, now receive this payment. Many middle class families have been transformed into welfare claimants as a result (Table 8).[87]

Table 8: Proportion of families receiving government payments

	One-parent families %	Two-parent families %	All families with children %
Child benefit	96	96	96
Child tax credit	65	54	57
Working tax credit	31	14	19
Income related benefits	56	8	21
No state support	**2**	**3**	**3**

Source: Department for Work and Pensions *Family Resources Survey* 2006-07, Table 3:19

The irony of this massive growth of middle class welfare is that many of these new welfare recipients are paying for their own benefits. Government figures show that four out of ten families with children now receive more in Child Benefit and tax credits than they pay in tax.[88] But this means that six in ten are paying more tax than they receive back in family payments.

Those families who are effectively financing their own benefits would be no worse off financially if the government scrapped all its family payments and reduced their tax by the equivalent amount. Indeed, they would be better off, for the government racks up substantial administration charges when it takes tax away and then hands it back as Child Benefit or child tax credits, and these overheads would be saved if the money were simply left in people's pockets.

86 HM Revenue and Customs, *Tax credits: Improving delivery and choice*, HM Treasury, May 2008.

87 Having argued in favour of universalism in the previous section, it might seem odd now to be complaining about 'middle class welfare'. If we favour universal family assistance, doesn't this mean increasing middle class welfare rather than reducing it? But this only follows if assistance is provided in the form of cash benefits. If, instead, families are assisted by reducing their tax liability, this meets the universal requirement (all families get tax breaks) while also reducing the amount of middle class welfare.

88 HM Revenue and Customs, *Tax credits: Improving delivery and choice*. HM Treasury, May 2008, p.4.

Not only that, but most families would then be earning and spending their own money, supporting themselves out of their own earnings, rather than waiting for the government to give them hand-outs. They would be self-reliant.

Table 9: Tax and welfare churning for families of working age with children at different income deciles (2006-7)

	Equivalised disposable income decile									
	Bottom	2nd	3rd	4th	5th	6th	7th	8th	9th	Top
Average £ pa										
Original income	**5205**	**8608**	**15708**	**21332**	**26599**	**33324**	**40922**	**49230**	**62299**	**121208**
Child benefit	1563	1322	1523	1330	1378	1365	1278	1253	1215	1137
Tax credits *	1700	2217	2602	2526	2047	1549	934	630	395	237
Other benefits	4343	5044	4151	2521	1958	1546	998	775	801	719
Tax & NI**	1297	1984	3709	4958	6016	7773	9645	12279	16004	31429
Disposable income	**11539**	**15207**	**19870**	**22751**	**25966**	**30011**	**34487**	**39609**	**48706**	**91873**

Source: Francis Jones, 'The effects of taxes and benefits on household income 2006/07 *Economic and Labour Market Review* vol.2, no.7, July 2008, Table 21 (Appendix 1)

* Includes Working Tax Credit and Child Tax Credit. Although Child Tax Credit is paid as a cash benefit to all claimants, tax credit income is classified by the ONS as negative tax payments until all income tax is exhausted, and only the balance is classified as cash benefits. This artificially reduces the amount of tax families appear to pay as well as reducing the true value of the tax credits they receive as cash payments. In this table, therefore, the value of these 'negative tax payments' has been added back into the overall value of tax credits received, and has also been added to the calculation of total tax paid

** Includes employers' and employees' NICs, plus council tax net of council tax benefit.

Table 9 identifies the taxes that families with children paid in 2006-07, and the cash payments and other benefits they received from government. It shows, for example, that the poorest 10% of families with children received, on average, just £5,025 of 'original income' in earnings from wages, pensions, investments and self-employment. This income was then supplemented by cash transfers from the government worth £7,603, which included £1,563 in Child Benefit and £1,700 in tax credits. However, the government also took back £1,297 in tax and National Insurance contributions, leaving an average disposable income of £11,539.

Looking across the table, from the poorest to the most affluent families, it is instructive to compare families' original incomes (before the government gets involved) with their disposable incomes (after direct taxes and cash benefits).

The first point to note is that many families around the middle of the income distribution end up with much the same disposable income as they had in original income.

At the 4th income decile, where the average family income before tax and benefits is £21,332, the average disposable income after tax and benefits is only 7% higher at £22,751. At the 5th income decile, the state begins to take more in tax than it hands out in cash benefits, but the net impact of its redistributive efforts is still tiny. An average original income of £26,599 is turned into a disposable income of £25,966 – a reduction of just 2%.

The second point to note is how much government activity is going into creating these tiny net changes in family income. In the 5th decile, for example, the government is taking £6,016 on average from each family in tax and NI contributions, and is then giving them back £5,383 as social security and family payments. For middle income families at least, the government might just as well leave them alone.

The third point is to compare the value of the family benefits received with the amount of tax and NI paid.[89] From the 4th decile of income upwards, all families with children pay more in direct taxes than they receive in family payments.[90] Even in the 3rd decile, where families receive an average of £4,125 in family payments, they pay £3,709 in direct taxes – i.e. their tax payments cover 90% of what they receive in family benefits.

The conclusion to draw from all of this is simple. Most families are paying for their own family benefits. If the government scrapped all family payments tomorrow, and compensated by reducing families' tax contributions by the same amount, at least two-thirds of families would be no worse off, and up to three-quarters would hardly notice any difference in their net incomes.

Cash or kind?

In the 2009 Policy Exchange-MORI family survey, respondents were asked how they thought government assistance for families is best delivered – through cash benefits, tax reductions, or subsidies to services like child care. In the choice between tax reductions and cash benefits, the former was quite heavily favoured, 63 to 37% . However, it was the third option – subsidizing services like childcare – that received most public support (Table 10).

Table 10: Support for universal family assistance

There are different ways support could be given to help parents with the cost of raising children. Which of these three options would you support?

	Parents %	Non-parents %	Total %
Reduce the tax parents pay	39	36	37
Subsidise services like childcare	40	45	43
Cash benefits	29	19	22
Don't know	9	11	10

N (weighted) = 2035.
Source: 2009 Policy Exchange/IPSOS-MORI Family Priorities Survey

The advantage of providing financial assistance in the form of services (or subsidies for services) is that the government can be sure how its money is being spent. This is also, however, the main disadvantage.

Cash, on the other hand, can be spent on anything. There is therefore no guarantee that money made available to parents so they can buy things for their children will actually be spent in this way. There is precious little evidence on

89 In Table 9, 'tax credits' include Working Tax Credit as well as the child tax credit, but WTC is tightly income-tested, so few families outside the bottom two deciles are likely to be receiving it. Tax credits also include tax relief at source on life assurance premiums, which may slightly inflate estimates of CTC received in the higher income deciles. But to derive reasonably accurate estimates, we can add the value of 'child benefit' and 'tax credits' to calculate the approximate total value of family benefits received by families from the 3rd decile upwards.

90 The government's claim, quoted earlier, that 4 in 10 families pay less tax than they receive in family payments does not square with the figures for the 4th decile in Table 9. It may be that the government's claim is excluding NI contributions.

how recipients of family payments use the money, and even though the UK government has in recent years hugely increased its financial assistance to families (and in particular, poorer families), we know very little about what impact, if any, this has had on children's wellbeing.[91]

What we do know is that a substantial portion of government financial assistance to families actually gets spent on adults, not children. And it is not even spent on adult necessities. Research for HM Treasury found that couples on average spend at least one-quarter, and perhaps as much as half, of the Child Benefit they receive on alcohol.[92]

It follows from this that increasing cash payments to families will not necessarily improve the lives of children, and may well have little effect. Several researchers, in the USA as well as in Britain, have found that overall spending on necessities for children does not differ very much between poor homes and more affluent ones. This is because most parents put their children first, and adults will sacrifice their own wants to ensure their children get what they need.[93] When governments then increase financial assistance to these families, parents take the opportunity to buy the things for themselves that they have been going without (like alcohol), rather than increasing their spending on the children.

> "If the aim is to reduce child poverty and improve child material wellbeing, the fact that a big chunk of family assistance gets spent on adults looks like a real problem"

If the aim behind family assistance is to increase horizontal equity, there is no problem with this, for family payments are meant to compensate parents for having to share their incomes with their dependent children. But if the aim is to reduce child poverty and improve child material wellbeing, the fact that a big chunk of family assistance gets spent on adults looks like a real problem.

One response is to provide assistance with strings attached – either by providing services in kind for parents, or by providing vouchers and subsidies tied to specific kinds of spending.

Food stamps in the USA are one example – they ensure that federal government money can only be spent on approved grocery purchases (although a black market in food stamps has often allowed recipients to cash them in at a discount). Australia's recent experiments with quarantining a portion of welfare payments to cover rent, food and other allowable necessities, is another.

In the UK, all families receive substantial government assistance in the form of services in kind. Most of this comes in the form of 'free' education and health care (which is not really 'free', of course, since many families pay for much or all of what they consume through their taxes).

In 2006/07, families with children consumed an average of £5,906 worth of state education each year and £3,862 of state health care. The poorest tenth of families, whose average disposable income was just £11,539 (Table 9), received another £13,371 in government services, bringing their 'final income' to over £20,000. Even the richest 10% of families received government services worth £7,772.[94]

From the point of view of the consumers of these services, provision in kind rather than in cash has two major drawbacks. First, it pre-empts their choice of supplier. If the government provides your child's schooling, you have to accept

91 "There is little evidence on what impact increasing incomes through extra government transfers has upon children's wellbeing". Adam S, Brewer M and Reed H (2002), *The benefits of parenting*, p.7.

92 See Blow L, Walker I and Zhu Y (2005), *Who benefits from Child Benefit?*, Department of Economics, University of Warwick.

93 Banks J and Brewer M (2002), *Understanding the relative generosity of government financial support to families with children*, Institute for Fiscal Studies, *Working Paper* 02/02, p.11.

94 Jones F (2008), *The effects of taxes and benefits on household income 2006/07*, Table 21, appendix 1.

the school you are given; if it provides your health care, you have no choice over your treatment. If you are happy with what you are given, there is no problem, but if you are not, the lack of alternatives (no right of 'exit') means you are locked into a service that you have to pay for (through your taxes) but which you cannot change.

The second problem with provision in kind is that it stops you spending the money on some other kind of service which might suit your needs better. This, of course, is precisely why governments provide help in this way. They want to support one set of parental choices (e.g. to spend £5,000 per year on sending their children to school) and close down another (e.g. to fritter £5,000 away every year on alcohol or gambling while leaving the kids uneducated).

Often this pre-emption of parental choices makes sense. But the government's judgement of what is best for families is not always self-evidently sensible, and there are times when it clashes with what parents themselves consider to be best for their children.

A clear example where this occurs is childcare.[95] For families with very young children, the UK government has substantially stepped up its help paying for pre-school childcare in recent years. In addition, low income workers (in practice, mainly sole parents) can claim up to 80% of their childcare costs, to a maximum value of £300 per week, through the Working Tax Credit, while all employees can deduct childcare payments from their gross income to reduce tax and NIC by £55 per week, provided their employers offer this option (the so-called 'electronic voucher').

The Early Years Entitlement pays nurseries to provide 12½ hours per week of pre-school for all 3-4 year old children, and the government is committed to financing 3,500 Sure Start children's centres by 2010, each of which will provide childcare as part of an integrated suite of family services for children aged 0-3.[96] 38% of three year olds, and 79% of four year olds, now attend maintained nursery schools with free places.[97]

But all this help is only available to parents who use formal childcare providers of which the government approves. It is not available to those parents who prefer to use informal care provided by neighbours or extended family members (although the 2009 budget did introduce NI credits for grandparents who spend 20 hours or more each week looking after their grandchildren). Nor is assistance provided to parents who prefer to remove themselves from the workforce and look after their own children at home.

Several commentators have noted that these policies strongly skew parental choices towards (a) using formal and state-sector childcare (even though many women prefer to use informal and family care)[98] and (b) going out to work rather than opting for full-time motherhood (even though many women prefer to raise their infant children at home).

In cases like this, where there is a clear divergence of preferences in the population, and where there is no conclusive evidence that children's interests are best served by one strategy rather than another, it would be less restrictive for government assistance to take the form of cash rather than provision in kind. That way, parents are freed to make their own judgements about what is best for their own children, rather than have the government decide this for them.

95 The childcare support system, and options for reforming it, have been examined in detail in an earlier Policy Exchange report, *Little Britons: Financing Childcare Choice* (Hakim C et al, 2008).

96 HM Revenue and Customs, *Help with the costs of childcare, October 2008; Building a Fairer Society* (2007 Budget), chapter 5, p.113.

97 Hakim et al (2008), *Little Britons: Financing Childcare Choice*, p.42.

98 Hakim et al (2008), p.19; Social Justice Policy Group, *Breakthrough Britain* vol.1, 2007, p.26; Dex and Joshi (1999), p.653.

Younger or older children?

The 2009 Policy Exchange-Ipsos MORI family survey asked respondents whether parents of young children should receive more, less or the same level of financial support from government as those with older children. There was little support for skewing assistance towards those with older children (just 9% supported this), but only 24% thought those with young children should get more. Two-thirds favoured all parents getting the same.

There are, however, quite powerful arguments in favour of paying different amounts according to the age of the children.

Generally speaking, children cost their parents more money as they grow older. They eat more, they need a room of their own, and they consume more leisure that has to be paid for. This would seem to indicate that financial assistance should be greater for older children than for younger ones, and a number of countries (including Australia and New Zealand) reflect this in their child payment systems.[99]

However, to these 'direct costs' we have to add the 'indirect costs' of having children, primary among which is the loss of income when one parent stops paid employment to look after them. This loss of income is greatest when children are very small, for many mothers return to the workforce as their children get older and go to school or into childcare. This suggests that financial assistance should be greater for very young children, and should be reduced as they get older, and this has indeed been the trend in recent UK family policy.[100]

There are also 'economies of scale' to take into account. A second child does not cost as much as a first, for much of the capital investment (in prams, toys, clothing, etc) has already been made (and the loss of parental income from working may already have been absorbed). It might therefore be sensible to pay higher amounts for a first child than for subsequent ones, and the UK Child Benefit does this.

On balance, it seems sensible to 'front load' financial assistance for families onto the early years. When children get older, parents can both work, at least part-time, and when they reach their teenage years, the children themselves can start some form of paid employment. The greatest financial sacrifice comes when people start a family, and concentrating most of the help at that point should extend their choices about whether to keep working or take time at home to raise the children, as well as compensating them for some of the additional costs they incur with new dependents to look after.

Proposition 4

Family transfers are intended to compensate parents for part of the cost incurred in raising children, not to redistribute income between richer and poorer households. At all levels of income, adults with dependent children should end up with a higher net income than single adults on the same income. This is best achieved by taxing them less. Giving them family benefits (which they may well have paid for out of their own tax contributions) is less empowering, and where possible should be avoided. Provision in kind, rather than cash, also undermines family autonomy. The best strategy for ensuring strong and autonomous families is to leave them with more of their own money, particularly in the early years of child rearing (when families are often hit with increased costs and declining incomes).

99 Nolan P (2006), 'Tax relief for breadwinners or caregivers?'; D'Addio and D'Ercole (2005).

100 Historically, child tax allowances, family income supplement and family credit all had lower rates for young children, but the new child tax credit pays extra for children under 12 months and the Sure Start maternity grant for low income mothers has also become more generous. See Adam S and Brewer M (2004), *Supporting Families*, p.26.

4

Tax Allowances for Dependents

Having concluded that the best way to assist families is to reduce the amount of tax they have to pay, it is disturbing to discover that family policy in the UK has for the last 40 years been headed in precisely the opposite direction. Governments of both main parties have since the 1970s systematically reduced tax breaks for families, and substituted them with cash payments, with the result that today, tax concessions for people with children have all but disappeared.[101]

This makes the UK quite unusual among OECD countries, most of which have some recognition of family responsibilities in their tax systems.[102] Before we look at our system of cash payments as it operates today, it is important to look back to try to understand how and why governments abandoned tax concessions as a major route for delivering assistance to families.

The history of tax allowances for children and for spouses

We have already seen that workers with children were until 1975 given an additional tax allowance in recognition of the fact that they had to share their income with their dependent children. In addition to this, workers with a dependent spouse similarly enjoyed an additional tax allowance for their partner – this did not disappear until 2000.

The origin of tax allowances for children dates back as far as income tax itself: they were first introduced in 1798, but then abolished in 1805. Reintroduced in 1909, they varied with the age of the child (older children got a bigger allowance).

Unlike family allowance payments, child tax allowances included the first child and continued for as long as children were dependent on their parents' income, even beyond the age of 18. They were also worth a lot more than the family allowance payments, particularly for higher-rate taxpayers who could get relief at their highest marginal rate.[103]

In effect, child tax allowances meant children had their own tax-free income allowance which the family's principal earner (normally the father) claimed on their behalf, along with his own. This allowance disappeared, however, when it was folded into the new Child Benefit in 1975.

In 2001, the government did briefly resuscitate tax allowances for children in the form of a new Children's Tax Credit.[104] Unlike the earlier allowance, this was means tested, so higher-rate taxpayers gradually lost their entitlement to it as their incomes rose. It also worked slightly differently. Whereas the old tax allowances increased the total amount a worker could earn before starting to pay tax, this new Children's Tax Credit was deducted from a parent's overall income tax bill.

101 One exception is the child care tax concession operated by some employers – see later.

102 Draper D and Beighton L (2008), *Taxation of Married Families*, p.7.

103 Bennett and Dornan (2006), section 4.

104 HM Revenue & Customs, *Tax credits: Improving delivery and choice*, HM Treasury, May 2008, p.9. As we shall see, this Children's Tax Credit replaced the Married Couple's tax allowance, which was scrapped in the same year.

Like the earlier child tax allowance, the Children's Tax Credit was 'non-refundable.' In other words, if the value of the credit was greater than your total tax liability, you could not claim the difference. This meant it offered little assistance to those on very low incomes who were paying little or no income tax. It was scrapped in 2003 when the new Working Tax Credit and Child Tax Credit were introduced.

In addition to claiming enhanced tax allowances in respect of their children, workers had since 1909 been able to claim a tax allowance for a dependent spouse. The logic was the same in both cases: because one income was having to support more than one family member, the dependents (be they children or a wife) were able to transfer a notional tax-free earnings allowance to the principal earner who could use it to reduce the family's overall tax liability.

The so-called 'Married Man's Allowance' was optional for couples. If both husband and wife were earning, they could choose to be taxed separately, in which case they would each receive a single person's tax-free earnings allowance. But if they wished, they could be taxed jointly, on their combined earnings, and this generally made sense if only one of them was working. If they exercised this option, the principal earner would receive an enhanced tax allowance, worth 1½ times the single person's allowance.[105]

Widows, widowers and sole parents with dependent children also received an enhanced allowance, called the Additional Personal Allowance, which put them on the same footing as a couple being taxed jointly.

In 1990, the Married Man's Allowance was scrapped as the government moved to a system of independent taxation where all taxpayers would be taxed separately on their own income with their own tax allowance. However, two elements of the older system survived for another ten years:

- A 'Married Couple's Allowance' was introduced, which could be claimed by either a husband or wife if their partner was not using their own personal allowance (this was to ensure that married couples who had been taxed jointly up to that point did not lose out as a result of the move to independent taxation);
- Sole parents continued to get the Additional Personal Allowance.

But in 2000, both the Married Couple's Allowance and the Additional Personal Allowance for sole parents were also scrapped (except for elderly couples). They were replaced by the Children's Tax Credit (discussed above), which was intended to compensate couples and sole parents for the loss of their tax allowances. This in turn gave way to the new Child Tax Credit in 2003, which despite its name is actually a benefit payment, not a tax relief.

For the last nine years, therefore, the UK family support system has contained no provision for tax relief in respect of either dependent partners or dependent children. Everybody is now taxed as an individual with no regard for how many other people may depend upon their income. A married man with a wife at home looking after two young children is subject to exactly the same tax as a single person working in the same job at the same rate of pay who has no other calls on his earnings. The principle of horizontal equity has thus been eliminated from our tax system.

105 Draper D and Beighton L (2008), *Taxation of married families*, CARE, p.12.

There are three main reasons why successive governments phased out tax allowances for dependents. One applies mainly to child tax allowances, one to the married couple's allowance, and the third is a problem common to any tax allowance:

- **Spousal tax allowances favour marriage and demean women:** Feminists who see marriage as a 'patriarchal institution' have long been unhappy about tax breaks for married couples. They favour individual taxation so women are not treated as 'dependents' of men.
- **Child tax allowances go to earners, not carers:** Tax allowances reduce the amount of income tax a worker pays by raising his or her tax-free earnings threshold. But there is no guarantee that principal earners who benefit from this reduced tax will pass the money on to their non-working partner who is actually caring for the children.
- **Tax allowances are 'regressive' and non-refundable:** Higher earners on higher marginal income tax rates benefit more from an increased tax allowance than lower earners on lower marginal rates. Moreover, a tax allowance is only worth something if you are paying enough income tax to benefit from it.

Let us consider each argument in turn.

Spousal tax allowances favour marriage and demean women

It is clearly true by definition that the Married Couple's Allowance (which was worth one and a half times the value of the single person's allowance) only benefited couples who were married. But provided there is no bar on couples choosing to marry, there is nothing inherently unfair or prejudicial about a provision like this, for it is a perk which is potentially available to everyone. The only exception is gay couples, for they cannot get legally married. However, if spousal tax relief were extended to gay couples in civil partnerships, there would be no discrimination at all.

The real question, therefore, is not whether a spousal allowance discriminates against unmarried couples, but whether there are good grounds for the state to favour marriage in this way. As we saw in chapter 1, the evidence on child well-being suggests that there may be – at least for couples with children. Research shows that children are generally better off if they are brought up by both natural parents, and that parents are more likely to stay together if they are married. A case can therefore be made for favouring married parents, although the argument for favouring married couples without dependent children (as was the case with the Married Couples' Allowance) seems less obvious.

It might be argued that unmarried couples who successfully stay together to raise their children, should also be favoured by tax breaks. But the problem with extending a spousal allowance to cohabitees is that tax authorities would need legal proof of their long-term interdependence. Only couples who marry (or sign civil partnerships) have made explicit, contractual ties to each other which can be externally verified.

As for the argument that treating a spouse as a 'dependent' for tax purposes is demeaning to women, and perpetuates their subordination to men, this might have held true when the spousal allowance was limited to husbands claiming for wives, but the Married Couples' Allowance could be claimed by either spouse on behalf of the other. In addition married women were not obliged to accept joint taxation with their husband, for couples were always entitled to opt for individual taxation.

Despite the unconvincing nature of this argument, by the year 2000 it prevailed within government when for the first time, all couples were forced to accept individual taxation. Joint taxation ceased to be an option.[106] Forcing couples to be taxed individually, whether they like it or not, has encouraged more 'housewives' to go out to work, which is precisely what proponents of this view wanted to achieve. According to the OECD:

> *"Tax systems that assess tax liabilities on individual income as opposed to taxation on the basis of all household income provide greater incentives for partners of already-employed people to work."*[107]

This is because in an individualised system there is no tax advantage to be lost if a hitherto dependent partner in a couple takes up employment.[108]

The people who lost out as a result of this change were married couples who prefer to have one partner stay home and raise their children while the other earns an income – in other words, traditional nuclear families. Scrapping the Married Couples' Allowance meant the stay-at-home partner in these families was effectively stripped of his or her right to transfer their tax-free income allowance to their partner. The impact of this on family budgets has been considerable.
In January 2007, the Institute of Fiscal Studies calculated that as a result of our individualised tax system, a family on an income of £30,000 per year paid £100.66 tax each week if the money were all earned by one of them while the other stayed home, but paid only £74.40 per week (£37.20 each) in tax if they both went out to work and each earned £15,000.[109] Viewed as a family unit (which is how the welfare system would see them), this is clearly unfair, for families on the same income, with the same per capita needs, are being taxed by different amounts and are therefore ending up with very different net incomes.

Traditional families, where the husband goes out to work while the wife raises the children at home, have been losing out as a result of changes in the tax system ever since the 1970s:

- A single person with no dependents earning the average wage pays roughly the same proportion of her/his earnings in tax today as 40 years ago.
- One-earner married couples, however, are today paying a lot more tax than they did 40 years ago, and although the new tax credits have compensated those on the lowest incomes, those on average earnings are paying more than twice as much tax (net of tax credits) as they did in the 1960s.[110]

Child tax allowances go to earners, not carers

There is a broad consensus among those who study family policy that cash payments to the principal carer (usually the mother) are more likely to be spent in

106 Patricia Morgan points to the irony that, under recent changes to parental leave, a mother can now transfer part of her maternity leave entitlement to the father, yet is not entitled to transfer her tax-free allowance to him. From the point of view of the government, therefore, "It is appropriate for fathers to mind babies, but not support families", *Family policy, family changes*, 2006, p.111 .

