The tax credit crunch

How to limit the losses for low-income families

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@resfoundation @davidfinchrf

SUMMER BUDGET IMPACT I

The effect of changes in 2016

*on **incomes***

Summer Budget contained good news and bad news from April 2016

Key **boosts to income**

- Raising the wage floor
  - Introduction of a 'national living wage' for over-24s (50p minimum wage supplement)

- Tax cuts:
  - Personal allowance increase to £11,000
  - Increase in the higher rate threshold to £43,000

Summer Budget contained good news and bad news from April 2016

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Key **cuts to income**

- Tax credits
  - Reduction in income threshold *(from £6,420 to £3,850)*
  - Increase in taper *(from 41% to 48%)*
- More widely:
  - Freeze to benefits *(limited impact in April because counterfactual inflation is so low)*
  - Benefit cap reduced *(overall limited impact)*

The gains are spread relatively evenly across the distribution

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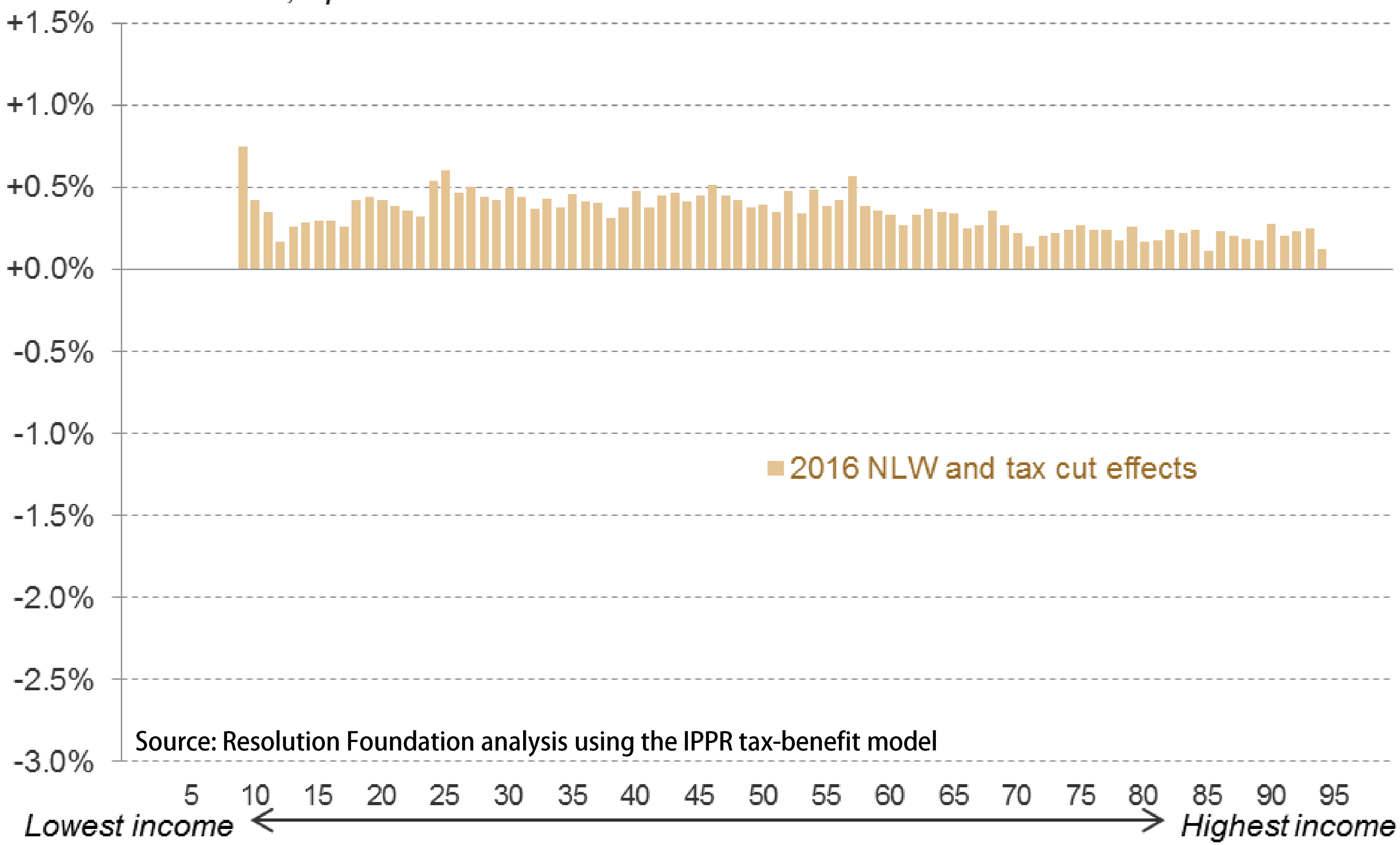
Percentage change in net equivalised household income due to Summer Budget measures: constant CPI terms, April 2016