107 OECD, *Babies and Bosses* (2007), p.83-4. Also Jaumotte F (2003), p.25.

108 Economists argue this results in less distortion of behaviour and greater 'tax efficiency' – for a review and evaluation of this literature see Kleven HJ and Kreiner CT (2004), *A revised efficiency principle for the taxation of couples*, University of Copenhagen. Whether this greater incentive to work actually results in more married women working under individual-based tax regimes is, however, debatable. Irene Dingledey (in 'European tax systems and their impact on family employment patterns', *Journal of Social Policy* vol.30, 2001, pp.653-72) claims there is no evidence that individual taxation raises female workforce participation rates while tax splitting reduces them, for women's participation rates depend on a complex combination of different factors.

109 Brewer M (2007), 'Supporting couples with children through the tax system' in Robert Chote and others, *The IFS Green Budget*, Institute for Fiscal Studies, January 2007, p.224.

110 Draper D and Beighton L (2008), *Taxation of married families*.

ways that benefit children than tax allowances to the principal earner (usually the father).[111] This was one of the key reasons why child tax allowances were replaced by Child Benefit in the late 1970s, and politicians of all parties now seem convinced there is no good reason for bringing them back again.

> "Despite apparently strong public support for paying money directly to the carer, there is precious little evidence on how government money flowing to families actually gets spent, and there is no clear evidence that children's wellbeing is improved by all these cash benefits"

When he was Chancellor in 1991, for example, Norman Lamont ruled out any return to child tax allowances on the grounds that cash benefits are "a better way of directing help straight into the pockets of mothers".[112] Similarly, in 1998 David Willetts MP, then Shadow Secretary of State for Social Security argued that while most fathers share their earnings with their family, some fail to pass on tax savings to their partners and children, and to overcome this, state aid should be paid directly to mothers – to "the purse" rather than "the wallet".[113] Introducing the new Child Tax Credit (paid to mothers) in 2003, Gordon Brown repeated the same argument:

> *"It is right that all children's benefits go direct to the mother who often buys the food, purchases the kids' clothes and knows the child's needs best."*[114]

Research conducted by the UK government in 2003 found strong public support for these views (although the survey focused solely on family benefits and never explicitly asked about tax concessions). Asked whether benefits aimed at children should go to the mother or the father, 65% opted for the mother, 34% thought it made no difference, and only 1% thought they should go to the father. Reinforcing this, 70% thought the mother was most likely to use this money for the benefit of the children (only 2% thought the father was), and 57% said women are better than men at looking after day-to-day household finances.[115]

Despite apparently strong public support for paying money directly to the carer, we saw earlier that there is precious little evidence on how government money flowing to families actually gets spent, and there is no clear evidence that children's wellbeing is improved by all these cash benefits. We also saw that, even though Child Benefit is paid directly to mothers, much of it does not get spent on the children, but on adults (although mothers understandably tend to deny this when asked in surveys how they spend the money).[116]

Having said that, we do know that in many families (particularly more 'traditional' ones), money is not regarded as 'fungible' (i.e. money is reserved for different kinds of purposes depending on which partner brings it in, and its source).[117] Husbands' earnings are often spent on transport, holidays and savings, while wives' money is more commonly spent on day-to-day household items. When times are hard, both fathers and mothers tend to sacrifice their own needs so their children will not go without, but women sacrifice around 1½ times more than men do.

Research has also found that government payments are more likely than personal earnings to be regarded as a common resource of the whole household:

111 For example: Sleebos J (2003), 'Low fertility rates in OECD countries', *OECD Labour Market and Social Policy Occasional Papers* No.15, p.37-8.

112 Budget speech 1991, quoted in Bennett with Dornan (2006).

113 Willetts D (1998), *The benefit of experience*, Centre for Policy Studies lecture, p.2.

114 HM Treasury Newsroom and speeches, 'Balancing work and family life', 14 January 2003, www.hm-treasury.gov.uk/press_03_03.htm.

115 HM Treasury, 'New campaign shows how tax credits shift from father to mother', 26 March 2003, www.hm-treasury.gov.uk/press_41_03.htm.

116 Research by Edwards, in 1981, claimed mothers spent it on children's clothes, general household goods and trust funds for the children, while Foreman and Wilson in 1995 claimed 75% of the money goes on items for children. Both studies are discussed in Waseem S (2003), 'Household monies and decision making', *Policy Research Paper* No.23, Department of Families, Housing, Community Services & Indigenous Affairs, Commonwealth Government of Australia.

117 This and the next paragraph draw on Waseem's review of sociological and economic research (ibid).

in many cases, Child Benefit is seen by fathers and mothers alike as belonging to the woman to spend as she sees fit on herself and the children. This would seem to suggest that the politicians are right: government assistance in the form of tax cuts for the principal earner are less likely to filter through to the children than cash payments made directly to the principal carer.

Some interesting econometric modelling appears to further support this. When the old family allowance and child tax allowance were replaced by Child Benefit in the late 1970s, there was a significant increase in expenditure on children's (and women's) clothing in the economy as a whole.[118] The researchers admit that this may not have been triggered by the policy shift, but rather because children became more focused on fashion branding during the 1980s. Nevertheless, it seems plausible that at least part of this shift in spending occurred because government assistance switched from tax breaks to cash payments, and from mainly male to mainly female recipients.

Overall, the sociological and economic evidence is suggestive, but not compelling. Much of it dates from two or three decades ago, when gender roles within the family may have been more sharply demarcated than they are today, and when the 'male breadwinner' model of family life was more widespread than it is now. Nevertheless, it does seem that financial support in the form of direct cash payments to the mother is more likely to get spent on children than tax concessions to the father.

This is an important consideration for policy-makers, but should it be (as it has become in recent decades) an overriding one? We saw in the last chapter that there are other, very strong reasons for favouring the use of family tax allowances, not the least being that they are less costly to administer, and they reduce 'churning' rather than adding to it. It might not be sensible to provide all family assistance in the form of tax breaks, but this does not mean it should all be given as cash benefits either.[119]

By scrapping tax allowances altogether in favour of benefits, governments have put all their eggs in the one basket. They have done so in an attempt to engineer a redistribution of income within households, by taking more tax from adults (often men) who earn, and giving more benefits to adults (mainly women) who take the primary responsibility for raising the children. This may (as intended) have reduced the dependency of some women on their male partners, but this has only been achieved by making whole families much more dependent on government.

Tax allowances are 'regressive' and non-refundable

Because the income tax system is 'progressive' (the more you earn, the higher the rate you pay on additional income), any system of allowances which reduces people's liability to tax is necessarily 'regressive' (i.e. it will be worth more to higher than lower earners).

Politicians and activists on the left have traditionally seen this as a fundamental flaw in family tax allowances. The Child Poverty Action Group, for example, thinks that because tax breaks disproportionately favour richer families, they must be "unfair".[120] But the argument is misleading as it can be argued that if it is 'fair' to tax higher earners at a higher rate, it must logically also be 'fair' to exempt them at a higher rate too.

118 Lundberg S, Pollak R and Wales T (1997), 'Do Husbands and Wives Pool Their Resources?: Evidence from the United Kingdom Child Benefit' in *Journal of Human Resources*, Vol. 32.

119 This is the conclusion reached by Waseem, advising the Australian federal government: "Overall, the review would indicate that the policy of spreading payments between the two partners should continue."

120 A Child Poverty Action Group briefing on child benefit describes the benefit as "fairer than child tax allowances" because tax allowances "were worth even more to higher rate taxpayers (the better off)" (Bennett with Dornan, 2006, section 4). Similarly, John Hills, writing for the Child Poverty Action Group, asserts that any return to child tax allowances would produce "unfair results relative to the flat-rate child benefit" (quoted in Greener and Cracknell, 1998, p.23).

A more serious concern is that tax allowances are not worth anything to people on very low incomes who do not earn enough to benefit from them. This was the key justification made by Barbara Castle in 1975 when she replaced child tax allowances with the new Child Benefit:

> *"What will the child benefit scheme achieve? First and most important the poorer families who have not been able to take advantage of child tax allowance in full, if at all, because of their low incomes, will in future do so, as the new benefit extends the cash advantage of the allowance to all these families."*[121]

This was a powerful argument for reform, but switching to cash benefits was not the only possible response to it. Rather than scrapping family tax allowances in favour of cash transfers, these allowances could have been made *refundable*. In other words, people earning more than the value of their allowance would pay less tax, while those earning less than the value of their allowance would get the balance refunded to them as a 'negative income tax payment' or a 'tax credit.'

This solution to the problem has been around for a long time – the idea of a Negative Income Tax was put forward almost 50 years ago by Milton Friedman – but for many years it was fiercely resisted by left-wing and centrist parties.[122]

Since 1997, however, New Labour has come to embrace refundable tax credits as a key element in the tax and welfare system, which are in principle no different from a Negative Income Tax (although we shall see that they have been implemented differently in practice). In both negative income tax and a tax credit system, people pay tax if they earn above a certain threshold, and they are topped up with government transfers if they earn below it.

Looking back over the last 30 years, it is ironic that a Labour government should have scrapped child tax allowances in the 1970s on the grounds that they were regressive, for ever since 1997, New Labour has been struggling to find a system of family support which does not penalize people when they work harder and earn more. Belatedly, it has embraced the idea of refundable tax credits as a way of supporting 'working families', yet 30 years ago, it abolished tax allowances which had been supporting working families for many decades.

121 House of Commons debate, 13 May 1975, quoted in Greener and Cracknell (1998), p.9.

122 Friedman suggested that in place of the existing array of welfare transfers, a guaranteed basic minimum income should be delivered through the tax system. Just as anybody earning above the tax-free earnings threshold pays a given proportion of their additional income in 'positive tax,' so anyone earning below it could be topped up at a given rate with a 'negative tax.' (Friedman M (1962), *Capitalism and Freedom*, University of Chicago Press, ch.12). I have discussed some of the problems with this idea in Saunders P (2007), *The Government Giveth and the Government Taketh Away,* Sydney: Centre for Independent Studies.

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Tax allowances for families have all but disappeared in the UK, but governments have rejected them prematurely. Arguments that family tax allowances 'unfairly' favoured married couples, or that they expressed men's domination over women, or that they 'unfairly' benefited more affluent families more than poorer ones, are not compelling. Other concerns were more significant – that tax breaks may not filter down to the children in some families, and that families on very low incomes did not get the full benefit from them – but these worries could have been met without scrapping all allowances. Provided tax allowances are not the sole means for delivering support to families, they should be an important element in any family support system that seeks to promote strong, self-reliant families.

5

What Support do Families Get?

With the eclipse of tax allowances, government financial support for UK families is now concentrated on the universal Child Benefit and means tested tax credits. In addition, working parents receive specific assistance with the cost of formal childcare and parental leave rights, and non-employed families are eligible for welfare support.

Universal Child Benefit

Child Benefit is a cash payment for which all families with children up to the age of 16 are eligible (families with young people over 16 and under 20 also qualify if they are in an approved training scheme or full-time, non-advanced education). It is administered by the Child Benefit Office, which comes under the umbrella of HMRC (Her Majesty's Revenue & Customs, previously known as the Inland Revenue), and it costs the exchequer more than £10 billion per year.

In 2009, the benefit was worth £20.00 per week for the oldest child, and £13.20 for each subsequent child.[123] This money is paid to the principal carer (usually the mother – 96% of claimants are women).[124]

Child benefit is not means tested – all families qualify, no matter how much they earn or how wealthy they are – and it does not count as taxable income. Take-up is estimated at 98%. After the retirement pension, it is the most commonly-received benefit in the UK, with 28% of households receiving it.[125]

Child benefit has its origins in the old Family Allowances which were introduced in Britain in 1945. A flat-rate payment was made to the mother (originally the intention was that the money should be paid to the father, but this was amended as the Act passed through Parliament), while the principal wage earner also received a tax allowance for each dependent child. The weekly payment to the mother was treated as part of the family's taxable income, so although there was no means test, it was worth less to those on higher marginal tax rates. Nothing was paid for the first child.[126]

Family allowances and child tax allowances were both replaced by Child Benefit in 1975. This was a tax-free payment and it was paid for the first, as well as subsequent, children. The new benefit achieved three things in comparison with the system it replaced:[127]

- By capitalising child tax allowances into a cash payment, it ensured that families whose incomes had been too low to benefit from these additional allowances would now get support;

123 http://www.direct.gov.uk/en/MoneyTaxAndBenefits/TaxCreditsandChildBenefit/Childbenefits/DG_073828

124 Bennett and Dornan (2006).

125 Bennett and Dornan (2006).

126 Greener K and Cracknell R (1998), *Child Benefit*, House of Commons Library Research Paper 98/79.

127 See Barbara Castle's speech in the House of Commons, 13 May 1975, quoted in Greener and Cracknell (1998), pp.8-9.

- By including first and only children, it boosted the incomes of 4 million families which were already drawing family allowance for their younger children, as well as another 3 million which had only one child;
- By merging a tax allowance with a cash benefit, it created a simpler, single system of family support which was universal in its coverage (and was therefore consistent with the principle of horizontal equity).

This simplicity however did not last for long. During the 1980s, the real value of Child Benefit was allowed to fall, and the benefit was frozen for three years between 1988 and 1990. The Conservative Governments were generally disinclined to fund increases in a universal payment, which they saw as wasteful and inefficient. They preferred to target support on poorer families, which they did through the Family Income Supplement/Family Credit (discussed below) and by means of special payments for sole parents.[128]

In 1991, Child Benefit was raised for the first eligible child, and ever since then, eldest children have received more than their younger siblings (the gap was widened again in 1999).

Since Labour came to power in 1997, Child Benefit has been increased in real terms, but its significance relative to other family support measures has continued to decline. In 1979, Child Benefit accounted for 78% of all child-contingent state support. It now accounts for less than half.[129] As politicians' support for universalism has waned, and their enthusiasm for targeting has increased, Child Benefit has gradually been eclipsed by the continued growth of means tested family payments.[130]

It is easy to criticise Child Benefit. It is expensive, and large chunks of money go to people who do not need it. Much of the £10 billion or so that is paid out each year is churned – families pay more tax than is necessary, and then get the money back in the form of a Child Benefit payment they do not really need. It would make more sense to allow these families to retain more of their own earnings in return for scrapping their entitlement to this benefit.

But Child Benefit is a policy where good principles collide, so there are also strong arguments in its favour:[131]

- Key is that it recognises the principle of horizontal equity – that families with children should be favoured over those without at all levels of income. A flat-rate payment is not the only way this can be achieved (family tax allowances can do it too), but Child Benefit certainly scores over targeted systems like the Child Tax Credit which phase out for more affluent parents.
- Another compelling argument is the fact that it does not disincentivise work or contribute to the poverty or unemployment traps. Because it is a universal, flat payment which does not get withdrawn as earnings rise, and because it is not treated as part of taxable income, Child Benefit does not get clawed back by the government as soon as you put in some overtime, secure a promotion or find a part-time job.
- It is also a simple, easy-to-claim benefit which is cheap to administer (just 1.05p in the pound goes in administration costs – one-third of the cost of child tax credits). It achieves almost 100% take-up (much better than targeted benefits) and it is paid to the principal carer, so is more likely to be spent on the children.

128 The 'additional child benefit' was introduced alongside Child Benefit in 1977 and was paid to sole parents. In 1981 it became One Parent benefit. See Morgan P (2006), *Family policy, family changes,* p.105.

129 Adam, Brewer, Reed (2002), 'The benefits of parenting'.

130 Adam and Brewer (2004), *Supporting Families.*

131 Greener and Cracknell (1998), pp15-17; Bennett and Dornan (2006), section 3.

If there is to be a government family payment, Child Benefit looks like a reasonable compromise. It also has widespread public support. In the 2009 Policy Exchange-Ipsos MORI family survey, only 30% of respondents (and only 25% of parents) thought Child Benefit should be restricted to families on lower incomes.

Benefits for working families

In 1971, the then Conservative government introduced Family Income Supplement (FIS) as a way of topping-up the earnings of low-income families with at least one 'full-time' adult worker (defined as 30 hours per week, or 24 hours for sole parents).

Up until then, financial assistance for working families had been limited to the flat-rate Family Allowance payment and the Child and Married Man's tax allowances, as it was assumed that these would be sufficient to ensure that even a low, full-time wage would stretch far enough to cover the needs of families. The introduction of FIS marked a change in this thinking.

FIS brought a qualitatively new element into the family support system, for unlike Family Allowance, it was means tested and limited to working families, and unlike tax allowances, it took the form of a direct government transfer payment. This policy innovation was triggered by two growing problems:[132]

- Evidence from poverty surveys in the 1960s suggested that child poverty was not limited to non-working households (as had previously been thought), but was also affecting families where a low-wage earner was struggling to support a spouse and several children;
- Rising levels of welfare payments and falling tax-free earnings thresholds were combining to narrow the gap between the net incomes of low wage working families and the net incomes of families relying wholly on welfare. The result was that work incentives were being eroded.

FIS was therefore intended to combat 'working poverty' and to maintain work incentives. In the event, however, it created as many problems as it solved. In particular, it failed to eliminate the 'unemployment trap' (the situation where people could be better-off out of work and living on welfare than in-work and paying tax), and because it was assessed on a family's gross income, it also created a new 'poverty trap'.

FIS was calculated at 50% of the difference between a family's gross income and an upper limit (in 1983, this limit was £85.50 per week for a family with one child, plus £9.50 for each subsequent child up to a maximum of £22). But as a family's income approached this upper limit, they not only lost 50 pence in the pound of FIS entitlement, but they also lost 25 pence Income Tax, 7 pence National Insurance contribution, and 23 pence in means tested Housing Benefit: a loss of 105p for every additional 100p earned. The more they earned, the more they went backwards.[133]

Take-up, too, was disappointing – only half of those eligible for the benefit actually claimed it (no more than 200,000 families at any one time). But from such small acorns, large oak trees grow. FIS opened up a new channel of government assistance which no future government would be able to shut down again. Over the next 30 years, the number of people receiving in-work benefits rose eleven-fold.[134]

132 Marsh A (1997), 'Lowering the barriers to work in Britain' in *Social Policy Journal of New Zealand*, Issue 8.

133 Blundell R and Walker I (2001), 'Working families' tax credit: A review of the evidence, issues and prospects for further research' in *Inland Revenue Research Report 1*, Inland Revenue.

134 Morgan (2006), *Family policy, family changes*, p.106.

In 1986, FIS was replaced by Family Credit.[135] In an attempt to reduce the high effective marginal tax rates associated with FIS, Family Credit was assessed on net rather than gross family earnings, and the taper took account of other means tested benefits that families might be receiving, like Housing Benefit and Council Tax Benefit. Nevertheless, the withdrawal taper was still very steep (at least 70 pence in the pound) as people's earnings rose. For families claiming Housing Benefit and/or Council Tax Benefit, every additional pound earned resulted in a net gain of only 15 pence.

Family Credit also reduced the number of hours people had to work in order to be eligible to claim, from 30 to 24. In 1992, this hours requirement was further reduced to 16 in order to attract more sole parents into part-time work. This meant the government was underwriting a full week's wage for half a week's work.[136]

Because this more generous work condition inevitably encouraged some claimants to reduce their work commitments,[137] a £10 premium was added in 1995 for those working at least 30 hours per week. Later reforms also introduced a disregard for maintenance payments up to £15 per week, and an allowance against childcare costs of up to £60 per week for one child, or £100 for two, which was added to the earnings threshold at which Family Credit started to be withdrawn.

By the time the Conservatives lost office in 1997, around 700,000 people, nearly all of them women (for Family Credit was paid to the mother) were claiming Family Credit. 44% of them were sole parents, claimants received an average of £55 per week and the take-up rate was around 70-80%. Most of those who failed to claim were close to the upper earnings limit, which meant they would have gained little by claiming.[138]

Evaluation of Family Credit suggests that, although it still suffered from a serious 'poverty trap' due to the high taper rate, it did go some way to restoring the incentive to leave welfare and find employment. A sole parent receiving maintenance payments from her former partner and working just 16 hours a week was now 60% better off in work than if she stayed on Income Support.[139] Rates of workforce participation rose, particularly among sole parents, as a result of this strengthening of rewards, but overall hours of work fell among existing employees, as a result of the reduced work requirement.[140]

In 1999, the Blair Labour government replaced Family Credit with the Working Families' Tax Credit (WFTC). Like its predecessor, eligibility depended on working a minimum of 16 hours per week, and there was an additional payment for those who worked 30 hours or more. But WFTC was different in several significant ways:[141]

- First and most important, it was not paid as a cash benefit to the principal carer, unless families specifically asked that it should be. Rather, it was a tax credit, paid directly into the worker's pay packet by his or her employer who was then compensated by the tax office;
- Payments were made more generous, particularly for parents with young children. The earnings point at which the credit started to be withdrawn was raised (from £70 to £90 per week), and the taper rate was reduced (from 70% to 55%) in order to reduce the effective marginal tax rate on claimants who

135 The 1986 Social Security Act made three simultaneous changes to the welfare system. In addition to replacing FIS with Family Credit, it replaced Supplementary Benefit with Income Support and rent rebate with Housing Benefit (Marsh, 1997, 'Lowering the barriers to work in Britain').

136 Marsh (1997), 'Lowering the barriers to work in Britain'.

137 Blundell and Walker (2001).

138 Marsh (1997), 'Lowering the barriers to work in Britain'; Morgan (2006), *Family policy, family changes*, p.108

139 Marsh (1997), 'Lowering the barriers to work in Britain'.

140 Blundell and Walker suggest Family Credit increased rates of workforce participation among sole parents while at the same time reducing their overall hours of work.

141 Brewer M and Browne J (2006), *The effect of the Working Families' Tax Credit on labour market participation,* Institute for Fiscal Studies, *Briefing Note* No.69; HM Treasury, *Tax credits: Improving delivery and choice*, May 2008.

increased their earnings. The result was that eligibility for assistance was pushed much higher up the income scale;

- The childcare costs disregard was replaced by a childcare tax credit, which was added to the WFTC and reimbursed 70% of childcare costs up to £135 per week for one child and £200 for two or more (in the case of couples, both partners had to be working a minimum of 16 hours to qualify for this).
- All child support payments received from an absent parent were disregarded in calculating eligibility for WFTC.

The introduction of WFTC hugely increased the number of working families claiming the government top-up – from 786,000 families claiming Family Credit in August 1999, the numbers rose to 1,327,000 receiving WFTC in November 2002.[142] More than half were sole parents.[143]

The new rules also increased the number of families getting help with their childcare costs – up from just 32,000 who benefited from the Family Credit disregard, to 160,000 claiming the new childcare tax credit.[144]

> "The introduction of WFTC hugely increased the number of working families claiming the government top-up – from 786,000 families claiming Family Credit in 1999, the numbers rose to 1,327,000 receiving WFTC in 2002"

Because the new payment was more generous, as well as wider in scope, the cost to the taxpayer rose at an even faster rate than the number of claimants. In its last year of operation, 1999, Family Credit cost £2.68 billion (in 2002 prices). Three years later, WFTC was costing £6.4 billion.[145]

The WFTC only lasted four years. In 2003, it was replaced by two new tax credits: a Working Tax Credit (WTC) and a Child Tax Credit (CTC) (which is discussed separately below).

Like WFTC, the WTC is paid through the wage packet (although the 'childcare element' of WTC is separated out and paid as a benefit to the principal carer).

Unlike its predecessors, however, the WTC is paid to employed or self-employed workers in low income households, even if they do not have children. It is no longer, therefore, a specifically family-oriented payment, but should rather be understood as an anti-poverty measure for low-wage workers, an alternative to raising the minimum wage.

Single people and childless couples qualify for WTC provided they are working at least 30 hours per week. Sole parents and couples with children qualify if they (each) work 16 hours a week.

The payment itself comprises several different 'elements' (Table 11). The 'basic element', worth a maximum of £1,800 pa, is supplemented by other elements according to the circumstances of the claimant. For example, a sole parent or couple qualify for another £1,770; claimants who work 30 hours get an extra £735; people over 50 who have previously been on welfare get another £1,235 (or £1,840 if they work 30 hours); and so on. There is also a childcare element, which covers 80% of childcare costs up to £175 per week for one child, or £300 for two or more.[146] Add up all the elements which apply to you, and you find your total maximum entitlement.

142 Brewer, Ratcliffe, Smith (2008), p.9.

143 Morgan (2006), p.108.

144 HM Treasury (2008), *Tax credits: Improving delivery and choice*, Box 7.1.

145 Brewer and Browne (2006), p.4.

146 In the case of couples, both must be working at least 16 hours. As we shall see later, this rule contributes to the bias in the tax credits system which favours families where both parents work.

Table 11: Working tax credit and child tax credit 'elements' (2007-08)

Element	Value £/year
WTC	
Basic	1,800
Addition for couple or sole parent	1,770
Addition if work 30+ hours	735
Addition if disabled	2,405
Addition if severely disabled	1,020
Either: Addition if 50+ returning to work 16-29 hours	1,235
Or: Addition if 50+ returning to work 30+ hours	1,840
Childcare element: 80% of actual cost up to	
For one child	(£175 per week)
For 2+ children	(£300 per week)
CTC	
Family	545
Addition for baby under 1 year	545
Addition for each child	2,085
Addition for each disabled child	2,540
Addition for each severely disabled child	1,020

Source: HM Revenue & Customs, WTC2: *Child tax credit and working tax credit – A guide*, June 2008.

How much of this entitlement you actually get depends on your income (Table 12). Eligibility for WTC disappears at a rate of 39p in the pound as incomes rise.[147] In June 2008, a single person without children working 30 hours per week for the minimum wage of £8,612 per annum would have received a WTC top-up of £1,685, but this would have tapered down to nothing at earnings just above £12,000. An equivalent childless couple would have got a £3,455 top-up if they were earning the minimum wage, declining to zero just above £17,000 p.a. (total household income).[148]

For employed claimants with dependent children, the WTC is combined with the second new tax credit created in 2003, the Child Tax Credit. As we shall see, this is paid as a cash benefit to the principal carer, not as a top-up to wages.

A claimant's maximum entitlement is calculated by adding all appropriate elements from each of the two tax credits (see Table 11), and the amount claimed then depends on how much the family is earning.[149] A two-child family with one adult working 30 hours a week on the minimum wage would get a top-up of £8,175, almost doubling their gross earnings.[150]

As a family's earned income rises, so the Working Tax Credit is phased out. Once that has been exhausted, the childcare tax credit (a separate element of WTC) starts to decline, and when that has gone, the Child Tax Credit starts to taper out (first the 'child element' and then the 'family element').[151] Payments do not disappear altogether, however, until a family is earning a household income of £58,000 per year (or £66,000 if they have a baby under 12 months old).[152] This means that nine in ten UK families are receiving a tax credit payment from the government.[153]

147 HM Treasury, *Working tax credit and labour supply,* Treasury Economic Working Paper No.3, March 2008, p.38.

148 HM Revenue & Customs, *WTC2: Child tax credit and working tax credit – A guide*, June 2008, p.18.

149 Non-working families are still able to claim CTC, but do not receive WTC (or the childcare element of WTC) – see next section.

150 Note that sole parents and couples with children receive the same top-up – no additional amount is payable to cover the living costs of partners.

151 WTC reduces by 39p in the pound once the first income threshold of £6,420 p.a. has been reached. If both WTC and CTC are being claimed, CTC reduces by 39p in the pound once all the WTC has been exhausted (if only CTC is claimed, it reduces at 39p in the pound once an income threshold of £15,575 has been reached). Once the 'child element' has been exhausted, the 'family element' of CTC continues to be paid up to a second income threshold of £50,000, at which point it is reduced by £1 for every extra £15 of gross earnings. See Department of Work & Pensions, *Tax Benefit Model Tables April 2008*, DWP, 2008, p.5.

152 HM Revenue & Customs (2008), *WTC2: Child tax credit and working tax credit – A guide*; HM Treasury (2008), Tax credits: Improving delivery and choice

153 HM Treasury (2008), Tax credits: Improving delivery and choice, p.22.

Table 12: Annual combined value of working tax credit and child tax credit for different household types employed 30 hours per week at different levels of earnings (2007-08)

Annual income £	Single person	Childless couple	One child	Two children	Three children
8,612 (min wage)	1,685	3,455	6,090	8,175	10,265
10,000	1,140	2,910	5,545	7,635	9,725
12,000	360	2,130	4,765	6,855	8,945
15,000	–	960	3,595	5,685	7,775
20,000	–	–	1,645	3,73	5,825
30,000	–	–	545	545	1,925
40,000	–	–	545	545	545
50,000	–	–	545	545	545
60,000	–	–	–	–	–

Note: Figures for one, two and three child families do not include Child Benefit.
Source: HM Revenue & Customs, *WTC2: Child tax credit and working tax credit – A guide,* June 2008.

Take-up of WTC in 2005-06 was only 61%, although 82% of the money was claimed, suggesting that most of those who were eligible but failed to claim were higher earners who would only have been entitled to small top-ups.

In all, 2.6 million families received WTC in 2006-07. There were also 305,000 childless workers claiming WTC,[154] although take-up among this group is very low, and there are thought to be about a million more eligible non-claimants.[155]

Some 384,000 families were also in receipt of the childcare element of WTC, and it is estimated that this number had increased to 450,000 by April 2008. They received an average of £59 each per week.[156] Government spending on the childcare tax credit in 2004 was more than 16 times greater than on the childcare disregard under the old Family Credit in 1998. Analysis suggests that, while this huge increase in government subsidies may have led some parents to shift from informal and family care (which does not qualify for the credit) to formal care (which does), it has had little impact on the overall level of female workforce participation.[157]

Means tested child benefit: the Child Tax Credit

Although the Child Tax Credit (CTC) is administratively integrated with the Working Tax Credit, it operates in a very different way and on very different principles. Indeed, despite its name, it is not really a 'tax credit' at all.[158] In essence, it is a second Child Benefit, but one that is means tested. As such, it represents yet another new departure in the burgeoning array of financial support measures now offered to families by the UK government.

Back in the Thatcher years, the government thought about means testing the Child Benefit, but rejected the idea. In 2003 the Blair government resuscitated the idea of means testing, but instead of applying income rules to the existing Child Benefit, it created a new one, and applied them to that instead. Since then, all families have received the same flat-rate amount in Child Benefit, on top of which most have also received varying amounts of the new payment, confusingly named 'Child Tax Credit.'

154 HM Treasury (2008), Tax credits: Improving delivery and choice, p.21.

155 Mulheirn I and Pisani M (2008), *Working tax credit and labour supply*, Treasury Economic Working Paper No.3, p.39.

156 HM Treasury (2008), Tax credits: Improving delivery and choice, p.46.

157 Brewer M (2007), *Welfare reform in the UK: 1997-2007, Institute for Fiscal Studies, Working Paper* 20/07 p.11.

158 "The family elements of the tax credits system, while masquerading as tax allowances and rebates, remain welfare payments in all but name". (Kirby J (2005), *The price of parenthood*, p.2).

CTC is not really a tax credit because (a) it is paid as a weekly or monthly cash payment, not as a wage supplement; (b) it is paid to the family's principal carer, not the person earning the income; and (c) it is paid regardless of whether or not parents are employed. On all three of these criteria, it looks exactly like Child Benefit. The only difference is that it is means tested on family income. It is paid by HMRC, but the tax office runs it in exactly the same way as the Department of Work & Pensions administers welfare benefits.[159]

The government likes to maintain the fiction that CTC is a genuine tax credit, for this allows it to claim that millions of families have been taken out of tax:

> *"The proportion of families with children paying no net tax has risen from 34% in 1997-98 to 42% in 2005-06 when NICs are excluded; the proportion of families paying no net tax including NICs has risen from 31% to 39%. The number of families paying net tax has fallen by around 500,000 on either basis."*[160]

> *"Four out of ten families with children now pay no net tax."*[161]

But claims like these are very misleading. CTC is no more a 'negative tax' transfer than Child Benefit is, and it should not be treated as if it were. WTC reduces the amount of tax people pay, but CTC does not. Given that WTC is the first of the so-called 'tax credits' to taper out as incomes rise, the great majority of families only receive CTC, and they get this as a payment, not a tax reduction. As the government coyly admits:

> *"Tax credit payable through employers is withdrawn first, so that many families with children receive all their tax credits by direct payment."*[162]

Workers in families receiving CTC pay just as much tax as anybody else on the same income. HMRC then hands some or all of this money back again as a cash benefit. The introduction of CTC has not, therefore, reduced the tax burden on families; it has simply increased tax-welfare churning.

When it introduced the now defunct WFTC in 1999, the government emphasised the importance of linking tax credits to the receipt of a wage:

> *"A tax credit will associate the payment in the recipient's mind with the fact of working, a potentially valuable psychological change."*[163]

But with the advent of CTC, this link to working has been broken. Just as the WTC is no longer a family payment (because people without children can claim it), so the CTC is no longer a working payment (because people without jobs can claim it). The government could have achieved exactly the same impact on family incomes simply by raising the value of the Child Benefit, and applying a generous means test to the top end of it.

As Table 11 shows, the CTC consists of a 'family element' and a 'child element'. Maximum CTC is payable to families with incomes below £15,575, at which point the child element begins to be withdrawn. When all the child element has gone, CTC is paid at the flat 'family element' rate until household income exceeds £50,000, when the family element too is withdrawn at a rate

159 Adam and Brewer (2004) *Supporting Families*, p.22.

160 HM Treasury, *Tax credits: Reforming financial support for families*, HMSO, March 2005, p.21.

161 HM Treasury (2008), Tax credits: Improving delivery and choice, p.18.

162 HM Treasury, *The child and working tax credits*, HM Treasury, April 2002, p.35 (emphasis added).

163 Tayler M (2002), *The modernisation of Britain's tax and benefit system*, para 1.22.

of £1 for every extra £15 of income. CTC eligibility finally expires altogether at a household income of £58,000. Only one in ten British families is above this eligibility threshold.

Take-up of CTC has been quite high – 82% of eligible families claim it, and 90% of the money available is claimed. Among sole parents, take-up is 95%.[164] Around 6 million adults and 10 million children receive tax credit payments from the government.[165] With one stroke of the legislative wand, the great majority of Britain's families have been transformed into welfare claimants.

Other assistance

In addition to Child Benefit and tax credits, there is a scattering of one-off or intermittent payments for which all or some families qualify. These include:

- The Sure Start maternity grant. A universal maternity grant was introduced along with Family Allowances after World War II, but in 1987 it was means tested. Today it is payable only to families on welfare and working families on low incomes. It is worth £500 on the birth of a new baby;
- A 'Health in Pregnancy Grant', worth £190 and payable to all expectant mothers irrespective of income, was introduced in April 2009;
- A government-financed Child Trust Fund voucher, worth £250 at birth (£500 for welfare and low income families) and another £250 (£500) at age seven, was introduced in 2003, and is paid to every child. It is put into a tax-free savings account in the name of the child and can be cashed at age 18. The idea is that it will provide all young adults with an asset which they can use as a deposit on a house, to set up a business, or to help pay for further education or training, but in practice there is no restriction on how this money can be spent.

Although we are concerned in this report mainly with cash support delivered directly to families through the tax and benefits systems, it is also important to remember that government delivers a lot of other assistance through other channels. Some of the most important include:

- Help with childcare costs. In addition to the childcare element of the WTC, which provides 450,000 families with a cash payment covering 80% of their childcare costs up to £300 per week, the government also allows parents to claim tax relief on childcare costs by 'salary sacrificing' (employers who participate in the scheme agree to deduct a sum for childcare payments from employees' gross earnings before tax is applied). As we saw earlier, the government is also spending huge sums on new Children's Centres, which compete with private sector and voluntary agencies to provide pre-school care for under-3s, and local authorities are required to offer free nursery places to all 3 and 4 year-olds, as well as providing out-of-school hours care for school pupils whose parents are working full-time.
- Statutory Maternity Pay and Maternity Allowance. In 2002, women were given the right to 6 months paid, and 6 months unpaid, maternity leave. Men were given 2 weeks paid paternity leave.[166] The right to paid maternity leave was

164 HM Treasury (2008), Tax credits: Improving delivery and choice, p.20.

165 Ibid, p.19.

166 Family & Parenting Institute, *Parenting Policy: The last 10 years*, 2007, p.6.

extended from 6 to 9 months in 2007, and the government is committed to extending it to a full year.[167] The cost is borne by employers who reclaim most of it by reducing their National Insurance contributions. Women are paid 90% of their previous salary for the first 6 weeks, then up to £133 per week for the next 33 weeks. Self-employed, casual and other workers not entitled to claim Statutory Maternity Pay can claim the Maternity Allowance, which is worth £133 per week for 39 weeks.[168]

- Welfare support for sole parents. All sole parents used to get a special payment, known as One Parent Benefit, but this was scrapped in 1998 on the grounds that "support should be on the identifiable needs of children, not on whether there happens to be one parent or two".[169] Notwithstanding this principle, however, sole parents are still only expected to work 16 hours per week before the government tops them up to the equivalent of a full-time wage (1.1 million sole parents receive more in state benefits than they earn from work).[170] Furthermore, until recently, provided they had school-age children, sole parents had a right to live permanently on Income Support, which also gave them access to Housing Benefit, Council Tax Benefit, free school meals and free prescriptions and dental treatment. Under new rules, this work exemption will in future only apply to sole parents whose children are under seven years of age.[171]

167 2007 Budget, *Building a Fairer Society*, Section 5.30.

168 DirectGov, 'Maternity Pay',http://www.direct.gov.uk/en/Parents/Moneyandworkentitlements/Parentalleaveandpay/DG_10029290.

169 Gordon Brown, House of Commons, March 1998, quoted in Adam, Brewer, Reed, *The benefits of parenting*, p.17.

170 58% of sole parents receive more in benefits than they do in earnings. This compares with only 11% of couples. Green D, 'If you want welfare, work for it', *Daily Telegraph*, 2 September 2008.

171 Department for Work & Pensions, *In work, Better off*, DWP, CM7130, July 2007.

Proposition 6

The system of tax allowances and welfare benefits for families has become very complex and very costly. Child Benefit is a simple, administratively efficient payment which does not lead to poverty or unemployment traps and which is widely understood and popular. The system of tax credits which has grown up alongside it, as a replacement for the old family tax allowances, is, by contrast, complex, costly and bewildering. Because tax credits are means tested, generate significant work disincentives, and encompass 90% of the nation's families, they have expanded 'middle class welfare' and exacerbated the problem of tax-welfare churning. Since 2003, the original rationale for tax credits has been lost altogether, as CTC has been uncoupled from employment. Despite its name and the claims the government makes about it, CTC is not a tax credit, but is a second layer, means tested, Child Benefit.

6
Are Tax Credits Working?

Child Benefit remains an important element of state support for families, but we have seen that it has declined in significance as measured by the proportion of child-contingent state spending that it absorbs. Tax credits are now at the core of the government's family policy.

The government describes the philosophy that underpins its increasing reliance on tax credits as "progressive universalism":

> *"The advent of the new tax credits offers the opportunity to introduce a new approach based on the principle of progressive universalism. This means supporting all families with children, but offering the greatest help to those who need it most through a light touch income test."*[172]

'Progressive universalism' is an oxymoron which draws attention to the income redistribution agenda which underlies recent changes to family policy. The 'universalism' is provided by the old child benefit; the 'progressive' element is delivered by the new tax credits.

In addition to supporting all families with Child Benefit, family policy has been broadened to encompass two further objectives which are the specific objectives of tax credits:

- Reducing child poverty;
- Strengthening work incentives.

In each case, we shall see that tax credits have delivered some, but not all, of what was hoped for.

Have tax credits reduced child poverty?

Patricia Morgan has argued that the move to tax credits marked the demise of family policy as policy emphasis has shifted away from a concern with supporting families, towards a focus on redistributing incomes; away from increasing 'horizontal equity' to increasing 'vertical equity':

> *"After reaching its apogee by the mid-twentieth century, family policy in the UK is a story of decline and fall. By the end of the last century, it was essentially dead… Instead, the targets of policies that impact on families are poverty and inequality."*[173]

There is some truth in Morgan's observation. Since it was elected in 1997, New Labour's overriding social policy emphasis has been tackling 'child poverty.' On the

172 HM Treasury (2002), *The child and working tax credits*, p.4.

173 Morgan (2006), *Family policy, family changes*, p.92.

face of it, this seems a laudable aim which nobody could disagree with, but in practice it has entailed a return to an old-fashioned, vertical income redistribution agenda. 'Poverty' has been conceptualised and measured in relative terms (the government thinks you are poor if you have significantly less money than most other people do). Reducing poverty therefore involves redistributing incomes from higher and middle-earning households to those towards the bottom of the income scale. Tax credits have been central to this strategy.

The problem with 'child poverty'[174]

'Poverty' is a slippery concept. Defined in 'absolute' terms, it denotes a standard of living below some basic, minimum level (e.g. an income which is insufficient to buy necessary foodstuffs, housing, clothing, and so on). Defined in 'relative' terms, it denotes a standard of living which is considered 'low' compared with the average or norm enjoyed in the society as a whole.

A family may be in 'relative poverty' yet still have enough money to buy the things they need: they are deemed 'poor' because they have less than others around them do. Relative poverty is, therefore, a distributional phenomenon: whether or not you are poor depends on how much money you have in comparison with what other people have.

Most academic poverty researchers in western countries focus on 'relative poverty', not absolute poverty, and they have influenced the way their governments address this issue. The European Union, for example, now defines 'poverty' as an income below 60% of the median income in any given country, the OECD often draws its poverty line at 50% of median income, while others draw it at 50% or 60% of mean income. Whatever the variations between them, these definitions have two immediate consequences:

- Two families enjoying exactly the same standard of living in two different countries may be classified differently, one as 'poor', the other not, depending on what the median income happens to be in each country;
- Countries (like the Scandinavian nations) which have a more compressed income distribution as a result of high taxes and generous welfare benefits will have much lower relative 'poverty rates' than countries (like the 'Anglo' nations) where the income distribution is more spread out.

'Poverty' defined in this way is inseparable from 'inequality', and anti-poverty measures become redistribution measures under a different name. If (as in the UK since 1997) a government wants to reduce its poverty rate, it can do it by redistributing incomes in such a way that significant numbers of people move from just below, to just above, the 60% of median income line.

If 'poverty' is a slippery concept, then 'child poverty' is even more problematic.

When assessing whether or not people are 'in poverty', researchers adjust actual incomes to take account of the number of people in their household. They refer to the result as people's 'equivalised income.' Every household member (including the children) is given the same equivalised income, and it is this figure that researchers use to gauge whether or not individuals fall below the 60% of median income poverty line.[175]

Assessments of the number of children 'in poverty' will vary according to how incomes within households are equivalised. There is no obviously 'correct' way of doing this, and the OECD has at least three different equivalence scales:[176]

174 This section draws on a more extensive discussion of problems in the conceptualisation and measurement of poverty in Saunders P and Tsumori K (2002), *Poverty in Australia: Beyond the rhetoric*, Centre for Independent Studies. I will be producing a research note for Policy Exchange on child poverty which will be published later this year.

175 Note that, statistically, it does not matter how far above this arbitrary line they are lifted, as long as they get above it. In many countries, many households cluster around this 60% of median income mark. In these cases, it would be possible to make a substantial impact on the poverty figures by increasing the incomes of a large number of people by a relatively trivial amount. This might not make much difference to their living standards, but it will make a big difference to the country's standing in international poverty league tables.

176 OECD Social Policy Division, *What are equivalence scales?*, http://www.oecd.org/dataoecd/61/52/35411111.pdf

- Its 'Oxford scale' assigns a weight of 1 to the first household member, 0.7 to each additional adult, and 0.5 to each child.
- Its 'modified scale' changes this to 1 for the first member, then 0.5 for each additional adult and 0.3 for each child.
- Its 'square root scale' simply divides total household income by the square root of the number of people in the household.

The OECD itself warns that choice of equivalence scales depends on value judgements as well as technical considerations, and that poverty estimates will be affected by this choice. Child poverty rates, for example, will be higher if you use a scale that gives greater weight to each additional household member, for the more children a household has, the more each members' equivalised income will be depressed.

Equivalising people's incomes is a sensible and legitimate procedure (it rests on the same principle of horizontal equity which in the past led governments to give workers with dependent families greater tax relief than workers with no dependents). But it inevitably introduces another element of arbitrariness into the calculation of poverty rates. It would be possible to develop an equivalence scale which would define almost none, or almost all, of the children in a country as 'poor.'

Claiming that 2.9 million British children are in poverty[177] therefore is almost entirely meaningless, for the figure derives from an arbitrary poverty line (60% of median income) and an arbitrary use of equivalence scales. The statistic tells us nothing about how many children are deprived or suffering hardship; nor does it tell us anything about the quality of life these children are enjoying. All that a statistic like this can really do is give a benchmark against which changes over time in the distribution of household incomes can be measured. In other words, it is more a statement about inequality than a statement about poverty.

We saw in Table 4 (page 25) that Britain's child poverty rate (defined as the number of children with an equivalised income below 50% of the median) was significantly higher in 2000 (16.2%) than the OECD average of 12.0%. It had been even higher – above 20% – in the mid-1990s, and it had been increasing more or less steadily ever since the 1970s.[178]

Britain's record on child poverty at that time compared poorly with most other EU countries. In France, child poverty was 7%; in Germany, 13%. The Scandinavian nations averaged only around 3%. Although the UK was not out of line with other 'Anglo' countries (the US figure in 2000 was 21.6%),[179] it was around the bottom of the EU poverty league tables, and New Labour wanted to do something about it. In March 1999, Tony Blair announced his target of halving child poverty by 2010, and eradicating it by 2020.

Tax credits were to be the main vehicle for achieving this, and they would do it in two ways. First, the child tax credit would boost family incomes directly, and because it was means tested, it would have most of its impact on those with the lowest incomes. Secondly, the working tax credit would increase the participation of low income parents (particularly sole parents) in paid work.

It was known that the main cause of poverty is joblessness – in 1999, half of all the children living in 'poor' households in the UK were in families where nobody worked.[180] Poverty in non-employed sole parent households was particularly high, although unemployed couples with children also ran a high risk of poverty (Table 13). The OECD estimated that if Britain could reduce the number

177 Hirsch D (2009), *Ending child poverty in a changing economy*, Joseph Rowntree Foundation.

178 HM Treasury, *Supporting children through the tax and benefit system*, November 1999, chart 1.4.

179 *Babies and Bosses* (2007), Table 1.1.

180 HM Treasury (1999), *Supporting children through the tax and benefit system*, p.10.

of jobless households to Swedish levels (Sweden was the third-best OECD performer), we could shave more than 3 percentage points off our poverty rate.[181]

Table 13: Poverty rates comparing the UK with the OECD (2000)

	UK	OECD average
Children	16.2	11.9
Households with children	13.6	10.3
Sole parents (employed)	20.6	19.9
Sole parents (not employed)	62.5	55.2
Couples (both employed)	3.6	4.4
Couples (one employed)	17.6	13.3
Couples (not employed)	37.4	41.5

'Poverty' defined as equivalised income below 60% of the median.
Source: Peter Whiteford and Willem Adema, What works best in reducing child poverty? *OECD Social Employment and Migration Working Papers* No.51, 2007, Table 3.

Here, then, was the logic behind introducing a tax credit linked to employment (the WFTC, and later the WTC). The hope was that this would encourage more people to take up jobs, and coupled with the child tax credit, would reduce poverty by raising earned incomes as well as benefits in the poorest families.

With the new tax credits in place, the OECD has calculated that a single-earner family in Britain working full-time at the minimum wage and receiving all the benefits and tax credits to which it is entitled should end up with an equivalised income above 60% of the median (one earner couples get 63% of the median, and sole parents get 75%).[182] Work full-time, in other words, and you should get enough income to insulate you and your family from the risk of poverty.

This is a significant achievement. The problem, however, is that many people do not work full-time, and many still live in families where nobody works at all.

The government's new tax credits have helped reduce child poverty, but not by as much as had been hoped. The Joseph Rowntree Foundation suggests that 1.1 million children will have been taken out of 'poverty' between 1998 and 2010 (although it warns that many of them are hovering 'very close' to the poverty line, and could drop back again very easily).[183] However, the same report also warns that the government is still going to end up 600,000 short of its target of halving child poverty by 2010.

To achieve the 2010 target, the Rowntree report suggests more income redistribution is needed. It wants the government to increase the value of the Child Tax Credit by £12.50 per week more than is currently planned. This would add another £4.2 billion each year to the nation's tax credit bill (on top of the additional spending of £2 billion already announced in the 2007 and 2008 budgets) – a significant amount even before the recent economic downturn.

Eradicating child poverty is proving to be a very expensive commitment. It is also a very frustrating one, for progress has slowed, and there are even signs we are going backwards. Most progress was made between 1998 and 2001. After that, things stalled, and in 2005-06, child poverty started increasing again.[184]

181 Whiteford P and Adema W (2007), *What works best in reducing child poverty?*, OECD Social Employment and Migration Working Papers No.51, Table 10.

182 Ibid, Table 11.

183 Hirsch D (2009), *Ending child poverty in a changing economy*.

184 Field F and Cackett B (2007), *Welfare Isn't Working: Child Poverty*, Reform.

The Rowntree Foundation forecasts that on current trends, far from being eradicated, child poverty in 2020 will be back to 3.1 million, close to where it was in 1997. This is why it is urging the government to increase expenditure on CTC still further but the cost of meeting the 2020 child poverty target already looks to have spiralled out of reach:

> *"In 2020, the Government would need to be spending an extra £30 billion a year in order to abolish child poverty. No one believes that anything like this sum will be forthcoming."*[185]

One reason why, despite the huge levels of expenditure, the government is failing in its mission to eradicate child poverty is that the number of sole parent families (a major risk factor for child poverty) is so large and growing:

- Between 1979 and 2003, the number of children in sole parent families in the UK more than doubled (from 1.4 to 3.2 million).
- Child poverty is much higher in sole parent households than elsewhere. Sole parent families make up 25% of all families with children in Britain, but they comprise 71% of the families in the lowest income decile.[186]
- Poverty is high among sole parent families mainly because their work rates are so low. In the 1990s, as few as 40% of UK lone mothers were in employment, compared with about 50% in France and Germany, and over 60% in the USA, Canada, Spain, Italy, Finland and Austria.[187] WFTC and WTC helped increase sole parent employment to 56% by 2005,[188] but most sole parents are still either not in work, or employed part-time, and are not therefore working enough hours to earn an income to take them and their children above the poverty line.

Compared with other EU countries, we have a very high proportion of children living with a sole parent (second only to Sweden), *and* we have the highest proportion of children living in sole parent families where the parent is not employed.[189] It follows that, no matter how much money we redistribute, we are unlikely to make a big impact on child poverty rates unless we (a) reverse the growth of sole parent families and/or (b) get more sole parents into full-time employment.

The government acknowledges there is a link between sole parenthood and low incomes, but it treats it as contingent. According to the Department for Children, Schools and Families:

> *"It is not being a sole parent itself that is problematic, but rather the relationship problems that led to the breakdown and the financial consequences that often follow."*[190]

But this official line makes no sense, for what the government calls the "financial consequences" of sole parenthood are inherent to it, and cannot be separated out from it.

The point is that one adult generally cannot devote sufficient labour time to earning enough money to sustain the whole family while also devoting the time that is needed to bringing up the children. This is why there are 'financial consequences.' The only exceptions to this are:

185 Field F and Cackett B (2007), *Welfare Isn't Working: Child Poverty,* p.15.

186 Cabinet Office Strategy Unit (2008), *Families in Britain: An evidence paper*, p.85.

187 HM Treasury (2005), *Tax credits: Reforming financial support for families*, Chart 2.3.

188 Gregg P, Harkness S and Macmillan L (2006), *Welfare to work policies and child poverty*, Joseph Rowntree Foundation.

189 Bradshaw J (2005), *A review of the comparative evidence on child poverty*, Joseph Rowntree Foundation, p.7.

190 *Families in Britain: An evidence paper,* 2008, p.86.

- When the parent earns an unusually good wage (which is why sole parenthood is generally less problematic among the professional classes than lower down the socio-economic scale where it is much more common);
- When the second (absent) parent funds the family with generous, regular child support payments equivalent to the income brought in by a live-in partner (which is extremely rare – most sole parents receive nothing from the absent parent).[191]

Because neither of these exceptions usually applies, the steady increase in the number of sole parents over the last three or four decades has inevitably been matched by a steady increase in child poverty rates.

> "When parents break up, or when women have a baby without a committed partner to help raise it, they significantly increase their children's exposure to the risk of poverty"

It could be argued (as the Rowntree Foundation does) that it is the government's job to counter this by transferring even more money to these families. This is precisely what has been happening since the 1990s, for policies for tackling 'child poverty' have in practice involved policies to assist sole parents. But such a policy is treating the symptom of the child poverty problem and not its cause, and ultimately it cannot work.

The growth of sole parenthood is not the only factor contributing to our high rate of child poverty, but it is the single most important one. When parents break up, or when women have a baby without a committed partner to help raise it, they significantly increase their children's exposure to the risk of poverty. The more parents who follow this path, the bigger the problem of child poverty becomes.

Politicians are generally loath to acknowledge this. It is safer to celebrate the 'diversity' of family forms in a neutral and non-judgemental way than to admit that the spread of sole parenthood is causing major problems. This policy of denial means child poverty is unlikely to be solved.

Have tax credits strengthened work incentives?

It has become a norm in Britain for sole parents to stay at home until their children reach their teens or beyond. Many do not even look for part-time work during this period.[192] Half of all sole parents work full or part-time, but the other half live on Income Support, and half of them have been on Income Support for 8 years or more.[193]

Table 14 shows that joblessness is much more common among sole parents than among couples, no matter how old their children are.

When children are under school age, almost three-quarters of sole parents do not work, yet only 7% of couples with children this age have no adult in employment, and in more than four in ten couples, both parents are going out to work at this time.

Once the children start school, part-time employment among sole parents rises to 37%, but only one in five have full-time jobs, and 43% are still not working at all. Yet among couples, more than half are both employed by the time their youngest child reaches 5.

191 In theory, the Child Maintenance and Enforcement Commission (formerly the Child Support Agency) ensures that parents continue to pay for their children's upkeep, even after the family splits up, but in practice 2 out of 3 sole parents receive nothing from the non-resident parent, and some (like students and those on low incomes) are formally exempted (Social Justice Policy Group, *Breakthrough Britain, vol 1: Family Breakdown*). Child maintenance payments should lift significant numbers of children out of poverty – in Australia, 25% of poor children are taken out of poverty as a result of these payments – but in the UK the comparable figure is 2.9% (Field and Cackett, 2007, *Welfare isn't working*, p.6).

192 The OECD notes that in Britain, "benefit levels are towards the upper end of the range of OECD countries, and the benefits are available without a work test until the youngest child is a teenager. These arrangements reinforce expectations that mothers should stay out of the labour force on a very long term basis" (Whiteford P and Adema W, 2007, p.34).

193 Kirby J (2005), p.21.

Table 14: Employment status of couple and sole parent families with children at varying ages (%)

	Age of youngest child				
	0-4	5-10	11-15	16-19	All
Couples					
Self-employed	14	14	18	17	15
Both FT work	14	20	29	36	21
1 FT, 1 PT work	27	34	28	26	29
1 FT, 1 not emp	32	19	15	13	23
Only PT work	6	7	5	5	6
No work	7	5	5	3	6
Sole parents					
Self-employed	1	1	3	1	2
FT work	9	19	31	49	22
PT work	19	37	31	29	29
No work	70	43	35	22	49

Source: Department for Work & Pensions, *Family Resources Survey 2006-07* Table 7.10

This norm of joblessness reflects the fact that, until recently, the UK was one of only a handful of western countries (the others were Ireland, New Zealand and Australia) where governments gave sole parents the right to stay on welfare without seeking employment until their children reached school leaving age. As the OECD notes:

> *"In Australia, Ireland, New Zealand and the United Kingdom, the entitlement to income support plays a key role in explaining low employment levels. In these countries, benefit durations are not limited and parents can receive benefits without a work test until their youngest child is a teenager. The signal being given to sole parents on income support has been that dependency is expected. Little effort was made in the past to tell sole parents that work is desirable and beneficial to the family as a whole."*[194]

This disastrous situation has now been reformed, and those claiming benefits will in future have to look for part-time employment when their oldest child gets to seven. This is still generous by European standards, however, and the cultural legacy of the old system continues to depress the participation rate.

Britain's sole parent employment rate is one of the lowest in the OECD. It has improved significantly over recent years, rising from 45.5% in 1997 to 56.5% in 2006, the highest rate on record.[195] Nevertheless, the UK still compares unfavourably with most other EU countries and is a long way behind the Scandinavians (in Denmark, for example, all sole parents are expected to work provided childcare is available, and the participation rate is 80%).

The improvement in the UK's participation rate is partly due to the strengthening economy in the years prior to 2008, but also reflects the impact of tax

194 *Babies and Bosses* (2007), p.87.

195 Brewer M (2007), *Welfare reform in the UK 1997-2007*, Institute for Fiscal Studies, *Working Paper* 20/07.

credits.[196] The WFTC, which ran from 1999 to 2003, is estimated to have increased the UK labour supply by 81,000 individuals (two-thirds of them women) and raised the sole parent employment rate by 5 percentage points.[197] Combined with the New Deal for sole parents, the WFTC helped almost half a million sole parents to enter employment after 1997, and reduced the number on benefits by quarter of a million to 783,000.[198]

Although tax credits have prompted more sole parents to take up jobs, many of them full-time, they have had little net impact on overall work levels among other groups. Eligibility for tax credits is calculated on family income, so second earners in couples find that their earnings reduce the family's entitlements. Not surprisingly, there is a tendency among low-income couple families for the second earner (usually the mother) to reduce her hours in response to this, or to stop work altogether, while low income single earners (usually the father) may be induced to increase their hours.

In every country where tax credits have been introduced, sole parent employment rates have risen, but women in couples have reduced their participation in paid work.[199] In Britain, it has been calculated that WFTC slightly reduced the employment rate of women in couples by 0.6 percentage points, while raising that of men in couples by 0.7 percentage points. While the overall work rate for couples remained virtually unchanged, there was therefore some reallocation of paid employment between partners.[200]

When eligibility for tax credit support was extended in 2003 to include low income workers without children (who were allowed to claim the new WTC), they increased their participation rate by between 2 and 3 percentage points, although some people who were already working reduced their hours to take more advantage of the top-up.[201] As we shall see, it is an inherent feature of in-work benefits like WTC that they reduce the hours people are willing to work even as they enhance their incentives to take up jobs.

The impact of tax credits on workforce participation has therefore been positive, but patchy. Sole parents have been the big gainers, single people without children have also increased their likelihood of working, but women in couples have slightly reduced their participation.

Proposition 7

Growing reliance on tax credits marks a shift in government priorities from supporting families with children, in accordance with the principle of horizontal equity, towards two other objectives: reducing 'child poverty' and increasing workforce participation by adults in jobless households. These objectives are linked, for child poverty is often a result of living in a household where no adult is employed. They also tend to target the same kinds of households, for poverty and joblessness are both much more common in sole parent families than in other household types. Tax credits have delivered lower child poverty rates and higher economic participation rates in sole parent families, but these successes have come at the cost of significantly increased public expenditure. Couples with children have generally gained much less from tax credits, and second earners (usually women) have been slightly disadvantaged by them.

196 *Babies and Bosses* (2007), p.92.

197 Brewer M, Duncan A, Shephard A and Suarez MJ (2005), *Did Working Families' Tax Credit work?*, HM Revenue & Customs.

198 Freud D (2007), *Reducing Dependency, increasing opportunity*, Report to the Department for Work and Pensions, HMSO.

199 Nolan P (2006), *Tax relief for breadwinners or caregivers?*, p.178.

200 Brewer M, Duncan A, Shephard A and Suarez MJ (2005), *Did Working Families' Tax Credit work?*; Brewer M and Browne J, *The effect of the Working Families' tax Credit on labour market participation'.*

201 Mulheirn I and Pisani M (2008), *Working tax Credit and labour supply*, Treasury Economic Working Paper No.3.

7

Problems with the New Tax and Benefits System for Families

The Government claims that tax credits have helped reduce the number of children in 'relative poverty' by 600,000 since 1997.[202] Coupled with other measures like increased subsidies for childcare, and stronger eligibility rules for claiming income support, tax credits have also tempted nearly half a million sole parents to take up part- or full-time jobs in that same period. These are substantial achievements

There is, however, a downside. The question is whether the gains that have been delivered to sole parents and low income households are worth the price others have had to pay. Vastly increased expenditure on tax credits has led to higher taxes. Stronger work incentives for sole parents have weakened support for single-earner couples. And the new tax credit system has turned many previously self-reliant families into welfare claimants.

Cost

When the Blair government replaced Family Credit with WFTC in 1999, it raised the value of payments, lowered the withdrawal rate, introduced a higher earnings disregard and increased the childcare element. The result was more claimants, each claiming on average more money. The overall cost of tax credits increased (in constant 2002 prices) from £2.68 billion in 1998-99, to £4.81 billion in 2000-01, and reached £6.46 billion in 2002-03.[203]

This, however, was only the beginning. Since 2003, when WFTC was itself superseded by CTC and WTC, the total cost of tax credits has spiralled. By 2007-08, £20 billion was being paid out in tax credits.[204] The cost of the childcare element alone increased fifteen-fold between 1997 and 2006.[205] Almost three-quarters of the post-1997 increase in expenditure occurred after 2003.

In 2009, the government is spending £13 billion more in real terms on family cash transfers each year than it was in 1997. This is the equivalent of an extra 4p on the standard rate of income tax.[206] And we have seen that another £4 billion or so will have to be committed each year if the government is serious about meeting its 2010 child poverty target – funding that seems extremely unlikely given the current state of the public finances.

Nor are cash transfers the only aspect of government family support that has risen since New Labour came to power in 1997. We saw earlier that the total cost of all 'child-contingent' government expenditure topped £22 billion in 2003, a

202 HM Treasury (2008), *Tax credits: Improving delivery and choice*, p.4.

203 Brewer M (2005), p.8.

204 Report of the Comptroller and Auditor General, appended to HMRC, 2007-08 Accounts, London, Stationery Office, July 2008, Table 1.

205 HM Treasury (2005), *Tax credits: reforming financial support for families*, p.44.

206 Field F and Cackett B (2007), *Welfare isn't working*, p.6.

real increase of 50% in six years. The government claims that by October 2007, families with children had on average gained £1,550 a year in real terms as a result of all this increased spending since 1997, and that the poorest families were £3,350 better off.[207] But if they gained, who lost?

Total income tax receipts have risen from £69 billion in 1996-97 to £147 billion in 2007-08.[208] At a time when inflation increased by 38%, government income tax revenues more than doubled.[209] This is partly due to economic growth – more workers earning more money and therefore paying more tax – but some people are also now paying more. If families on average have gained, childless households (and some more affluent families) have lost out.

Table 15: Views of parents and non-parents regarding shifting tax balance between families and childless workers

Over the last 10 years, people without children have paid more tax so families raising children can receive increased support. Do you support or oppose this policy?

	Parents %	Non-parent %	Total %
Support	51	42	38
Neither support nor oppose	21	17	18
Oppose	23	35	33
No opinion	5	6	6

N (weighted) = 2035. P<0.05
Source: 2009 Policy Exchange/IPSOS-MORI Family Priorities Survey

We have seen there is a strong case for redistributing money from people without children to families with children in order to increase horizontal equity. Moreover, Table 15 shows that many members of the public support what the government has been doing (although people without children are significantly less enthusiastic).

But most of the new spending since 1997 has not been directed at increasing 'horizontal equity' between those with children and those without. It has been aimed rather at increasing 'vertical equity' by redistributing cash from higher to lower income households, irrespective of their family circumstances. Much of this spending, in other words, is better understood as support for low income households than support for families (even though it is presented as 'family policy'). The cost has been enormous, and to rub salt into the wound, much of the money has been paid out to people who were not even entitled to it.

Complexity and fraud

Unlike Child Benefit and the old family tax allowances, tax credits are extremely complicated. There are two of them – WTC and CTC – for a start. Both are made up of a number of 'elements' and involve various tapers, thresholds and eligibility

207 Bennett and Dornan (2006), chapter 6.

208 HMRC website, http://www.hmrc.gov.uk/stats/t_receipt/table2-8.pdf.

209 http://www.statistics.gov.uk/STATBASE/tsdataset.asp?vlnk=229&More=Y. d

tests, and they both operate alongside other government welfare payments, like Income Support and Housing Benefit, which are administered by a completely different department of state (DWP).

It seems unlikely that many potential claimants understand the system, and those with the least education are often confronted with the most complicated calculations (for with a lower income, they become eligible for more elements and are subject to more tapers). They have little option but to put their trust in 'experts.'

The organisation *Working Families* warns in its explanatory factsheet that, "The calculation for tax credits is very complicated", and it suggests phoning their helpline to get assistance.[210] Similarly, one Citizens' Advice Bureau worker observed: "The system is very complicated and I can't see how anyone could navigate it on their own without expert advice."[211] According to the National Audit Office, "Many have found it difficult to understand exactly how much they are due... The administration of the new tax credits has proved complex in parts, reflecting the underlying design."[212]

When tax and benefit systems become overly complex, a number of things happen. Bureaucracy multiplies and overhead costs increase accordingly. People take advantage of the opacity of the system by trying to defraud it. And clients end up confused about what their entitlements are and whether they have received too much or too little. From the point of view of the final consumer, it can seem that the system is operating almost randomly, like a giant fruit machine, paying out here and withholding there in quite unpredictable ways.

One particular problem that has dogged the UK tax credits system from the outset is widespread over-claiming, resulting in excess payments being made and half-hearted attempts by HMRC to get the money back.

The problem arises because (unlike the Earned Income Tax Credit in the USA, on which the old WFTC was loosely based), the decision was taken in Britain to pay credits to families prospectively, so that they would get the financial assistance on a regular basis as they needed it, rather than having to wait for the end of the tax year to receive a lump sum.[213] For this to work, HMRC has to calculate the total income it expects a claimant to earn over the coming tax year. Normally, this calculation is based on what they earned in the previous year.

At the end of the tax year, HMRC works out whether the total amount of tax credits a household has received accords with its entitlement based on its actual earnings, and an adjustment is made. If a family has claimed too little, it gets the balance as a lump sum (in 2006-07, 800,000 families were found to have under-claimed a total of £525 million).[214] But if a family has claimed too much (a much more common occurrence), then it has to repay the difference to the tax office. That, at least, is the theory.

Few families claiming benefits or low income households have ever encountered a system like this. Most have never even completed a PAYE tax return, and almost none of them keep records of their income or spending. Changes in financial or personal circumstances which impact on their tax credit eligibility are common, and in these cases, claimants are expected to notify HMRC each time their circumstances change, and to "keep records of income and circumstances, and changes in these, and be aware of often quite complex rules about the reporting of changes".[215] Unsurprisingly, many do not bother.

210 Working Families, *Tax credits and benefits,* April 2008, p.7.

211 Jay H, quoted in Boys Smith (2006), *Reforming welfare*, p.71.

212 Quoted in Boys Smith (2006), *Reforming welfare*, pp.75-6.

213 HM Treasury (2008), *Tax credits: Improving delivery and choice,* p.12.

214 Report of the Comptroller and Auditor General, appended to HMRC, 2007-08 Accounts, London, Stationery Office, July 2008, Table 9.

215 Whiteford P, Mendelson M and Millar J (2003), *Timing it right?*, Joseph Rowntree Foundation, p.23.

According to the latest figures, a total of 5.5 million families received tax credit payments in 2006-07, and 1.3 million of them were given more money than they should have been. Each of these over-paid families received, on average, £770 more than it was entitled to. The total cost to the taxpayer of wrongly handing out this money was estimated at between £1.3 and £1.5 billion – about 8% of all the money paid out that year.[216]

The Auditor General notes that, "Since the tax credits scheme was introduced in April 2003 it has suffered from high levels of error and fraud."[217] HMRC thinks that most cases of overpayment arise through genuine error on the part of claimants, and that no more than 10% of it is the result of deliberate fraud, but this is probably an under-estimate.[218] It employs 1,430 staff working purely on compliance.[219]

More than one-third (37%) of the families who receive too much in tax credits under-estimate their income. Another fifth inflate their childcare costs. About one in eight give the wrong information about their work or hours, and the same proportion again fail to declare the earnings of a live-in partner.[220] In 2004-05, the government paid tax credits to 200,000 more 'sole parents' than were actually living in the UK at that time, and £305 million was paid out incorrectly in tax credits to 90,000 couples who falsely claimed they were sole parents.[221]

In some cases, the money is clawed back, either through direct payments to the tax office, or by adjusting the following year's tax credit award. But when HMRC demands repayment, it can cause genuine hardship, and some claimants take years to pay the money back. Sometimes, it never gets returned. Between 2003 and 2007, £7.3 billion of debt built up, of which only £2.7 billion has so far been recovered. £1 billion has been written off, and HMRC is pessimistic about another £1.8 billion.[222]

In recent years, overpayments have fallen somewhat (they were estimated at £2.3 billion in the first year of operation), and HMRC is committed to reducing overpayments to no more than 5%. But it is difficult to reduce the overpayment problem significantly for as long as payments are based on forecasts of future income and circumstances. There are three inherent problems with a prospective payments system like this:

- **Volatility:** Changes in personal circumstances are common, particularly among low income households. A new relationship, a relationship breakdown or a change in working hours can all significantly change a householder's eligibility for tax credits. Claimants are expected to notify the tax office when such changes happen, but many fail to do so.
- **Unpredictability:** It is difficult to predict changes in future income or in expenditure on things like childcare.
- **Moral hazard:** Claimants know they stand to gain higher tax credit payments if they under-estimate their income, and there is a temptation to artificially depress earnings in the period during which income is being assessed. Even if money that is overpaid has to be paid back the following year, claimants may be tempted to exploit the rules to get an immediate gain and deal with the consequences later. Knowing that a certain amount of under-reported income will be disregarded, this incentive to over-claim becomes much greater, and if there is the possibility of avoiding repayment altogether, the motivation to do so is likely to become compelling.

216 House of Commons Public Accounts Committee, *HM Revenue and Customs: Tax Credits and Income Tax*, Fourteenth report of 2008-09 session, 2 March 2009, London, Stationery Office, HC311.

217 Comptroller (2008), page R2.

218 According to the House of Commons Public Accounts Committee: "The Department's current definition of fraud risks overstating the level of genuine error and understating those cases where claimants are setting out to exploit the scheme" (p.6).

219 Public Accounts Committee (2009), p.14.

220 Report of the Comptroller (2008), Fig.8.

221 Brewer M (2007), *Supporting couples with children through the tax system*, p.225.

222 Public Accounts Committee. See also Cooke G and Lawton K (2008), *Working out of poverty*, Institute for Public Policy Research, p.53. Cooke and Lawton suggest all debts should be written off and a no claw back rule introduced so, no matter how much people are overpaid, HMRC never takes it back.

Overpayments have become a difficult political issue for the government, but rather than solving the problem by tackling its root cause, the government has accommodated it through a massive increase in the annual income 'disregard.' A claimant can now under-estimate his or her future income by up to £25,000, claim tax credits on this basis, and then keep the money when it is discovered the following year that they have earned much more than they forecast.

It makes sense to have a small disregard, otherwise officials spend countless hours chasing people for small sums which involve no dishonest intent. Back in 2002, the Treasury calculated that a £2,500 disregard should be sufficient to accommodate typical year-on-year fluctuations of income while "minimising the chances of overpaid tax credit":

"A claimant can now under-estimate his or her future income by up to £25,000, claim tax credits on this basis, and then keep the money when it is discovered the following year that they have earned much more than they forecast"

> *"A disregard for rises reduces the number of claimants who may need to have their rewards reassessed purely because of income changes. Increasing the size of the disregard would further reduce the number of those who might need to have their awards reassessed. But a larger disregard increases the cost of the new tax credits and reduces the effective targeting of resources."*[223]

But in 2006-07, the disregard was raised to £25,000 – a 1000% increase! This change was introduced as a crude response to the problem of overpayments, and it has worked, to a degree. HMRC thinks the higher disregard has reduced overpayments by about one-third, and this change has been the main driver in the fall in overpayments in the last two years.[224] But levering up the disregard treats the symptom, not the cause, and it "makes a mockery of a supposedly accurately-targeted benefit".[225]

The Treasury boasts that complaints and disputes about overpayments and clawbacks have fallen by one-third since this change was introduced.[226] This is hardly surprising. If government stops chasing people to recover money they should never have been given, recipients will stop complaining.

Work disincentives

There are two ways in which giving people government payments can undermine their incentive to work:[227]

- **The unemployment trap:** if your total income from welfare is not much lower than the income you can get from working, you may be deterred from taking a job;
- **The poverty trap:** if withdrawal of means tested benefits, combined with increased income tax payments, means that you lose a large proportion of the next pound you earn, you may be deterred from increasing work effort.

Tax credits were originally designed to tackle the unemployment trap, and in this they have had some success. They achieved this by increasing the income gap between

223 HM Treasury (2002), *The child and working tax credits*, p..27.

224 See Report of Comptroller (2008), para 2.30.

225 Boys Smith (2006), p.76.

226 HM Treasury (2008), *Tax credits: Improving delivery and choice*, p.26.

227 HM Treasury (2005), *Tax credits: reforming financial support for families*, p.11.

people who were working in low-wage jobs, and people living on welfare. Tax credits top up the wages of people in work so they end up with disposable incomes substantially higher than those available to people on welfare. This should then strengthen the incentive to leave welfare and find a job.

Table 16: Replacement rates and effective marginal tax rates for sole parents and couples on median income, 1997 and 2004

	Replacement rate		Effective MTR	
	1997	**2004**	**1997**	**2004**
Sole parents	71.9	65.9	72.5	69.0
Proportion whose rate rose:		21.3%		31.2%
Proportion whose rate fell:		56.7%		46.9%
Couples with children, one earner	62.6	65.5	35.7	42.1
Proportion whose rate rose:		52.7%		45.4%
Proportion whose rate fell:		26.6%		21.0%
Couples with children, two earners	58.5	62.7	33.0	34.9
Proportion whose rate rose:		53.8%		39.4%
Proportion whose rate fell:		6.6%		10.0%

Source: Mike Brewer, 'Welfare Reform in the UK', Institute for Fiscal Studies *Working Paper* 20/07, 2007, Tables 3.1 and 3.2

The size of the unemployment trap can be measured by 'replacement rates' which calculate the proportion of earned income which is replaced by welfare when someone stops working. The higher the replacement rate, the smaller the relative rewards from employment, and therefore the lower the incentive to find a job.

Table 16 shows how 'replacement rates' changed between 1997 and 2004 as a result of tax and benefit changes. In 1997, a sole parent on welfare could expect to receive 71.9% of what an employed sole parent on the median wage was getting. This was significantly more generous than the replacement rates for one or two-earner couples. However by 2004, this difference had more-or-less disappeared as sole parent replacement rates fell, and those for couples rose. In theory, this gave sole parents more of an incentive to find a job but reduced the work incentive for couples to a point where the two converged.

This weakening of the unemployment trap had a downside, however, for when you top up people on low wages with tax credits and their earnings increase, they start to lose additional benefits which increases the 'poverty trap.' Coupled with the additional income tax and NICs they have to pay on higher earnings, workers in receipt of in-work payments can find the government taking the lion's share of any additional money they earn.

The extent of this problem can be measured by looking at the 'effective marginal tax rates' (EMTRs) that people face as their earnings increase i.e. the proportion of the next pound you earn that disappears in tax and in withdrawn benefits.

The problem of high EMTRs has dogged the organisation of in-work benefits ever since the FIS was introduced in the 1970s. It has been compounded by (a) a long-term failure to raise personal tax-free allowances in line with earnings (so workers now get hit by income tax deductions on a lower wage than they used to), and (b) the evolution of a plethora of other income-tested benefits, such as Housing Benefit and Council Tax Benefit, which overlap each other and which all phase out as incomes rise.

New Labour's tax credits reforms have tried to ease this poverty trap problem in two ways. First, the government has rationalised the way the different benefits interact with each other, so they do not simply sit on top of one another and all phase out together. Secondly, it has reduced the rate at which payments collectively are withdrawn (the so-called 'taper'), so people can keep a bigger slice of each extra pound they earn.

Table 16 shows the net result of these changes. Most sole parents have gained (in 1997, a sole parent on median income lost 72.5p from the next pound they earned, but this fell to 69p by 2004). EMTRs faced by couples have worsened, however, over the same period.

Before 1997, some workers were in the absurd situation where they became worse off if they increased their gross earnings. We see from Table 17 that this can no longer happen. Not only that, but nearly half a million fewer low-income families now face marginal deductions of 70 pence or more in each extra pound they earn.[228]

Table 17: Number of workers facing marginal deduction rates of over 60% in 1997-98, 2002-03 and 2008-09

Marginal deduction rate (cumalative)	1997-98	2002-03	2008-09
Over 100%	5000	–	–
Over 90%	130000	45000	30000
Over 80%	300000	210000	150000
Over 70%	740000	255000	200000
Over 60%	760000	940000	1875000

Source: HM Treasury, *Tax credits: Improving delivery and choice* May 2008, Table 3.2

However, as the number of people facing very high EMTRs has fallen, the number getting dragged into a less vicious poverty trap has grown substantially. This is because EMTRs have been reduced by making the income taper shallower. This can only be done by extending eligibility for benefits higher up the income scale, thereby dragging more people into the payments net.

Table 17 shows that the number of people facing marginal deduction rates of 70% or more has been cut from around three-quarters of a million in 1997 to just 200,000 today, but it also reveals that the number of people facing marginal deduction rates of 60% or more has mushroomed from around three-quarters of a million to almost two million. The government likes to draw attention to its

228 HM Treasury (2008), *Tax credits: Improving delivery and choice*, p.4.

success in reducing very high EMTRs on low earners, but this has only been achieved by massively increasing the number of people facing relatively high EMTRs a bit further up the income distribution. There are now 2½ times as many people facing effective marginal tax rates over 60% than there were in 1997.

There is a limit to what any government can achieve in reducing EMTRs. For as long as we remain committed to a progressive income tax system (you pay a higher rate if you earn more) and a targeted benefits system (you receive more if you earn less), there will always be a problem of high EMTRs at the lower end of the income distribution where tax cuts in and benefits taper out. Policy changes in recent years have moderated this problem, and the UK actually compares quite favourably with many other OECD countries,[229] but EMTRs remain high for many low-income people, and many more people are now affected than was the case before.

Whether and how much this matters is not entirely clear. Obviously it is undesirable that people on low incomes should lose 60 pence or more of every extra pound they earn, but this may not necessarily deter them from increasing their hours.[230] Economists have found that the decision whether or not to enter work in the first place tends to be much more sensitive to economic rewards and penalties than the decision once in employment whether or not to increase hours.[231] The unemployment trap, in other words, is much more pernicious than the poverty trap, and tax credits have in this sense done more good than harm.

There are, however, other features of the tax credits system which also give cause for concern when it comes to weakening the incentive to work. The WTC, combined with the introduction of the minimum wage, now ensures that most people are better off working than on welfare. But there are exceptions to this.

Many British couples rely on 'one and a half incomes' (normally, the man works full time and the woman works part-time to allow her to spend time at home raising the children). But this popular household strategy has been undermined by the new tax credits system, for second earners in low-income households now gain little from working part-time. This is because a family's tax credit entitlement is assessed on its total income. If one partner starts to bring in part-time earnings, these are then added to the existing full-time wage of the other partner, which means the family's tax credit receipts are likely to drop substantially.

The result is that it can be hardly worth the second partner working at all. It is estimated that 20,000 women and 10,000 men have given up work as a direct result of this disincentive effect in the tax credits system.[232]

A further problem is that the structure of tax credits appears to be limiting the amount of work sole parents do. We have seen that sole parent workforce participation rates have risen significantly since 1997, and that this partly reflects the stronger work incentives created by tax credits. However, these incentives fall away after the minimum tax credit eligibility requirement of 16 hours per week is reached.[233] There is little incentive after that for sole parents to increase their hours, for the taxpayer can be relied upon to top up a low, part-time wage to a level closer to a full-time pay packet.

Many sole parents have reduced their total hours to maximise their tax credit entitlement. Research on how sole parents responded when the minimum work hours for Family Credit changed in 1992 shows that the number who found jobs

229 In 2002, a sole parent with two children who took a full-time job at two-thirds the average wage lost 58.9 pence in the pound in income tax, NICs and reduced tax credit and housing benefit, but the equivalent OECD average deduction was 75.1 pence in the pound. Similarly, a single earner couple with two children earning two-thirds the average wage faced an EMTR of 70.4 pence in Britain, compared with an OECD average of 82.5 pence. Boys Smith (2006), slide 17.

230 Whether their willingness to work is necessarily weakened as a result is a matter of some debate. In the USA it has been found that, as EITC phases out, it has no effect on hours of work, even though theory suggests it should. It may be that many people are unaware of the marginal deductions they are suffering, for their total income does continue to increase – see Meyer B (2008), *The US earned Income Tax Credit, its effects and possible reforms*, Institute for Labour Market Policy Evaluation, *Working Paper* No.14,, p.14.

231 Brewer M, Francesconi M, Gregg P and Grogger J (2009), *In-work benefit reform in a cross-national perspective*, p.F11.

232 Boys Smith (2006), *Reforming welfare,* p.70.

233 Although there is an additional payment element if people work for 30 hours.

increased, but the average hours they worked decreased. Before the change, there was a 'spike' in average working hours at 24 hours per week (the old minimum entitlement level); after it, the spike moved to 16 hours (the new one). The same rule carried over into WFTC similarly depressed average working hours compared with the pattern that would have prevailed had the credit not been available.[234]

The significance of all this is that, despite the rhetoric, tax credits have not moved large numbers of sole parents out of the welfare system. Tax credits have helped many sole parents move into part-time jobs, but this is a long way from achieving genuine self-reliance. In 2008, 1.1 million sole parents – 58% of the total – were still receiving a greater portion of their income from government payments than from their own earnings (this compares with just 11% of couples).[235] This is still mass welfare dependency (albeit moderated by supplements from paid work), and the 16 hours rule underpins it.

Many of these continuing problems associated with tax credits reflect the fact that they have lost their original focus and purpose. Tax credits today are being used to deliver two quite distinct objectives which are pulling against each other:[236]

- On the one hand, there is the original concern to ensure that work pays more than welfare. This is achieved by topping up low earnings. For this to work, it is obviously necessary to limit eligibility for tax credits to people who have jobs, and to give bigger rewards to those who work more hours.
- On the other hand, there is the desire to use tax credits to raise people out of poverty by giving them more government money. For this to work, the government has had to extend eligibility for CTC to people without jobs, and give bigger rewards to those with lower incomes, even though they may only be working a few hours per week. These measures clearly undermine work incentives.

Tax credits were always meant to be linked to employment – you get a top-up if you work. This is what distinguished them from other welfare benefits, like Income Support or Housing Benefit. But this principle has been eroded – partly by chipping away at the number of hours someone has to work to be eligible for a credit (reduced from 30 when FIS was introduced, to 24 in Family Credit, and then to 16), and partly by making CTC available irrespective of whether somebody works or not.

In the USA, where modern tax credits originated, the Earned Income Tax Credit (EITC) has only ever had one objective: to increase work incentives. The Americans leave alleviation of poverty to the welfare system. Unlike our CTC, therefore, EITC is not paid to parents who do not work, and unlike our WTC, it has no 16 hours rule (it tapers in as well as out, so it increases as people increase their hours from zero).

Because of this, the American system costs much less than ours. Per head of population, the US only hands out 60% of the money the UK gives out, and where UK tax credits extend all the way up to families on £60,000 pa, the US system tapers out at an annual income of $33,995 (for one child) and $38,646 (for two). Yet despite this lower level of spending, the EITC in the US has had a *bigger* impact on workforce participation rates than WFTC, CTC and WTC have had in the UK.[237]

234 Blundell R and Walker I (2001), *Working Families Tax Credit*, p.41.

235 Green D, 'If you want welfare, work for it', *Sunday Times*, 2 September 2008.

236 Boys Smith (2006); Brewer (2007).

237 Boys Smith (2006).

Mike Brewer, who has probably carried out more in-depth analysis of this issue than anybody else in Britain, leaves us in no doubt that the desire to strengthen work incentives has been compromised in the UK by the confounding encroachment of an anti-poverty agenda:

> *"Although we have argued that there have [sic] been a set of changes to taxes and benefits designed deliberately to strengthen financial work incentives, the story is more complicated than this for at least two reasons. First the expansion of the WFTC and the expansion in the generosity of tax credits that followed have generally been weakening the financial work incentives of (potential) second earners in families with children. Second, as well as increasing the generosity of tax credits that are conditional on work, welfare benefits for families with children and (after 2003) the child tax credit (which is not work-contingent, and is means tested with an extremely generous earnings disregard) have been increased too. In other words, the extent to which financial work incentives have been strengthened has been compromised by the Government's desire to achieve broad reductions in relative child poverty."*[238]

The original rationale behind tax credits – to support and reward hard-working families – has been lost, for we now have one tax credit that supports families even if they do not work, and another that supports workers even if they have no family. This confusion can only be sorted out by disentangling family policy from anti-poverty policy. It would be better to allow tax credits to incentivise work, which is what they were designed to do, and leave the alleviation of poverty to the welfare system, which is where such policies have traditionally been based.

Proposition 8

Tax credits were originally intended to strengthen the work incentives of low income (and particularly sole parent) families by boosting their take-home pay. This original rationale has been compromised by using tax credits to reduce poverty – an objective for which they were not intended. Giving Child Tax Credit without a work condition, and increasing the generosity of payments, have both weakened work incentives rather than strengthening them.

Very high Effective Marginal Tax Rates (EMTRs) have been reduced in the UK, but at the expense of trapping almost two million people in a 60%+ EMTR band. EMTRs for sole parents have been reduced, and more sole parents are in work, but their average hours have fallen as a result of the 16 hours rule, and most are still more reliant on government payments than on their own earnings. Meanwhile, couples with children are now discouraged from supplementing a full-time wage with part-time earnings from the second partner because of the impact this has on their tax credit receipts.

Unfairness

The WTC and the couple penalty

We have seen that tax credit entitlement is based on various 'elements.' Table 11 (page 54) showed that Working Tax Credit has a basic element of £1,800, plus an additional element worth £1,770 which both couples and sole parents get. A low income worker with children and a partner thus receives exactly the same top-up as a sole parent on the same income with the same number of children but no partner.

238 Brewer (2007), *Welfare reform in the UK*, p.27.

One in nine adults (and one in six children) lives in a couple household where one adult is in full-time employment while the other has no paid work at all.[239] They appear to be losing out:

> *"The tax credit system favours children who live with a sole parent rather than with both parents. This occurs because the system expects two adults and a child to live on exactly the same amount of money as one adult and a child."*[240]

Critics refer to this failure to allow for the living costs of partners in couples as the 'couple penalty'.[241]

The couple penalty is the product of the long-term trend in family policy that has shifted support from couples to sole parents. Ever since the 1970s, when Family Allowance was replaced by Child Benefit and Family Income Supplement was introduced for low income earners, policy reforms have tended to benefit sole parents much more than couples, and this disparity has become more marked over time.[242]

The official justification for this skew is that couples enjoy an 'implicit income' as a result of the extra time they have available for caring for their children. This is why the childcare element of WTC is only payable to couples if they both work at least 16 hours per week. If only one of them is working, the other is presumed to be available to look after the children. A single earner couple does not therefore qualify for the WTC childcare element, even though a single earner sole parent does.[243]

There is, however, a logical contradiction built into the way tax credits treat single-earner couples. On the one hand, the stay-at-home partner is seen as contributing to the family's standard of living through their domestic labour. He or she is here regarded as an 'economic producer.' But on the other hand, that same partner is ignored when it comes to assessing the family's cost of living. He or she is not regarded as an 'economic consumer.'

For example: the 'free childcare' provided by a stay-at-home parent is taken into account when calculating a family's eligibility for the childcare element of WTC payments. But the subsistence costs of this partner are not taken into account when calculating that family's basic needs. The WTC recognises the 'free labour' supplied by the second partner in a couple, but does not recognise the cost of supplying it.

In chapter 4 we saw that the 'poverty line' for any given household varies according to its composition. The more people who have to live from a given income, the higher that income needs to be if they are all to escape relative poverty. But the tax credits system fails to acknowledge this. It thinks one parent with children needs exactly the same income as two parents with children.

This failure to allow for the living costs of the second adult in a couple means that, while tax credits have helped reduce poverty rates in sole parent families, they have achieved much less for members of two-parent families:

- Two-parent households have to earn a lot more money to raise themselves above the poverty line than comparable sole parent households have to earn. In 2004-05, two parents with two children had to earn £240 a week to get a net income (after tax credits and other benefits are added) of £295 – which is just above the poverty line for a household of this composition. Yet a sole parent with two children only had to earn £76 per week to achieve a net income of £230, taking this household above the poverty line.[244]

239 Draper and Beighton (2008), *Taxation of married families*, p.28.

240 O'Neill R (2005), *Fiscal policy and the family*, Civitas, p.7.

241 For example: Social Justice Policy Group, *Breakthrough Britain*, p.69; Morgan P (2007), *The war between the state and the family*, p.34.

242 Adam, Brewer and Reed (2002), *The benefits of parenting.*

243 Not only does the single earner couple fail to qualify for the WTC childcare element that the sole parent earner gets, but they will of course pay tax to finance the extra payment to the sole parent.

244 Field F and Cackett B (2007), *Welfare isn't working.*

- A couple with two children has to work 74 hours per week at the minimum wage to clear the poverty line, but a sole parent with one child has to work only 16 hours a week at the minimum wage to achieve a comparable.[245]

Table 18: Children's risk of living in 'relative poverty', comparing sole parent and couple families in 1997 and 2005

	% in household with equivalised income below 60% of median	
	1997-98	**2005-6**
Sole parents	64	50
In FT work	14	14
In PT work	42	30
Not employed	84	75
Couples with children	25	23
Both FT work	2	3
One FT, one PT work	6	7
One working FT	27	26
Neither employed	82	74

Relative poverty defined as 60% of median income, calculated after housing costs.
Source: Frank Field and Ben Cackett, 'Welfare Isn't Working' *Reform* June 2007, Table 5 (based on DWP household data)

The results of this disparity of treatment by the tax credits system can be seen in Table 18:

- Although children's risk of 'poverty' (defined here rather generously as an income below 60% of the median) is much lower if they live in a couple family than in a sole parent family (23% against 50%), the former have hardly improved their situation since 1997 (down to 23% from 25%), whereas the latter have seen a significant improvement (down to 50% from 64%). The biggest winners since 1997 appear to be sole parents and unemployed couples. Two-parent families where one or both adults work have not gained at all.
- If we compare sole parent families where the parent works full-time with couples where one parent works full-time and the other stays home to care for the children, we see that children raised by two parents are almost twice as likely to be in poverty as those raised by sole parents (26% against 14%). This disparity is at least partly due to the 'couple penalty' in our family tax and benefits system.[246]

It has often been suggested that this 'couple penalty' in the tax credits system "incentivises sole parenthood and acts as a driver towards family breakdown".[247] For example, if a lone mother earning £10,000 pa meets a new partner earning £25,000, the couple will be £5,473 worse off if they tell the authorities they are living together.[248]

245 Morgan P (2007), *The war between the state and the family*, p.72.

246 It is important to remember, however, that such judgements depend heavily on the way equivalence scales are applied to different kinds of households. There is research which suggests that children of single-earner couples may suffer less hardship than the poverty statistics imply, which indicates that the OECD's equivalence scale may be treating them too generously (see Brewer M, Muriel A, Phillips D and Sibieta L, 2008, *Poverty and Inequality in the UK* Institute for Fiscal Studies). Nevertheless, the fact remains that it costs more to maintain two adults and their children than one, and this is not being recognised in the tax credits system.

247 Social Justice Policy Group (2007), *Breakthrough Britain*, p25.

248 Green D (2009), *Individualists who cooperate*, Civitas, p.43.

Patricia Morgan calculates that working couples are better off living apart than living together for as long as their joint incomes do not exceed £50,000 per annum. Only above that income level does the couple penalty cease to operate.[249]

Having said that, it is difficult to find conclusive evidence that couples really are deterred from living together by our tax credits system. There is evidence that women married to low-income men are more likely to get divorced as a result of WFTC.[250] But an overview of the cross-national evidence finds that, "On balance, tax credits have little or no effect on family structure."[251]

Nevertheless, we saw earlier in this chapter that there is plenty of evidence that couples often *claim* to be living apart in order to maximise their entitlements.[252] In less than a generation, we have gone from a system which encouraged parents to stay together by giving married couples an additional tax allowance, to one which encourages them to live apart, or to pretend to live apart, by basing tax credit entitlements on joint income while refusing to acknowledge the additional costs of maintaining two adults in a household rather than one.

This 'marriage penalty' bites hardest at the bottom of the income distribution, for it is here that parents rely most heavily on means tested benefits which are assessed on total household income. The poorer you are, and the more children you have, the more you stand to lose if you get a live-in partner or get married, and the more you stand to gain if you split up.[253] A working mum on the minimum wage would be 5%-12% better off on her own than if she stayed married to a minimum wage husband. Where both she and her husband are unemployed, she would be 20 to 35% better off on her own.[254]

Individualised income tax and single income couples

Not only are couples disadvantaged by the tax credits system, but couples with only one earner are also penalised by the way families are assessed for income tax.

With the abolition of couple tax allowances in 2000, the UK adopted an income tax system which is radically individualised. While our system of welfare payments (including tax credits) is still based on assessment of household income, our tax system is now based almost entirely on assessment of people's individual incomes.

Couples who prefer to have one parent at home looking after the children while the other goes out to work lose out in both systems. In the welfare system they get no tax credit payment for the extra adult, and in the tax system they get no allowance for the living costs of the non-earning partner. Just as the non-working partner is invisible when it comes to claiming WTC, so too she or he is invisible when it comes to claiming allowances against income tax liabilities.

A family tax and benefit system which taxes people as individuals but grants them welfare as households generates quite perverse work incentives for single-earner couples:

- If the employed partner is earning a low income, there is little incentive for the second partner to go out to work, for their extra earnings will result in the loss of means tested welfare benefits and tax credits at a rate of 60p in the pound or more;
- If, on the other hand, the employed partner is earning a high income, there will be every incentive for the second partner to go out to work, for their extra earnings will be taxed individually, without regard to their partner's earnings.

249 Morgan P (2007), *The war between the state and the family*, p.73.

250 Fracesconi M, Rainer H and van der Klaauw W (2007), *The effects of in-work benefit reform in Britain on couples*, University of Essex.

251 Brewer M, Francesconi M, Gregg P and Grogger J (2009), *In-work benefit reform in a cross-national perspective*, p.F12.

252 Brewer (2007), *Supporting couples with children through the tax system*, p.224.

253 Immervoll, Kleven, Kreiner and Verdelin (2008), *An evaluation of tax-transfer treatment of married couples in European countries*, p.22.

254 O'Neill E (2005), *Fiscal Policy and the Family*, p.14.

So our family support system deters partners in low income families from supplementing the family income, even though they need more money; but it encourages those in high income families to work rather than stay home and look after the children, even though their need for additional income is less.[255]

Single earner couples in the UK pay much more tax than two-earner couples who bring in the same gross household earnings between them. In 2007, for example, a couple with each partner earning £15,000 pa was paying a total of £74.40 per week in income tax. A single-earner couple with exactly the same total earnings of £30,000 pa was, by contrast, paying £100.66 tax per week.[256]

OECD figures show this tax disparity between one- and two-earner couples is higher in the UK than in any other country.[257] The UK tax system 'stands out' as containing the strongest bias of any OECD nation against single-earner couples.[258] For most people in Britain, the tax burden is no heavier than it would be if they were living anywhere else in the EU, but for a one-earner married couple with children on the average wage, income tax is 25% higher in the UK than in the rest of the EU (it is 40% higher than in the OECD). Across the OECD, one-earner couples on an average wage pay about half as much tax as single people on the same income, but in the UK they pay three-quarters as much, even after Child Benefit and tax credit receipts are taken into account.[259] And things have been getting worse, for their tax burden has increased by 13% in real terms since 2001.[260]

It is true that, if couples were taxed jointly, many second earners (particularly in more affluent households) would face higher EMTRs than they do in our current, individually-based system, for their marginal tax rate would be pushed up by the earnings of their partner.[261] However, we shall see in chapter 9 that modifying our individually-based system need not necessarily mean switching to a couple-based one, for couples could be given the choice of whether to be taxed separately or jointly.

255 As the OECD notes: "While second earner participation in the UK is strongly discouraged in low-income families, it is encouraged in higher income families due to the individual income tax" – Immervoll, Kleven, Kreiner and Verdelin (2008), *An evaluation of the tax-transfer treatment of married couples in European countries,* p.10.

256 Brewer (2007), *Supporting couples with children through the tax system*, p.224.

257 With a total household income worth 133% of the average wage, a couple with two children where only one parent works was in 2003 paying 19.4% of its earnings in tax. This fell to 12.9% if the earnings were divided 100/33 between the two parents (i.e. the 'one and a half' worker model), and to 8.5% if the earnings were evenly split between both parents 67/67. See *Babies and Bosses* (2007), Table 4.5.

258 "The UK system stands out by being much more favourable to second-earner participation than all other countries" – Immervoll, Kleven, Kreiner and Verdelin (2008), *An evaluation of tax-transfer treatment of married couples in European countries*, p.7.

259 Draper and Beighton (2008), *Taxation of married families,* p.8.

260 Ibid, p.8.

261 Immervoll H and Barber D (2005), *Can parents afford to work?, OECD Social, Employment and Migration Working Papers* No.31, p.31. The authors go on to qualify this, noting that second earners in high-taxing, individually-based systems (such as in Scandinavia) are often worse off than those in lower-taxing, couple-based systems (such as the United States, Spain, or even France).

Proposition 9

The UK has one of the most individualised personal tax systems in the OECD, but eligibility for welfare payments (including tax credits) is still assessed on household earnings. The perverse result is that families on low incomes are generally better-off if the parents split up than if they live together. There is also a specific bias against single-earner couples with children. These couples are disadvantaged in the tax system because, unlike dual earner couples, they cannot claim an allowance for the non-working partner. They are also disadvantaged in the tax credit system which refuses to acknowledge the living costs of the non-working partner (even though it takes their labour into account when assessing eligibility for the childcare tax credit).

Dependency culture

We have seen that recent family policy reforms have hugely increased the level of state spending and at the same time have significantly extended the number of people claiming state benefits.

In 1997 there were 5.4 million people of working age on benefits, plus 731,000 people receiving Family Credit – a total of 6.1 million. By 2008, not counting people who were only claiming Child Tax Credit, this total had grown to 7.3 million (5.2 million on benefits plus 2.1 million on WTC).[262]

When we add in CTC claimants, we find there are now approaching 6 million people claiming tax credits in addition to the millions more on Income Support, Job Seekers' Allowance and other working-age payments. Two-thirds of tax credit recipients only claim CTC, either because they are not working, so are ineligible for WTC, or because they are working and are earning too much to qualify for WTC top-ups. Three-quarters of tax credit claimants are in work, and one-third of them have incomes over £30,000 per annum. It is estimated that 33% of all tax credit expenditure is spent on the richest half of the population, and that only 18% is spent on the poorest quintile.[263]

Almost half a million families also get the childcare tax credit, which is a separate element of WTC.[264] Most of them are in the middle of the income distribution, too, for you have to be employed to qualify for this credit, and most poor families are not working: "The vast majority of families that are entitled are not in poverty, and many are in the top half of the income distribution of families."[265]

Some people think it does not matter that so many middle income families have now been locked into claiming what are essentially welfare benefits. Some even think it is a good thing. In 2005, for example, a group calling itself the 'Commission on Families and the Wellbeing of Children' issued a report which asserted:

> *"People on middle incomes should feel that the state is making some significant contribution to the cost of bringing up their children...The social solidarity required to sustain adequate protection for the worst-off children is strengthened if some significant benefit is extended to every family."*[266]

This reasoning repays careful reading. The argument is not that middle class parents should get tax or welfare concessions because the wider society has an obligation to help with the costs of children; it is rather that middle class parents should be made more dependent on the government so they will support more generous welfare payments for the less well-off in order to safeguard and extend their own benefits.

This cynical argument has long been peddled in social policy circles. Left-leaning academics want the middle class to become more dependent on state welfare, even if they do not need help, because they think this will bind them into the system and give them a financial interest in maintaining and improving it. It is thought that locking the middle class into welfare strengthens their solidarity with the poor by making them all claimants together. As one academic succinctly explains:

> *"It is the taxes of the middle classes that ultimately provide most of the revenue on which the welfare state depends, and it is therefore necessary to give the middle class a stake in the welfare system by extending its benefits to them."*[267]

This is a recipe for spiralling welfare expenditure and extended tax-welfare churning. Many tax credit recipients do not need the money, and we saw earlier that

262 Green D (2009), *Individualists who cooperate*, p.41.

263 Boys Smith (2006), *Reforming welfare*, p.73.

264 HM Treasury (2008), *Tax credits: Improving*.

265 Brewer M, Crawford C and Dearden L (2005), 'Helping Families', *IFS Election Briefing Note* no.7, p.13.

266 *Families and the State* (2005), pp.xix, xxv.

267 Somewhat confusingly, this was written by an Australian academic who shares my name – Saunders P (2002), *The Ends and Means of Welfare*, Port Melbourne: Cambridge University Press, p.223. This view was originally advanced by Robert Goodin and Julian Le Grand in *Not only the poor* (Allen & Unwin 1987) and has been enthusiastically endorsed by many other social policy intellectuals ever since.

most are paying for their own benefits through their taxes. Their financial independence has been eroded quite unnecessarily, and they have been enmeshed in a tortuously complex system which is dispensing benefits to millions of people who have no need of them.

Proposition 10

The cost of cash transfers to families has spiralled by £13 billion in the last 12 years – the equivalent of 4p on the standard rate of income tax – yet it is estimated that at least £4 billion more needs to be spent each year if the government wants to meet its 2010 child poverty target. Much of the money that is spent on tax credits is wasted. More than £1 billion is wrongly allocated or fraudulently claimed, yet rather than back claw this money, the government has increased the income disregard, which has further undermined the effectiveness of targeting. Many Child Tax Credit claimants are affluent, middle class families who do not need welfare assistance. They have unnecessarily been turned into welfare claimants.

8

What Can We Learn from Other Countries?

National differences matter. Policies that work well in one country may not have the same effects in another. Policies operate differently in different institutional contexts and generate different outcomes in different cultural milieu.

Family tax and benefit policies impact very differently in high and low tax countries, for example, and in different welfare state 'regimes' where notions of 'social rights' vary quite markedly.[268] Scandinavians accept levels of taxation that many Americans would find outrageous, while America is prepared to tolerate levels of income inequality that many Scandinavians regard as unconscionable. Such differences are bound to influence the way policy interventions work when applied in these two countries. What is good for Sweden is not good for America, and vice-versa.

> "It is a mistake to trawl the world for policies that seem to have certain desired effects, pluck them out of their context, transplant them to Britain, and expect them to generate the same outcomes here"

Policies will also have very different effects in more individualistic cultures than in more collectivistic or 'statist' ones. The UK, along with other liberal 'Anglo' nations like the USA and Australia, is one of the most individualistic cultures in the world, and it is a mistake to assume that policies which evolved in more homogenous and communal cultures (such as those in Scandinavia) would work well here.[269]

Policies will also generate different outcomes in strongly familistic cultures (such as those in Japan and Korea) than in countries like the UK where family ties and responsibilities have been attenuating. Policies like subsidised childcare and generous parental leave that work well in countries where mothers commonly return rapidly to full-time employment may work less well in countries where women expect to stay home to raise their children, or (as in Britain) where they look to combine child rearing with part-time employment.

It is therefore a mistake to trawl the world for policies that seem to have certain desired effects, pluck them out of their context, transplant them to Britain, and expect them to generate the same outcomes here. One of the problems with much of the international comparative research that gets done by OECD and others is that it uses multivariate modelling to identify cause and effect across different countries while rarely, if ever, taking account of the differing cultural

268 Goran Esping-Andersen.

269 Saunders P (2001), 'Australia is not Sweden', *Policy* vol.17, pp.29-32.

values of these countries.[270] We should be cautious about acting on research which compares half a dozen variables across a couple of dozen countries and then reports statistically 'significant' (yet often quite small) associations between them.

We can, of course, learn from what other countries do, but we should not forget that individual policies mesh with the specific socio-economic environments in which they are implemented.

International trends in family policy

There are some features of family policy that most developed countries share in common, despite the differences between them. Child benefit is one such example. Nearly all developed countries make some allowance for the cost of raising children, and most have a universal child benefit paid regardless of income (the exceptions in the EU are Greece, Spain and Italy, where payments are means tested).[271] It seems that most countries have recognised the principle of horizontal equity and pursue it by making a flat rate contribution to all parents to help with the cost of raising their children.

A second common feature is that government expenditure on family transfers has been increasing in almost every developed country in recent decades, even though the number of children has been falling. Higher expenditure on a smaller number of children led to a rapid rise in spending per child in most countries from 1980 onwards. In the UK, it increased by 25% in two decades, in France and Germany by about 70%,while in Finland, Norway, Ireland and Australia it has mushroomed by well over 100%.[272]

This increased spending has a variety of different causes. Concern about falling fertility was a key focus in many far eastern countries, where increased government spending was designed to encourage women to have more babies. In the Anglo-American nations – what Esping-Andersen calls the 'liberal' welfare state regimes – the main driver was the desire to raise levels of female workforce participation, especially among sole parents. And as more women have entered the labour market, there has also been a growing concern in many countries to 'balance' the competing pressures of home and work by increasing spending on parental leave entitlements and childcare support.

In many countries, increased government outlays on support such as childcare subsidies and early education initiatives, coupled with attempts to strengthen work incentives through in-work tax credits and other similar measures, have reduced the relative importance of traditional child benefits. We saw that this was the case in Britain, but the same thing has happened elsewhere too. In 1980, 66% of all public expenditure on family benefits and services in OECD countries went on child benefits. By 2001, this was down to 43%.[273] It is not that child benefits have been eroded; rather that other spending programs have grown up around them.

Most governments nowadays are trying to use family policies to achieve a wider range of outcomes than was the case in the past. When the primary concern was simply to help parents meet the costs of raising their children (the horizontal equity principle), flat rate child benefits were the main delivery mechanism. But as governments became more ambitious in their objectives, so they

270 This is a point made by Nobutaka Fukuda in a review of how family allowances, childcare provisions and parental leave entitlements affect fertility rates across countries: "Policies supporting childbearing are implemented in diverse contexts...It is therefore necessary to investigate whether or not family-friendly policies have an influence on fertility behaviour in specific social conditions. Most studies on governmental policies and fertility behaviour have hitherto employed variable-oriented – mainly muiltivariate – quantitative analysis, and thereby the covariation between an independent and a dependent variable is examined with the effects of the remaining independent variables set constant. However, this method is not suitable for investigating the covariation between an independent and a dependent variable if the degree of the association between these two variables is strongly affected by the configuration or contextuality of the remaining independent variables... social contexts in which family-friendly policies are implemented vary greatly across industrialised countries." (*Three worlds of protonatalism?*, 2003, pp.3-4).

271 Morgan (2006), *Family policy, Family changes*, pp.84-5.

272 Gabel S and Kamerman S (2006), 'Investing in children' in *Social Service Review*, pp.239-63, Table 5.

273 Ibid, p.253.

expanded the range of interventions. We saw in the last chapter how the Blair and Brown governments in Britain built up tax credits, not simply to supplement family incomes, but also to tackle child poverty and increase work incentives. They were not alone, for governments around the world have been pushing family policy far beyond its traditional focus on horizontal equity:

> *"Whereas the primary goal of family benefits at the close of the 1970s was to supplement the income of families with children, the current goals of family policies have expanded to include balancing work and family responsibilities; providing incentives to work; enhancing and strengthening the development of young children; targeting help to families considered most vulnerable due to the age of children, family size or family structure; and preparing young children for formal schooling... The goals of child and family policies in most countries remain concentrated on improving the economic situation of children and their families, but these goals have expanded."*[274]

Joint versus individual taxation

Another common theme that emerges from a review of international developments is the move towards individualised taxation. This has been prompted partly by the argument that women should be taxed on their own incomes without reference to their partner's income, and partly by a desire to increase female workforce participation.

The OECD reports that by 2003, nineteen of its member countries had separate taxation of spouses, and six more offered this option. Nevertheless, a sizeable minority of countries still had joint taxation for couples, including the United States, Germany and France.[275]

To conclude from this that the world has been abandoning joint taxation would, however, be misleading, for unlike the UK, most of the countries that have moved away from joint taxation still offer a dependent spouse tax allowance to married couples.[276] The UK is most unusual in offering no tax allowance for a non-employed spouse or any dependent children. We share this 'radical individualist' position with only a handful of other OECD countries such as Mexico, Greece and Hungary.[277]

Most of the nations that have moved to 'individual taxation' still take account of family circumstances when assessing the tax owed by couples with children. Some do it by offering the principal earner a spousal allowance (equivalent to the UK Married Couples Allowance that was scrapped in 2000). Others do it by permitting couples to transfer unused allowances or tax credits between each other, so that a parent who is not employed can transfer his or her tax-free earnings allowance to the one who is. In Denmark and the Netherlands, for example, any part of an allowance not used by one partner can be added to the tax-free earnings allowance of the other.[278] It would therefore be more accurate to say that these countries have moved to 'partially individualised' (rather than 'individualised') tax arrangements.[279]

Countries which operate joint taxation systems go even further than this, of course, for they treat the couple as the basic tax unit. In the USA, for example, married couples can choose to file individually or jointly. Those who file jointly enjoy higher tax thresholds than those who file individually. There is also a per capita tax deduction for each dependent child.

274 Ibid, pp.260-1.

275 *Babies and Bosses* (2007), p.84.

276 Jaumotte F (2003), *Female labour force participation*, p.8.

277 Draper and Beighton (2008), Table 3.

278 Hansen H (2006), *Documentation of care packages for children in OECD's 2003 Tax/Ben model*, Danish National Institute of Social Research, *Social Policy and Welfare Services Working Paper* 17; Immervoll and Barber (2005), *Can parents afford to work?*, fn.30.

279 Dingledey I (2001), 'European tax systems and their impact on family employment patterns' in *Journal of Social Policy*, vol.30, pp.653-72.

In Germany, the income tax liability of married couples is calculated by pooling their income, halving it, and applying the relevant tax rate to each part. The cost of children is additionally recognised by applying a credit to the amount of tax owed (this tax credit is refundable, so families who do not earn enough to claim this extra allowance against their tax receive it as a cash benefit instead).[280] By adding the incomes of both partners together and halving the result, the total tax liability in families with only one earner, or where one partner earns substantially more than the other, is significantly reduced. This overcomes the 'couple bias' associated with a radically individualist tax system like that in Britain.

We saw earlier that in the UK, a single-earner couple with total household earnings of £30,000 pa would pay £26.26p per week (£1,369 per year) more in income tax than a couple earning the same amount split evenly between them. In a joint taxation system based on income-splitting, such as that in Germany, this bias will not occur. In Germany, single-earner and dual-earner couples earning the same total income will pay the same total amount of tax, irrespective of how they divide their paid labour between them.

In France, tax-splitting goes even further, for it is based on the whole family, and not just the couple. Ever since the war, French social policy has recognised and promoted the family unit as an institution in its own right.[281] This is reflected in the tax system, where total household income is divided between all family members, children as well as adults (children count as 0.5), before tax is applied. The resultant amount is then multiplied by the number of people in the family to arrive at the total amount owing. In this way, the tax system explicitly recognises that in families, incomes may be earned by just one or two members, but they often have to be shared among several more.

Tax credits

Tax credits for working families were pioneered in the USA in 1975 with the introduction of the federal Earned Income Tax Credit (EITC). This initiative began modestly but has been expanded several times, and a number of states also now offer their own, complementary, programs. EITC now costs the federal government more than the food stamps and TANF (welfare) programs combined.[282]

Since 1975, tax credits have been adopted in varying guises in eight other countries,[283] but it is in other 'liberal,' English-speaking countries that they have achieved their strongest following. Not only the UK, but Canada, Australia and New Zealand have all implemented some sort of tax credit system intended to boost the incomes of low-income, working families, and thereby at least partially avoid the unemployment trap. But they have done it in different ways.

USA

In the USA, EITC is part of the tax system.[284] It is a refundable credit, so people with no net tax liability claim it as a benefit, and those who pay tax claim it as a rebate. In both cases, the money is claimed as a lump sum at the end of the tax year based on declared income for that year. The over-payment problem which has plagued British tax credits therefore never arises, for the tax office knows what people have earned and tops them up accordingly.

280 Hansen H (2005), *Documentation of care packages for children in OECD's 2003 Tax/Ben model*; O'Neill R (2005) *Fiscal policy and the family.*

281 Revillard A (2006), 'Work/family policy in France' in *International Journal of Law, Policy and the Family* vol.20, pp.133-50. The social security system established in 1945 guarantees social rights to all family members through the workforce participation of a single breadwinner, and generous benefits (in addition to the child allowances built into the tax-splitting system) have been paid ever since the war to mothers staying at home and raising several children. In the 1990s, eligibility for this benefit, the Allocation Parentale d'Éducation, or APE, was extended to those with two children; before that, the minimum was three. It entitles a parent to an income of around €500 a month for three years after the birth of an infant. See Laroque G and Salanié B (2004), *Fertility and financial incentives in France*, CESifo Economic Studies vol.50, pp.423-50.

282 Brewer M (2001), *Comparing in-work benefits and the reward to work for families with children in the US and the UK*, Fiscal Studies vol.22, pp.41-77.

283 Boys Smith (2006), *Reforming welfare.*

284 What follows is based on Meyer B (2008), *The US Earned Income Tax Credit.*

This retrospective payments system is obviously less flexible than the British one, for there is no immediate adjustment when personal circumstances change. It requires people on low incomes to wait for their top-ups rather than getting help immediately through their weekly pay packet (as in the case of the WTC) or their fortnightly bank transfer (as in the case of CTC). Yet despite these apparent disadvantages, surveys find the great majority of American recipients prefer things this way and would not want to move to a weekly or monthly based system. Indeed, recipients can apply to receive up to $1,750 of their EITC in advance each year, but few do.[285]

Another major difference between the UK and US systems is that only people who are in paid work and on low incomes are eligible to claim the US tax credit. As in the UK's WTC, childless workers can claim EITC, but the amount they get is very small (up to $438 pa). Nearly a quarter of claimants do not have children, but they receive only 6% of all the money that is paid out.

In 2008-09, an American family with one child could claim tax credit if their income was below $33,995; a family with two children could earn up to $38,646. The maximum amount payable to a one-child family is $2,917 pa; for those with two or more children it is $4,824.[286] Half of all the money paid out goes to sole parents.

In the US system there is no equivalent of Britain's 16 hour rule. Instead, payments are phased in at 40 cents in the dollar over the first $11,790 of income until they reach a plateau of $4,716 (for those with one child, payments phase in at 34 cents in the dollar up to an income of $8,390, reaching a plateau of $2,853). The credit remains at this value until pre-tax earnings reach $15,390, when the credit is phased out at 21 cents in the dollar (16 cents for one-child families).

This taper is much shallower than the one in Britain, so it generates a smaller work disincentive. Indeed, the evidence suggests that the higher EMTR on workers who start to lose the tax credit has virtually no effect on the number of hours they are willing to work, even though economic theory tells us that it should.[287] This may be explained by the way EITC is paid as an end-of-year lump sum, so there is no immediate tax credit impact from increasing (or decreasing) hours. The end-of-year tax credit appears to many recipients like an annual reward for working, and the link between the number of hours worked in any one week, and the size of the lump sum received at the end of the tax year, appears tenuous. The EITC thus has a positive impact on the decision to participate in the labour force, but does not have much of a negative effect on the number of hours people work.[288]

Like the UK, system, however, EITC does contain a disincentive to marry or remain together as a couple, for income is assessed on a household basis and there is no deduction for second earners.

Because it applies retrospectively, and because there are only three payments schedules (for those with no, one or two or more children), the EITC is much simpler to administer than the UK system. Even so, the full EITC rulebook is still 56 pages long. It also requires all claimants to complete a tax return. Applicants complete a single form, which asks for details of the children living with them, and this is appended to their annual tax return. As in the UK, there is a high degree of error in claims, most of it arising from people falsely claiming that a child resides with them when it does not.

285 Brewer, *Comparing in-work benefits and the reward to work for families with children in the US and the UK*, p.66.

286 IRS website, http://www.irs.gov/individuals/article/0,,id=150513,00.html

287 Meyer (2008), pp.13-14.

288 Brewer (2001), *Comparing in-work benefits and the reward to work for families with children in the US and the UK*, p.66-7.

Canada

The Canadians first introduced a refundable child tax credit in 1978, but the present Canada Child Tax Benefit dates from 1998. It consists of two elements: the basic Child Tax Benefit is paid (according to household income) to some 80% of Canadian families, and a supplement is paid to low-income families.[289]

The Canadian child tax benefit system is like the British CTC, in that it is paid irrespective of the employment status of the parent, and is normally paid to the mother. Like the US EITC, however, it is assessed as part of the annual tax return and is paid in arrears (although unlike the US system, it is not paid as a single lump sum, but is spread over the next tax year in twelve monthly payments, by cheque or direct bank transfer).

"Although the UK government has fretted about the lack of responsiveness of 'fixed' systems, such as those in the US and Canada where tax credits are paid in arrears, this is not experienced as a problem in the countries where such systems operate"

There are no mid-year adjustments for changes in household income in the Canadian system, although changes in family circumstances (e.g. a marriage, divorce or birth of a child) are taken into account, and these affect almost a quarter of all claims each year. If a family's income drops, they may be eligible for emergency social assistance payments (administered by the provinces), but this affects only 6% of the caseload. Everybody else must wait for the following year's adjustment.

Despite this time lag, the system's lack of responsiveness to changing household incomes has never become a political issue in Canada, any more than it has in the US.[290] Although the UK government has fretted about the lack of responsiveness of 'fixed' systems, such as those in the US and Canada where tax credits are paid in arrears, this is not experienced as a problem in the countries where such systems operate.[291]

Australia

Australia's Family Tax Benefit comprises two different payments: 'Part A' is means tested on household income and is claimed by most families, while 'Part B' is a flat rate payment made to single-earner families (sole parents or couples with only one earner) to compensate for the loss of a second tax-free earnings allowance. As in Canada, there is no requirement that recipients have a job. Family Tax Benefit is paid to the principal carer (normally the mother) and can be claimed as a fortnightly cash payment, or as an end-of-year tax adjustment. Overwhelmingly, claimants opt for the fortnightly payment, which makes it look very like any other state benefit.

In an attempt to reduce EMTRs, the Australian federal government in 2005 reduced the income taper at the bottom end of the income scale from 30 cents to 20 cents in the dollar, but it remains at 30 cents for higher income earners (who can also face an income tax rate as high as 46.5%). As in Britain, reducing the taper has brought more families at the top end into the system, so nine out of ten Australian families now receive the Part A payment.[292]

As in Britain, Australian claimants have to forecast their income for the coming year, and this led to major overpayment problems in the early years of the system,

289 Whiteford P, Mendelson M and Millar J (2003), *Timing it right? Tax credits and how to respond to income changes*, Joseph Rowntree Foundation.

290 Whiteford P, Mendelson M and Millar J (2003), *Timing it right? Tax credits and how to respond to income changes*, Joseph Rowntree Foundation, p11.

291 "The Government has decided that any advantages of a fixed system would be outweighed by the loss of flexibility and the delay with which income and other changes would feed through to awards" (HM Treasury, *Tax credits: Improving delivery and choice*, Appendix A, p.69).

292 Maley B and Saunders P, *Tax reform to make work pay*, in Saunders P (ed), Taxploitation: *The case for income tax reform,* Sydney: Centre for Independent Studies, Sydney, 2006.

just as it did in Britain. When the tax office tried to claw these overpayments back, it opened up a major political issue which the government resolved by giving every family an additional lump sum which in most cases was generous enough to cover their repayment arrears.[293]

This pragmatic response has now been written into the rules of the system, so a regular supplement is paid, net of end-of-year adjustments, as an annual lump sum.[294] The Australian system is in this sense a hybrid of the US and UK systems, for like the UK, it requires income to be predicted in advance and it pays fortnightly throughout the year, but like the US system, it withholds at least part of the payment as a lump sum paid annually in arrears after claimants' exact income is known.

Cash versus provision in kind

Most OECD countries subsidise institutional childcare in one way or another, and most make legal provision for some form of paid maternity and/or parental leave. The 'Anglo' nations tend to be among the least generous providers on both counts (Australia and the US are the only countries that do not have paid maternity leave), while the Scandinavians – the countries identified in Esping-Andersen's taxonomy as the 'social democratic welfare regimes' – tend to be at the forefront of both of these trends.[295] Sweden, for example, offers heavily subsidised childcare and generous leave provisions to encourage women to remain in, or return to, the workforce.[296] As a result, female workforce participation rates are generally higher than elsewhere, although they are not as high as the official statistics indicate.[297]

A detailed analysis of childcare and parental leave policies lies beyond the remit of this report, but it is appropriate to draw attention to two Scandinavian countries – Finland and Norway – where women have the right to 'trade in' their entitlement to use state-subsidised childcare in exchange for an enhanced cash allowance which enables them to stay at home to look after their own children.

In Norway, all parents with children aged between 12 and 36 months are eligible for a flat-rate, tax-free monthly payment known as the 'Cash For Care' (CFC) payment.[298] This is payable to parents who choose not to use full-time, publicly-subsidised, day care. The policy is intended to compensate parents who do not use subsidised child care, to increase the choices available to them between work and family, and to encourage parents to spend more time at home with their children when they are very young.

Norwegian mothers have the right to one year's paid maternity leave at 80% of salary, plus two more years unpaid leave after that. The CFC payment provides an additional incentive to them to stay at home during this period to raise the child themselves, and has proved extremely popular. About four out of every five mothers claim CFC, and 80% of them receive the full benefit, which means they make no use of institutional childcare at all. It is estimated that CFC has reduced mothers' labour supply to the economy by between 4 and 5% , although most mothers return to work when the CFC ends. It has also been found that CFC leads women to delay childbirth (so it has a negative impact on fertility rates), which increases marital stability by a small but statistically significant extent.

In 2003, CFC was worth €5,500 per annum, which was equivalent to about 8% of average household earnings. This was roughly the cost incurred by the state in subsidising a full-time place in a childcare centre.

293 Whiteford P, Mendelson M and Millar J (2003), *Timing it right? Tax credits and how to respond to income changes*, Joseph Rowntree Foundation.

294 HM Treasury (2008), *Tax credits: Improving delivery and choice.* pp.13 and 43.

295 For data on government expenditure on childcare, and leave entitlements, in different OECD countries, see Jaumotte F (2003), *Female labour force participation*, Table 5. For a summary of international childcare provisions, see Immervoll and Barber (2005), *Can parents afford to work?*, Table A2.

296 Patricia Morgan goes so far as to suggest that Swedish policy has "involved the comprehensive political control of family life, where Sweden has made just about the most concerted attempt in history to engineer the freedom of women from child rearing responsibilities and the demise of the traditional family" (*Family policy, family changes*, 2006, p.19).

297 Morgan reports that, on any given day, 20% of the women who are recorded as in paid employment are actually away from work on paid leave. For mothers of children under three, it is 48% (*Family policy, family changes,* 2006, p.57). Similarly, Jonathon Bradshaw confirms that "The Nordic countries actually "hide" some of their workless sole parents by generous parental leave arrangements" (*A review of the comparative evidence on child poverty*, Joseph Rowntree Foundation, 2005, p.13).

298 Hardoy I and Schøne P (2005), *Cash for care: More work for the stork?*, Institute for Social Research; Hardoy I and Schøne P (2008), 'Subsidizing stayers? Effects of a Norwegian child care reform on marital stability' in *Journal of Marriage and the Family* vol.70, pp.571-84.

Similarly in Finland, a Homecare Leave Allowance (HLA) was introduced in the 1980s for families who chose not to use state-subsidised childcare.[299] In 2006, the basic allowance was worth around €300 per month for the first child, with another €100 for each additional child under three. The municipalities then add to this as they stand to make savings when women choose not to use their childcare facilities. The average allowance is worth about 40% of average female earnings.

The HLA proved highly popular from the outset. As in Norway, Finnish mothers have a right to three years of maternity leave, and only half of all mothers with children under three remain working. One-third stay at home throughout the first three years of their child's life.

Proposition 10

There may be lessons we can learn from other countries. Nearly all developed countries support parents with a child benefit payment, although this has become less significant as spending has increased on other family policies. The UK's highly-individualised tax system is unusual, for most other countries which require couples to be taxed separately still allow non-employed spouses to transfer their allowances to their partners, and in joint tax systems, like those in Germany and France, income-splitting explicitly recognises that family incomes have to be shared among several dependents. Our tax credits system is also distinctive, and the combination of no work requirement, prospective payment, and broad eligibility makes it very different from the US system on which it was originally modelled. Some countries allow parents to cash in the value of state childcare services if they do not wish to use them, but no such provision exists in the UK.

299 Hakim C et al (2008), *Little Britons*, pp.28-9.

9
Ten Modest Proposals

UK family policy has gone through a period of major reform and substantial upheaval. In the area of family tax credits alone, David Willetts MP calculates that, in the last 10 years, five new credits have been created (WFTC, Disabled Person's tax credit, Childcare tax credit, Children's tax credit, and Baby tax credit), four were later scrapped, and two additional, new ones were then introduced (CTC and WTC).[300] Similarly in childcare, "One initiative has followed another in dizzying succession, without the Government even waiting for the results of its own impact assessments."[301]

Perpetual policy revolution is a sign of bad governance. Not only does it take time for policies to bed down, but radical change creates a heavy burden of new administration costs, and the public gets confused as to their responsibilities and entitlements when rules and programmes keep changing.

We should, therefore, avoid the temptation to tear up the existing system of family tax and benefits and start again with a blank sheet. We have a system of tax credits, so we should try to make it work better rather than scrapping it. We have moved to an individualised tax system, so we should find ways to allow for dependents within this rather than moving to a French-style joint system. We should try to build on what we have, and where possible, any new elements should only be added onto this system if they have been tried and tested, either here in Britain, or overseas.

What follows, therefore, is not a radical blueprint for reform. It is, rather, a set of ten modest proposals which would help achieve the basic objectives of a pro-family fiscal and welfare policy without throwing the whole of the existing system into further disarray.

1. A spousal tax allowance for those who want it

The abolition of the Married Couple's Tax Allowance in 2000 was a mistake, and there are three good reasons for reintroducing it in some form:

- There is overwhelming evidence that children's wellbeing is maximised when they are raised by the same two parents from birth to maturity. Parents are more likely to stay together if they are married. It is therefore appropriate for the state to signal its support for married parenthood by giving married couples (and couples in civil partnerships) tax breaks that are not available to those who do not marry.
- In the very early years of a child's life (certainly the first 12 months, and probably up to 36 months) it is desirable that it be looked after at home by one or

300 Quoted in Boys Smith (2006), *Reforming Welfare*, p.68.

301 Hakim C et al (2008), *Little Britons*, p.11.

both parents. But when one parent (usually the mother) stays at home to look after young children, she has to depend on the income generated by the other parent (usually the father). The tax system should recognise this by reducing the tax payable on an income which has to be shared. This is essential in any tax system committed to the principle of horizontal equity.

- Every adult (and every child too) has a right to a basic, subsistence income before being taxed. When a parent stays at home, his or her right to a tax-free allowance is lost unless the allowance can be transferred to another family member who is working. This creates an unjustifiable and undesirable inequity of tax treatment between single-earner and dual-earner couples. This can only be rectified by allowing the stay-at-home partner to transfer some or all of their tax-free earnings allowance to the working partner.

Proposing that married couples and those in civil partnerships should be entitled to an additional tax allowance does not mean moving back from an individual to a joint taxation system. As we have seen, most OECD countries now have individually-based taxation, but they still retain tax allowances for partners in couples who want to claim them. Horizontal equity can therefore be restored without reverting to joint taxation (e.g. the income-splitting of the French or German models), but it can only be done in one of two ways:

- We could allow parents the option of transferring unused personal allowances between them (as in Denmark and the Netherlands);[302]
- We could allow one partner to claim an additional couple allowance (as in Australia, Ireland or the USA).

The first of these options may be unnecessarily generous, for it means a single earner could claim a double tax-free allowance, even though two adults can live together more cheaply than two single people can. The basic, subsistence income needed to maintain a couple is higher than that for a single person, but is not twice as high. Introducing a couple allowance worth, say, one and a half times the single allowance (or allowing a spouse to transfer half the personal allowance, which amounts to the same thing) therefore seems the more sensible option.

There are three crucial points to note about this proposal to reintroduce a Married Couple's Allowance (MCA) in revised form:

- The allowance is intended to compensate single-earner couples where only one allowance is being used and the other is going to waste. It would therefore be for couples to decide whether they each wished to retain their own personal allowance, or if one wanted to relinquish half of their personal allowance in order for the other to claim an enhanced couple allowance.
- The allowance would only be available to couples with dependent children. Childless married couples (and childless couples in civil partnerships) would not be eligible because there is no compelling reason why the state should seek to encourage childless couples to marry rather than cohabit or live apart. There is also no reason why both partners in a childless couple should not earn their own income, so the horizontal equity argument does

302 This was also proposed by the British Conservative Party in 2007 for basic rate taxpayers with children under six years of age – Brewer (2007), *Supporting couples with children through the tax system,* p.229.

not apply in this case. If a married couple is sufficiently affluent for one to stay at home all day, even though there are no children to look after, it is difficult to see why taxpayers should be expected to provide additional assistance.

- The allowance would only be available to parents who share a contractually binding relationship of mutual obligation to each other – i.e. to those who are married or in civil partnerships. Couples who have no binding claim on each other's income cannot expect taxpayers to alleviate the costs of supporting a non-working partner. The reintroduction of the MCA would reinforce a public norm that, when people have children, they should make a binding commitment to each other as well as to their offspring.[303]

It has been estimated that a MCA worth half an additional single person's allowance would cost £1.6 billion per year in tax foregone if it were given to all married couples, but this would fall to just £750 million if (as proposed) it were limited to married couples with children.[304]

Proposal 1

Introduce an optional Married Couple's Allowance, (MCA) worth 50% more than the single person's allowance. Married couples (and couples in civil partnerships) with dependent children could choose whether to retain their two single allowances, or relinquish half of one while the other spouse claims the additional MCA. Couples would nominate either the husband or wife to be the MCA claimant.

Estimated cost= £750 million per year

2. A transferable tax allowance for dependent children

Child tax allowances were scrapped in the UK in 1975, when they were folded into a new and more generous Child Benefit. As with the later abolition of the Married Couple's Allowance, this was a mistake, and should be reversed.

There were three main reasons for abolishing child tax allowances:[305]

- Low-income families were not benefiting from child tax allowances, for they did not earn enough money to take advantage of them. However, now that we have refundable tax credits to top up the earnings of these families, this argument no longer holds. Tax credits can be used after child tax allowances have been applied to top up the incomes of families which are still below some minimum acceptable threshold.
- Tax allowances are worth more to high earners than to basic rate taxpayers. This is true but irrelevant. If it is right to levy a higher marginal rate on higher earners, then it is also right that legitimate allowances should be claimed at the highest marginal rate.
- Child tax allowances often went to fathers when it was mothers who were mainly responsible for caring for the children. This is an important consideration, but (a) if both parents are working, they should be able to nominate which of them receives the allowance; and (b) even if child tax allowances went to the father, Child Benefit still goes to the mother, so carers will still have a direct payment made to them.

303 The Conservatives have stated their intention to reinstate some version of the MCA for the same reason. See Winnett R, 'Tories to give tax break to married couples', *Daily Telegraph*, 23 August 2008.

304 Social Justice Policy Group (2007), p.71.

305 HM Treasury (2005), *Tax credits: Reforming financial support for families*, p.18; *Building a fairer society* p.110; Greener K and Cracknell R (1998), *Child Benefit*, p.30.

The key reason for making the change back to child tax allowances is to restore self-reliance to more families.[306] We have argued that a pound earned, retained and spent on one's own family is far preferable to a pound given up in tax and then churned back in the form of a fortnightly welfare payment. Wherever possible, state financial support for families should involve leaving them with more of their own money, rather than taxing them and then returning the cash in some other form.[307]

The way to do this is to take more families out of tax by raising their total tax-free earnings allowance. This is what we used to do 30 or 40 years ago by giving workers with family responsibilities both a married couple's and children's tax allowances. If we did this again today, it would take some low-income working families out of the tax system while reducing the total tax burden of those on higher incomes. This would obviate the need to top up middle-income families with tax credits, which are welfare payments in all but name and which should be limited to those on low incomes.

Family payments (mainly tax credits) have been the main driver of the growth of middle class welfare. They have also created most of the incentive problems associated with the 'poverty trap' and high EMTRs as in-work benefits phase out. To reverse the trend to middle class welfare, and to restore work incentives to low and middle income earners, it is desirable wherever possible to substitute family payments with additional tax allowances. This would leave tax credits as a supplementary system aimed at boosting the incomes of low-paid working families (which was their original purpose) rather than as means tested supplements to the universal Child Benefit payment (which is what they have effectively become).

There are around 11.3 million children living in households in Britain where at least one parent is earning (although not all of these parents are earning enough to pay income tax). If each of these children were given a tax-free allowance worth half the adult allowance (£3,017), working parents on the basic tax rate would end up paying about £600 less income tax each year for each of their children. The total cost to the Treasury would be up to £7.7 billion in tax revenues foregone.[308] Much of this would be recouped by reduced tax credit payments (see Proposal 6, below).

306 This has also been argued by Kirby J (2005), *The price of parenthood,* p.44.

307 Saunders P (2007), *The government giveth, and the government taketh away*, Centre for Independent Studies; Morgan P (2007), *The war between the state and the family*.

308 The current adult tax allowance is £6,035, so each child would be eligible to claim £3,017. At the basic 20% tax rate, this would be worth £603 p.a. per child (more for higher rate taxpayers). According to 'The Poverty Site', there are 11.3 million children in working households (plus 1.8 million in workless households) – see www.poverty.org.uk/18/index.shtml. There are some 23 million basic rate taxpayers and 3.7 million higher rate taxpayers (Nugent H, '20% increase in higher rate taxpayers', The Times, 30 January 2008). If we assume that 14% of the 11.3 million children in working families have parents paying tax at the higher rate, this means about 1.6 million would claim 40% of £3,017 (total cost = £1.9 billion) with the remaining 9.7 million claiming at 20% (total cost = £5.8 billion). This assumes that all 9.7 million are earning enough to pay basic rate tax – in reality, the total cost would be slightly less.

Proposal 2

Reintroduce child tax allowances. Each dependent child should be entitled to its own tax-free earnings allowance worth 50% of the single adult allowance. This reflects the claim that each child makes on the family income in order to secure its own subsistence. Because children do not work and earn this money themselves, their tax-free allowance should be claimed on their behalf by either parent, provided they are working. In this way, more working families would achieve financial self-reliance without needing to claim tax credit payments from the government.

Estimated cost = £7.7 billion per year

3. Limit tax credits to families who work, and pay them as an annual lump sum net of family tax allowances received

If working families were allowed to retain a bigger slice of their earnings, by claiming a married couple's allowance and/or by claiming child tax allowances, they would obviously end up paying significantly less income tax than they do at the moment. We might nevertheless decide that some of them still needed income top-ups, in which case tax credits will need to be retained. Tax credits would, however, operate on a much more modest scale than presently, for with family tax allowances in place, far fewer working families would qualify for tax credit payments (for their income would be assessed net of the value of tax allowances received), and those who did qualify would receive smaller amounts.

Non-working families would no longer receive tax credits, for the system would be refocused so that it once again rewards only those who work.[309] This used to be the principle that underpinned earlier tax credits: Family Income Supplement, Family Credit and Working Families Tax Credit were all *in-work* benefits aimed at boosting the take-home income of poorer working families and therefore increasing the gap between their standard of living and that achieved by comparable families who did not work. The same is also true of the US Earned Income Tax Credit, on which our system was originally modelled.

“Tax credits need to be seen as an unambiguous reward for working, just as they are in the USA, rather than just another in an array of state benefits”

Until 2003, the various tax credit schemes operated in Britain had one, core objective, which was to reward work. The new system has lost sight of this objective and is trying to achieve two often-incompatible things. On the one hand, it wants to strengthen incentives for families to work; on the other, it wants to reduce child poverty.

These objectives are not necessarily incompatible, for the principal cause of child poverty is joblessness (which is often associated with sole parenthood). Strengthening work incentives for adults in families – particularly for sole parents, who commonly do not work – is therefore a sensible plank in any anti-poverty strategy.

But the new Child Tax Credit is not set up to do this, because it is paid whether you work or not. Working Tax Credit still functions as a reward for working, but Child Tax Credit does not, and because it is means tested on household income, it is actually less generous if you do work than if you do not. Added to this it creates marriage disincentives too, for a mother will get more CTC if she lives alone with her children than if the father lives with her.

Of course, if CTC were limited to working parents, parents in the welfare system would have to be given extra benefits to cover the costs of their children as well as themselves. The amount paid to Income Support and JSA claimants with dependent children would therefore have to be increased to make up for their lost CTC payments. This effectively means going back to 2003, when parents on welfare received an additional ‘child element’ worth £38.50p per week for each dependent child under the age of 18.[310]

The net impact of this change on the government budget will therefore be close to neutral – the saving on tax credits by taking 1.8 million non-working families out of the system, will be roughly matched by the increased spending on welfare benefits as a result of reinstating the child element in JSA and Income Support payments.

If the net result is more-or-less the same, why bother making the change? The answer is that tax credits need to be seen as an unambiguous reward for working, just as they are in the USA, rather than just another in an array of state benefits.

309 For a similar argument, see Boys Smith (2006), *Reforming Welfare*, and Kirby J (2005), *The price of parenthood.*

310 Department for Social Development, http://www.dsdni.gov.uk/jsa_background_information.pdf, Annex 6, Table 1A.

Limiting them to people who work means we could get back to paying tax credits through the wage packet, as was the case with WFTC before 2003 (since 2003, WTC has been paid by employers who then claim it back from HMRC, but CTC has been paid as a state benefit). Alternatively, part or all of the tax credit could be paid (as in the US and Australia) as an end-of-year tax adjustment.

This latter option is in many respects the preferable one, for it (a) saves on administration costs for government and employers; (b) avoids the current overpayment problems in the tax credits system; (c) represents a clear and tangible 'reward for working' each year, and (d) helps low income families to save.

It is vital that we resolve the overpayments problem and reduce the level of fraud in the existing system. This is necessary, partly because of the distress caused to families who unwittingly over-claim and then have to pay the money back, and partly because of the cost to taxpayers (the total amount overpaid up to 2008 was £7.3 billion, of which only £2.7 billion has been returned).

The fundamental flaw in the system derives from the commitment to 'flexible' prospective payments, for these can only work by making predictions of future incomes that will often turn out to be wrong. Things could be, and are being, done to improve the accuracy of these predictions, but large sums will still be fraudulently or erroneously paid out for as long as tax credits are paid in advance. The obvious solution is to learn from the Americans and Australians and hold back at least part of a family's tax credit entitlement until the end-of-tax-year reconciliation when their exact entitlement can be calculated.

In most cases, payment in arrears should not result in undue hardship because families will be paying substantially less tax each week than they do currently (as a result of the reintroduction of child tax allowances). Many of those who currently claim tax credits will no longer do so, for they will be able to retain more of their own earnings instead, and even those on lower incomes who continue to receive tax credit top-ups will claim less, because of their lower tax burden. With fewer families relying on smaller pay-outs, delaying payment until the end of the tax year becomes more feasible than it might otherwise be.

However, low-paid, part-time workers moving out of welfare could suffer if their entire tax credit top-up were delayed to the end of the tax year. For example, a sole parent moving from income support onto a minimum wage job for 16 hours per week would lose the whole of the welfare payment they had been receiving, but would have to wait up to twelve months to get the compensating tax credit payment. To avoid problems like this, it may still be necessary to pay tax credits in advance to new claimants up to the point where the fortnightly sum payable matches the amount otherwise payable by welfare benefits, with the remainder paid as a lump sum at the end of the tax year.

Many analysts agree that a major problem facing low-income families is their inability to save (which is why the child trust funds were introduced), so paying part or all of the tax credit entitlement as a lump sum at the end of the tax year could be seen as positively advantageous for many recipients. And as we saw in the case of the US, receiving a lump sum tax adjustment will be regarded by many recipients as a 'reward for working' and may have a stronger impact on workforce attachment rates than the present system of fortnightly top-ups.

Deferring tax credit payments to the end of the tax year would generate some significant savings to the government, both in reducing erroneous payments and in cutting overheads. Savings of around £1 billion per annum could be anticipated.[311]

A successful crackdown on fraud would also generate savings. HMRC currently only prosecutes what it calls 'serious' cases of fraud involving "organised attacks on the system", and 165 prosecutions were brought in 2007-08.[312] But where claimants are found to have deliberately defrauded the system (e.g. by failing to declare a live-in partner's earnings), prosecutions should always be considered. At the very least, financial penalties should be imposed, and eligibility for tax credits should be withdrawn, at least for a fixed period.

Proposal 3

Reintegrate CTC and WTC into a single tax credit available only to working families, and pay it mainly as an end-of-year lump sum. This means the £25,000 earnings disregard should be scrapped. Families on welfare where nobody is working would be compensated for the loss of CTC by including an element for the costs of children to JSA and Income Support.

Estimated saving = £1 billion per year

4. Base tax credit payments on the number of hours worked above the 16 hour threshold

Insisting on a work requirement for recipients of tax credits begs the question of how much work should be expected. The current rule for receipt of Working Tax Credit is that parents must work 16 hours to be eligible, while single people and childless couples have to work 30. This is not ideal, for it discourages claimants from working more than the relevant threshold of hours.

We have seen that sole parents can end up with something approaching a full-time wage simply by working 16 hours and then allowing the government to top them up with tax credits. When they were required to work 24 hours, modal working time clustered around 24; when the requirement was cut to 16, modal working time fell to 16.

There are three possible ways round this problem:

- We could copy the American EITC and taper tax credits in, as well as tapering them out. Credits would then rise as incomes rise above zero, before reaching a plateau and then falling. This would avoid any clustering of work around 16 hours and give an incentive to increase work hours across the low income range. However, applied to the UK system, it would create a grey area where people could be claiming both welfare and tax credit (for the 16 hours rule clearly demarcates 'welfare' from 'employment'). There would also still be the problem that a worker on a higher hourly rate may choose to trade off earned income against hours and let the tax credit make up some of the difference.
- We could raise the minimum hours eligibility to ensure that people work closer to a full-time week before getting top-ups. This has recently been proposed by David Green who argues that sole parents (other than widows and widowers) "should normally be required to work to the extent necessary

311 We saw earlier that overpayments currently cost around £1 billion, most of which would be saved by moving to end of year lump sum payments. There would also be some administrative and staffing savings in HMRC as a result of simplifying the system.

312 Report of the Comptroller (2008), para.2.18 and Table 7.

to avoid welfare dependency".[313] He suggests that, once their youngest child starts school, sole parents should work at least 35 hours per week for 47 weeks a year before getting a 'hard-work top up' (WTC would be scrapped). The key problem with this suggestion is that there would be little incentive for sole parents to take part-time work (which is why the 16 hour rule was introduced), and those taking full-time jobs would have to find and pay for out-of-school hours care in the afternoons and during school holidays.

- Tax credits could be restructured so that they top up earnings on an hourly-wage basis, rather than on an aggregate-wage basis. If tax credits topped up the hourly wage rate, the total amount paid to a family would increase proportionate to the number of hours worked above the 16 (or 30) hour minimum threshold.[314] A reform like this would not only strengthen work incentives, but it would also cost less than our existing system, for people working relatively small numbers of hours would no longer be so generously supplemented.

We believe that the third of these options is the most desirable one.

If workers are allowed to retain more of their earned income as a result of the proposed new tax allowances, full-time work by one adult earning the minimum wage should generate an income sufficient to raise most families above the government's poverty line. However, families whose principal earner works less than full-time may not earn enough to provide them and their children with an adequate income. Provided they work at least 16 hours per week (in the case of sole parents), or 30 hours between them (in the case of couples), they would still qualify for top-ups under the reform outlined here, but the fewer hours they work above these thresholds, the smaller will be the total value of the top-ups they receive (because it is their hourly rate, and not their total income, which attracts the tax credit supplement).

It is plainly unfair and counter-productive to use tax credits to raise the incomes of part-time workers to a level close to that achieved by comparable people who work full-time, yet this is what we are doing at the moment. The proposed change would rectify this anomaly.

There are three possible problems with making a change like this:

- There is a danger of reintroducing the unemployment trap, for parents who work part-time (say, 16 hours per week) will get a smaller top-up than they do now, which means their total income will fall closer to the amount they could get on welfare by not working at all. Tax credits would still need to ensure that the minimum income for families working part-time still exceeds that available to comparable families living on benefits.
- Sole parents with very young children might be induced to work full-time in order to maximise their tax credit entitlement, and this could harm their child's development and wellbeing. This problem could be overcome if (as outlined below) Child Benefit were amended, and a new Parenting Care Allowance were introduced, so that more financial support is made available for parents with children under three years of age who do not work.
- There may be practical problems, for the tax office would need to know how many hours each claimant has worked over the year, as well as how much money they have been paid, in order to work out their tax credit eligibility.

313 Green D (2009), *Individualists who cooperate*, p.67.

314 A similar proposal has been made and evaluated in America by MaCurdy T and McIntyre F (2004), *Helping Working-Poor Families*, Employment Policies Institute.

> Employers would therefore need to keep records of the hours worked by their employees, and self-employed and professional workers would have to self-certify. But hours have to be checked in the existing system (HMRC has to determine whether claimants have reached the existing 16/30 hour eligibility thresholds), so basing payments on hours worked should be feasible.

This change could result in significant savings to public expenditure as tax credit payments are reduced to those working shorter hours. It is difficult to gauge the scale of these potential savings, for we do not know how many people currently working just 16 hours per week would increase their hours in order to boost their tax credit top-up. In the USA it has been estimated that switching to a tax credit assessed on hourly wage-rates would result in 20% savings on the existing EITC budget.[315] If the same were true here, we could be looking at expenditure savings of up to £4 billion per year, but this should be regarded as a very tentative estimate.

Proposal 4

Reintegrate Child Tax Credit into the Working Tax Credit so that paid employment is restored as a condition of eligibility for tax credit payments. Retain the current 16 and 30 hours minimum eligibility rules, but change the calculation of tax credit payments so that they are scaled according to the average hourly wage over the assessment period, rather than according to aggregate weekly earnings.

Estimated saving = £3-4 billion per year

5. End the 'couple penalty' in the tax credits system

Turning tax credits back into top-ups for low-income working families would help to overcome the work disincentives which have grown up in the current tax credit system, but there are other problems with it, too, which need to be addressed. A key one is the 'couple penalty'.

We have seen that the income tax system penalises all single earner couple families by failing to allow for the costs of the non-working parent. This unfairness is compounded for low-wage couples by the fact that the tax credits system also fails to allow for the costs of a non-working parent. Just as the solution in the case of income tax is to give couples the option of claiming a Married Couple's Allowance, so too the tax credits system should include an additional element for a non-working spouse.

The same conditions which would attach to the MCA would attach to this new non-working spouse element in the tax credits system too, and for the same reasons. Thus, it would only be available to couples with dependent children, and it would be limited to parents who are married or in civil partnerships. It would be calculated after taking the value of the MCA into account.

Like the MCA, a spousal element in the tax credits system would contribute to horizontal equity by ensuring that a low-income worker with a spouse and children to support would take home a bigger slice of his/her gross earnings than a comparable worker with fewer or no dependents. However, both these changes would tend to depress the rate of female workforce participation, for they increase the incentive to have only one earner and they reduce the incentive for second earners to work more hours to increase the family income.[316] Seen from the

315 MaCurdy and McIntyre (2004), p.17.

316 Brewer M (2007), *Supporting couples with children through the tax system*, p.227. Mike Brewer notes in a personal communication that introducing a couple element into the tax credits system would create sharp work disincentives for second earners, for it is difficult to see how such a credit could be phased out when the second parent starts to work. This is true, but it is important to remember that the number of families affected will be significantly smaller than at present. This is because the reintroduction of child and married couple allowances will boost family take-home incomes and remove many households from the tax credits system altogether.

perspective of the child's development, this may not represent a 'downside,' for child wellbeing is likely to increase if one parent stays home in the early years.

This is less true as children grow older, and we have seen that, the longer women remain out of the labour market, the more their long-term careers suffer. As time goes on, therefore, the balance of the argument shifts, and for families with older children (over the age of three), there is no strong case for using other people's taxes to enable and encourage one parent to stay home.

How big should the tax credit supplement be for a non-earning spouse? The Institute for Public Policy Research says couples should get one-third more than sole parents with the same number of children since equivalised poverty lines draw the line for a couple about one-third higher.[317] The Social Justice Policy Group says the tax credit for couples should be about 60% higher, since this is the premium paid to couples in the social security system. This would raise average payments by £32 a week at a coat of £3 billion.[318] If (as proposed here), the supplement were limited to married couples and those in civic partnerships, were paid at only 50% (to make it consistent with the proposed MCA), and were reduced to take account of the value of the MCA, the cost would be significantly lower than this – perhaps around £1.2 billion.[319]

Proposal 5

Introduce a 'non-working spouse' element into the tax credits system for married couples where one partner stays at home to look after dependent children. This should be paid net of the Married Couple's Allowance.

Estimated cost = £1.2 billion per year

6. Reduce middle class welfare

In addition to the work disincentives, fraud, wastefulness, and the couple penalty, the other main problems with the current system of tax credits are its cost (an increase in just 10 years from £2 billion to £20 billion) and its inefficiency (taxing middle class families with one hand, and then giving the money back with the other). These problems must also be addressed.

Two of the proposals outlined above would do much to reduce the size of the tax credits budget. Limiting tax credits to working families would knock out welfare claimants and take us back to the eligibility rules operating in 2003 (when the total cost of WFTC was around £6 billion). However, most or all of the money saved on tax credits would have to go on increased welfare benefits, so the net impact on government finances would be small.[320]

Reintroducing family tax allowances – the MCA and child allowances – would also enable spending on tax credits to be slashed, for we could then take the middle classes out of the tax credit system altogether. Net government expenditure will still rise, for the cost of the new MCA and child allowances would exceed the savings under the tax credits budget (because high income families not currently eligible for CTC would in principle qualify for these tax allowances). Moreover, if the new MCA and non-employed spousal element in the tax credits system resulted in a decline in female workforce participation, tax revenues would fall accordingly.[321]

317 Cooke G and Lawton K (2007), *Working out of poverty*, Institute for Public Policy Research, p.58.

318 Social Justice Policy Group (2007), p.70.

319 The £3 billion estimate of the Social Justice Policy Group is deflated by 20% (because the value of the partner element is 20% lower), and then by another 20% (on the assumption that no more than 80% of couple claimants will be married). The result is then reduced by a further £750 million (the value of the MCA), leaving a final estimate of £1.17 billion.

320 At the 2003 rate of £38.50 per child per week, the 1.8 million children in workless families would generate an increased welfare spend of £3.6 billion per year. Against this would be set a CTC saving of roughly the same amount, for CTC pays £2,635 for one child in a workless family, and 1.8 million children paid at this rate comes to £4.7 billion. Given that some children are paid less than this (for a second child attracts CTC of only £2,085), and that the 2003 welfare rate has to be upgraded for inflation, the figures roughly balance out.

321 The more we move from a pure individual to a pure joint system of taxation, the more we achieve horizontal equity, but the greater the disincentives become for second earners (normally women) to take up employment. See Jaumotte F (2003), *Female labour force participation*, p.25.

Nevertheless, with tax allowances restored for dependent children and a dependent spouse, fewer families would need additional support from tax credits, so these would be concentrated solely on poorer families. The long eligibility tail up to families with combined incomes as high as £60,000 could therefore be drastically curtailed.

The size of the savings would obviously depend on how tightly the new income test was drawn. We have seen that, per head of population, the American EITC costs only 60% of what the UK spends on tax credits because it tapers out much earlier, yet it has had a bigger impact on rates of workforce participation. If the UK emulated the US income test, the cost of our tax credits system would plummet from £20 billion per annum to a figure closer to £12 billion.

To achieve savings on this scale, eligibility for tax credits would need to be restricted to families in the bottom half of the income distribution. This should save one-third of what we are currently spending (for it is estimated that one-third of current spending goes to the most affluent 50% of families).[322] With a total tax credit budget of £20 billion per year, this would amount to annual savings of almost £7 billion.

Proposal 6

Eliminate 'middle class welfare' from the tax credits system, and reduce tax-welfare churning, by restructuring the tax credit taper so it cuts out before families move into the upper half of the earnings distribution.

Estimated saving = £7 billion per annum

7. Frontload Child Benefit on the first three years and make it conditional on 'responsible parenting'

It would make sense to restructure Child Benefit so that most of the money is paid in the first three years of a child's life. This has been proposed by Labour's Frank Field, endorsed by a Conservative Party policy group, and is supported by more than half of the British public.[323] The logic behind this proposal is that, as children get older, both parents can return to work, at least part-time, whereas in the first two or three years (when it is most desirable for the child to be raised at home), families incur a considerable income sacrifice in addition to the direct costs incurred in having a new infant. Front-loading the Child Benefit would help defray these expenses.

Child Benefit for the first child is currently worth £20.00 per week (second and subsequent children get £13.20). Typically, a first child might therefore attract an average of about £1,000 per year in Child Benefit for 18 years (a total of £18,000), while later children get around £650 (a total of just under £12,000).

If half of this money were brought forward to the first three years, it would mean a first child would qualify for £3,000 per year for the first three years (approximately £58 per week), dropping to £600 per annum after that, and subsequent children would get nearer £2,000 per year (£40 per week) for the first three years, and £400 per year thereafter.

This enhanced Child Benefit would be paid, as of right, to every family. There is a danger, however, that increased payments in the early years might encourage

322 Nicholas Boys-Smith estimates from Treasury data that 33% of all tax credit spending goes to families in the top half of the income distribution – *Reforming Welfare* (2006), pp.73-4.

323 Social justice Policy Group (2007), *Breakthrough Britain*, pp.72-3.

irresponsible parents to have more children for the wrong reasons (we saw earlier that economic incentives may have some impact on fertility rates among lower-income groups). There is therefore a case for making the enhanced payments conditional. Where there is evidence of a child being raised in a potentially harmful environment (e.g. where a parent is abusing drugs or alcohol, or fails to make the child attend school regularly), some or all of the benefit might be withheld until the situation improves. Such conditionality would need to be based on clear, measurable and objective criteria – things like school attendance records or officially-recorded indicators of neglect – to avoid the possibility of capriciousness.[324]

In the long run, this proposal is revenue-neutral, for over the first 18 years of a child's life, it will receive the same total amount of Child Benefit as it does now. There would, however, be an initial 'budget-shock' during the transitional, phase-in stage of this reform, for children currently over the age of three would continue to receive the existing 'flat' payment while those under three received the enhanced, front-loaded, payment with no compensating saving elsewhere. The greatest additional burden would occur three years into the new system, when the government would be spending £3.3 billion more on Child Benefit than it does at the moment.[325] After that, the cost would gradually decline, until, in year 18, it returned to its current level.

Proposal 7

Keep Child Benefit as a universal, flat-rate payment, but restructure it so that half the total value is paid in the first three years of a child's life, conditional on 'responsible parenting.'

Estimated cost = Nil (long-term); maximum £3.3 billion (in Year 3)

8. Replace current childcare subsidies with a Parenting Care Allowance

The front-loading of Child Benefit could be coupled with a change to the way formal childcare is currently subsidised.

As things stand, parents who choose to raise their children at home not only sacrifice the earnings of the main carer, but they also subsidise through their taxes the childcare costs of other parents who decide to keep working. Moreover, parents who prefer to use informal care (e.g. grandparents or neighbours) lose out relative to those who use formal, approved care, yet these are often the less affluent families.

One possible answer to inequities like this is to offer a cash allowance to parents who do not use formal childcare, so that they can pay for informal care, or offset loss of earnings by caring for their children themselves. This was proposed in 2005 by the Conservative Party,[326] and we have seen that some European countries do something similar. Parents who do not use state-subsidised childcare are offered a cash equivalent so they can stay home and look after their infants themselves.

A simpler version of the same idea was put forward in a 2008 Policy Exchange report which proposed that existing state childcare subsidies (like the childcare element of the WTC and employer childcare 'electronic vouchers') should be scrapped and replaced with a new, universal 'Parenting Care Allowance' for all

324 The Social Justice Policy Group (2007) makes a similar recommendation, proposing that the enhanced part of the Child Benefit be made subject to health visitors and other professionals being satisfied that infants and young children are making good progress (pp.72-3). Knowing that money is at stake could lead parents to put pressure on these professionals, however, and the proposal sounds rather heavily interventionist. It might be better simply to withhold payment if there is formal evidence of specified kinds of behaviour – e.g. illicit drug use – or neglect.

325 Assuming (for the sake of simplicity) a £10 billion annual spend on Child Benefit, and equal cohort sizes each year, each cohort currently receives £0.56 billion each year. Under the new system, cohorts 1 to 3 will receive £1.67 billion per year, reducing to £0.33 billion per year after the age of three. In the third year of operation, therefore, there will be three cohorts of under-threes, each receiving £1.67 billion rather than the existing £0.56 billion, with no older cohorts receiving the reduced level of £0.33 billion.

326 Brewer M, Crawford C and Dearden L (2005), *Helping Families*, p.21.

parents with children aged 0-3.[327] This benefit would not be means tested and would not be contingent on working. It would be worth around £55 per week for each child, tax-free, and could be spent on childcare or for any other purpose as the parents see fit.

The logic behind this proposal is that parents are generally the best people to judge how to raise their children. With the money in their pockets, parents of young children could choose whether to continue working while paying for childcare, or leave the workforce for a while in order to raise their children at home and use the money to help soften the financial blow from the loss of an income.

The problem, of course, is the cost. The Policy Exchange report *Little Britons* estimated that around £1.5 billion would be saved by winding up the WTC childcare element, electronic vouchers and the Sure Start Maternity Grant, and another £0.5 billion might be saved in administration costs. But set against these savings, a new Parenting Care Allowance would cost £5.4 billion if it were untaxed, or £4.1 billion if it were taxed. The net additional cost would therefore amount to between £2.1 billion and £3.9 billion per year, depending on whether admin savings materialise and the new PCA is taxed. At the very least, it would probably cost around £3 billion.

Taken together, a front-loaded Child Benefit, plus a new Parenting Care Allowance (in place of existing childcare subsidies) would boost family incomes in the first three years of a child's life by as much as £120 a week. This amount of money would give parents a real choice about how to balance the demands of family and career.

Proposal 8

Scrap the childcare element of the Working Tax Credit, as well as the employer-based childcare 'electronic vouchers' and the Sure Start maternity grant, and replace with a new Parenting Care Allowance, paid to all parents in the first three years of a child's life as an addition to the Child Benefit, and worth approximately £55 per week, per child.

Estimated net cost = £3 billion

9. Investigate the feasibility of Parental Leave Savings and Loans schemes for families who want them

The proposals outlined so far go a long way to enabling parents who want to look after their young children at home to do so, without prejudicing the choice between staying at home and continuing to work. Couples who want to raise their own children would be able to replace a sizeable chunk of the lost second income with the enhanced early years Child Benefit and the new Parenting Care Allowance, they could boost their earnings by claiming MCA and child tax allowances, and those on a low income would also qualify for tax credit support, including a new non-working spouse element.

The decision to leave work for an extended period in order to raise children will, nevertheless, still involve significant loss of income for many families. This could be relieved by increasing existing paid leave entitlements.[328] But any significant extension of existing paid leave entitlements will increase an already heavy burden on employers and taxpayers at a time when the economy can ill afford it. It will also transfer more money from poor single people to rich couple families, and will do nothing to encourage a culture of self-reliance.

327 Hakim C et al (2008), *Little Britons*. A similar proposal has been made by Dex S and Joshi H (1999), *Careers and motherhood*, p. 656.

328 Grandparents Plus, *Rethinking family life: Exploring the role of grandparents and the wider family*, March 2009, www.grandparentsplus.org.uk.

A better solution could be to develop a new system of tax-favoured savings instruments so that parents can make provision for their career breaks in advance. For those who fail to save enough, there might also be parental leave loans, modelled loosely on the existing student loans scheme.

The problem of financing parental leave is basically one of how to 'smooth incomes' over an expensive but largely predictable period of the life cycle. Like students in higher education, new parents need to replace an income for a relatively short and clearly-defined period. They will normally have been earning before stopping work to have children, and they will normally also expect to return to work and resume earnings afterwards. This means that they should be in a position to save, prior to having a child, and/or to borrow during the period of leave with a view to paying the money back later, when they return to the workforce.

> "What we propose is a 'family savings' instrument which would allow employees to 'salary sacrifice' up to a certain limit each year so that neither their deposits, nor the interest earned, are taxed"

The UK already has tax-exempt savings schemes (principally, the Individual Savings Accounts, or ISAs). We also pioneered tax-exempt savings accounts for children (the child trust funds). These schemes exempt interest from tax, although tax still has to be paid on the earnings which create the initial deposits.

What we propose is a 'family savings' instrument which would allow employees to 'salary sacrifice' up to a certain limit each year so that neither their deposits, nor the interest earned, are taxed. This money could then be drawn to provide a replacement income (which would be taxed as it is drawn) for a period up to three years after the birth of a child (if a parent wants to care for the child at home), or to pay for childcare (if he/she wishes to return to work earlier).

There is a precedent. In 2006, the Netherlands introduced a tax-free savings scheme to finance extended, unpaid parental or other family leave. Called the 'Life Course Savings Scheme' it seeks to encourage employees to take more responsibility for themselves by saving for extended periods out of the labour force, such as parental leave. The scheme is voluntary, and the Dutch government gives tax relief of up to €650 per month.[329]

For parents who have not saved, a loan scheme might also be introduced to cover extended parental leave.[330] As in the case of student loans, interest could be charged at a preferential rate and repayments deferred until household income passes a certain threshold point (say, average earnings). To ensure gender equity, both parents would need to be held responsible for repaying loans, irrespective of which of them takes the time out from paid employment.

329 Moss P and Wall K (2007), *International Review of leave policies and related research 2007,* Department for Business Enterprise and Regulatory Reform, Employment Relations Research Series N.80.

330 This has been proposed by Australian economist, Andrew Leigh 'A HECS on everything', *Australian Financial Review*, 6 May 2008.

Proposal 9

Research is needed into the viability and likely cost of a voluntary, tax-exempt Life Course Savings scheme to enable working families to save for extended periods of parental leave and/or childcare costs. Research should also consider the viability of a discretionary Parental Leave Loan, made available at preferential interest rates to either parent in a couple (provided they have previously been active in the labour market) and for which both are jointly liable.

10. Decouple family policy from anti-poverty programs and apply the same financial expectations to all parents

We have seen that an anti-poverty agenda has come to dominate family policy. This has two main consequences:

- Family policy has increasingly been equated with providing increased financial assistance – in particular, to 'poorer' sole parent families;
- Other aspects of family policy, such as the desirability of strengthening family ties, promoting greater self-reliance of families, and ensuring horizontal equity, have been forgotten or abandoned.

Most financial assistance for families is now provided in the form of tax credits. But since 2003, the function and purpose of tax credits has become hopelessly confused. Notwithstanding the continuing rhetoric about helping 'working families', we now have one tax credit (CTC) which does not require that you work, and another (WTC) which does not require that you have any family responsibilities.

This confusion has arisen because tax credits have increasingly been directed at reducing poverty. As originally conceived, tax credits were supposed to reduce poverty indirectly, by promoting greater participation in paid work, but since 2003, they have been used to reduce poverty directly, by giving more money to families with little or no income of their own. This means tax credits are now made available to people whether they are employed or not. This enhances their incomes, but the initial cause of their poverty goes uncorrected.

This extension of tax credits has built a contradiction into the heart of contemporary family policy. Giving non-employed families more money erodes work incentives, reduces the relative advantage of working over non-working, and reinforces dependency. Extending tax credits to people who do not work has in this way destroyed their rationale and turned them into just another welfare payment.

Much of the money spent on tax credits has gone to sole parent families. This is because sole parents have, on average, much higher rates of joblessness (and therefore higher levels of child poverty) than other family types.

Since 1997, Labour governments have tried to reduce rates of sole parent joblessness, but they have refused to recognise that the rising rate of sole parenthood is itself the major cause of the poverty problem. They have therefore been focusing on the symptom while ignoring the principal cause of the problem they claim to be tackling. Politicians in all parties should be brave enough to break from the comfortable myth that pretends that all family arrangements are equally positive. Policy must acknowledge that family structure is itself a major cause of family poverty, and begin addressing this directly.

Governments have achieved significant success in raising what was an extremely low rate of workforce participation among sole parents (although moving people from welfare into just 16 hours of employment per week is rarely enough to sustain genuine financial independence). New eligibility rules should also help weaken the culture of dependency which has grown up as a result of sole parents having a right to remain on Income Support until their children leave school (from October 2008, sole parents have been required to look for work once their youngest child passes the age of 12, and in 2010, those with children as young as seven will have to register as available for work).

All of this is positive, but there is scope for taking these reforms further. The proposals outlined above would make it possible for all families to raise their children at home up to the age of three if they wish to do so, but beyond this age, there is no reason in principle why parents should not be in work, at least part-time. We have seen that in many couple families, both parents work when their children are three, and the children do not suffer – and may well benefit – if they are placed in child care at this age. What is good for couples should be good for sole parents too. Taxpayers should not be expected to subsidise parents to stay at home once their children pass three years of age, whether they are couples or sole parents.

Another key factor contributing to high poverty rates among sole parents is that absent fathers too often fail to meet their financial responsibilities for supporting their children. Families should draw first on their own resources before seeking additional financial assistance from taxpayers, and this principle applies just as much to parents who live apart as to those who remain together. It is wrong that lone mothers claim financial support from taxpayers to replace income they should be getting from the father of their child, and it is wrong that tax credits get calculated disregarding income support payments from an absent partner.

To rectify this, the state should ensure that sole parents (other than widows and widowers) receive regular receipt of adequate child support from the absent parent. These receipts should count as assessable income when calculating eligibility for state assistance. This right to child support should be reinforced by legal sanctions as necessary. The 1948 National Assistance Act provided for fathers to be traced and prosecuted if they abandoned their families without making adequate financial provision for them. Every year until 1982 there were 500 to 600 such prosecutions, about 10% of which resulted in prison sentences.[331] But after that, criminal prosecution fell out of favour, and predictably, defaults have multiplied ever since.

Parents must be required to fulfil their financial responsibility to maintain their children until they reach maturity, irrespective of whether they separate or continue to live together. In jobless sole parent families, where child support is insufficient, state welfare should play a secondary role in supplementing the family income, but any offer of state assistance should be calculated on the basis of both parents' incomes.[332]

Proposal 10

Family tax credits should have one aim – to improve work incentives and rewards for low income families. They should not also be used as an instrument of anti-poverty programmes, for this undermines their effectiveness. High rates of relative poverty among sole parent families should be tackled by increasing work requirements for all welfare parents with children over three years of age, and by enforcing child support responsibilities of absent parents. Governments should acknowledge that sole parenthood is inherently linked to high poverty risk and is itself therefore part of the problem that has to be tackled.

331 Green D (2009), *Individualists who cooperate*, p.66.

332 Kirby J (2005), *The price of parenthood*, p.44.

Appendix: Can We Afford It?

With government budgets under enormous pressure as a result of the economic recession, it would be fatuous to publish a set of reform proposals which required any substantial increase in government expenditure. The proposals set out in this report aim to change the *form* of government expenditure on families without adding to the already burgeoning size of the family policy budget. In particular, the aim is to reduce the amount of money going to families as government payments, and to balance this by reducing the amount of tax families have to pay.

The proposals which entail increased government expenditure are:

- The restored Married Couple's Tax Allowance: £0.75 billion;
- The restored Dependent Child Tax Allowances: £7.7 billion;
- A new Spousal Allowance in the tax credit system: £1.2 billion;
- A new Parenting Care Allowance: around £3.0 billion (net of savings on current child care expenditure).

This adds up to approximately £12.7 billion of expenditure each year. In addition, front-loading Child Benefit would cost up to £3.3 billion in the early years, but would be revenue-neutral in the long term.

The proposals which entail reduced government expenditure are:

- End-of-year tax credit payments to eliminate overpayments and reduce fraud: -£1 billion;
- Hours-based tax credit top-ups to reduce subsidies to part-time workers: -£4 billion;
- Termination of tax credits for more affluent families: -£7 billion.

These annual savings amount to around £12 billion. Comparing this with the estimated costs of between £13 billion and £16 billion (depending on the timing of the Child Benefit front loading), there is clearly a potential overspend in this package of proposals. To avoid this, and to achieve revenue-neutrality, some combination of the following should be considered:

- Cut-back more sharply on middle class welfare by limiting tax credit eligibility to families significantly below average incomes;
- Introduce a less generous Parenting Care Allowance by capping the initial cost of the proposal at the £2 billion saved from scrapping existing childcare subsidies;
- Delay the introduction of front-loaded Child Benefit, or phase-in the change over a period of years.

British families have changed radically over the last 40 years: marriage rates have fallen, cohabitation outside marriage has become the norm, divorce has risen and the number of children being raised by sole parents has escalated. As politicians of all parties have attempted to respond to these changes, UK family policy has gone through a period of major reform and substantial upheaval. Since 1997 in particular, both the method and level of support provided to families through the tax and benefits system has been changed significantly.

Through a detailed analysis of the development of family support in the UK, this report argues that we have ended up with a system that is very costly, often unfair, and which undermines the independence and self-reliance of families rather than promoting it.

We identify where family policy has gone wrong – often with good intentions – and suggest a number of key policy recommendations. In particular, families should be allowed to retain more of their own income, rather than relying on hand-outs from the government. This requires reform to the tax credits system, changes to child benefit and child care allowances, and a restoration of tax allowances for children and married couples so that more families can achieve the level of self-reliance that used to be the norm in Britain.

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