Source: Resolution Foundation analysis using the IPPR tax-benefit model

In combination, raising the wage floor and cutting taxes have positive impacts across the distribution

The main NLW gains are made in the middle of the distribution because low *earners* do not necessarily live in low *income* households

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But losses from reducing the tax credit threshold are highly concentrated

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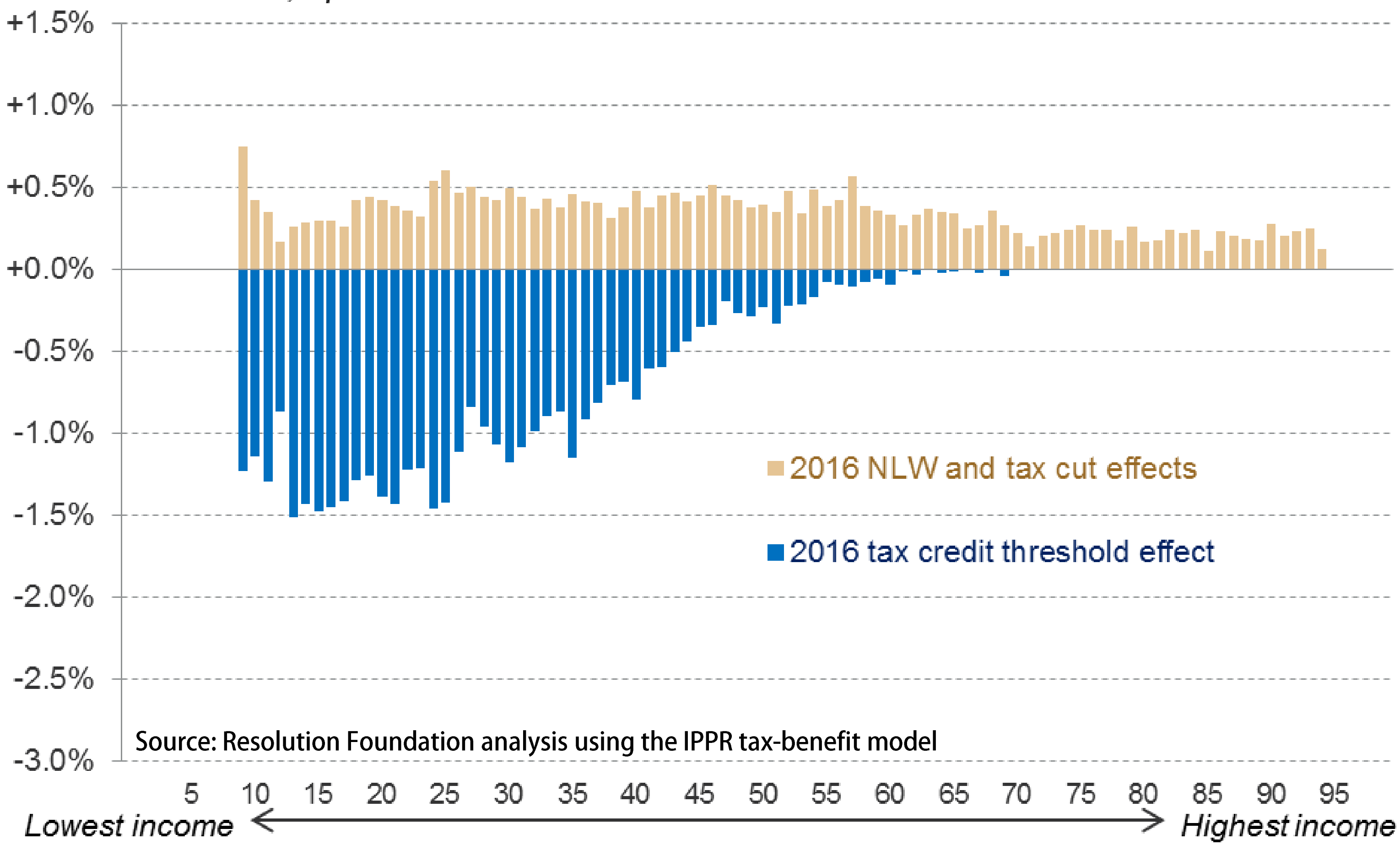
Percentage change in net equivalised household income due to Summer Budget measures: constant CPI terms, April 2016



Source: Resolution Foundation analysis using the IPPR tax-benefit model

Of the cuts due in April, reducing the income threshold for tax credits has the biggest impact, with the effects felt most acutely among low and middle income households

This produces a straight income shock for all tax credit recipients of up to £1,050

As are losses associated with increasing the tax credit taper

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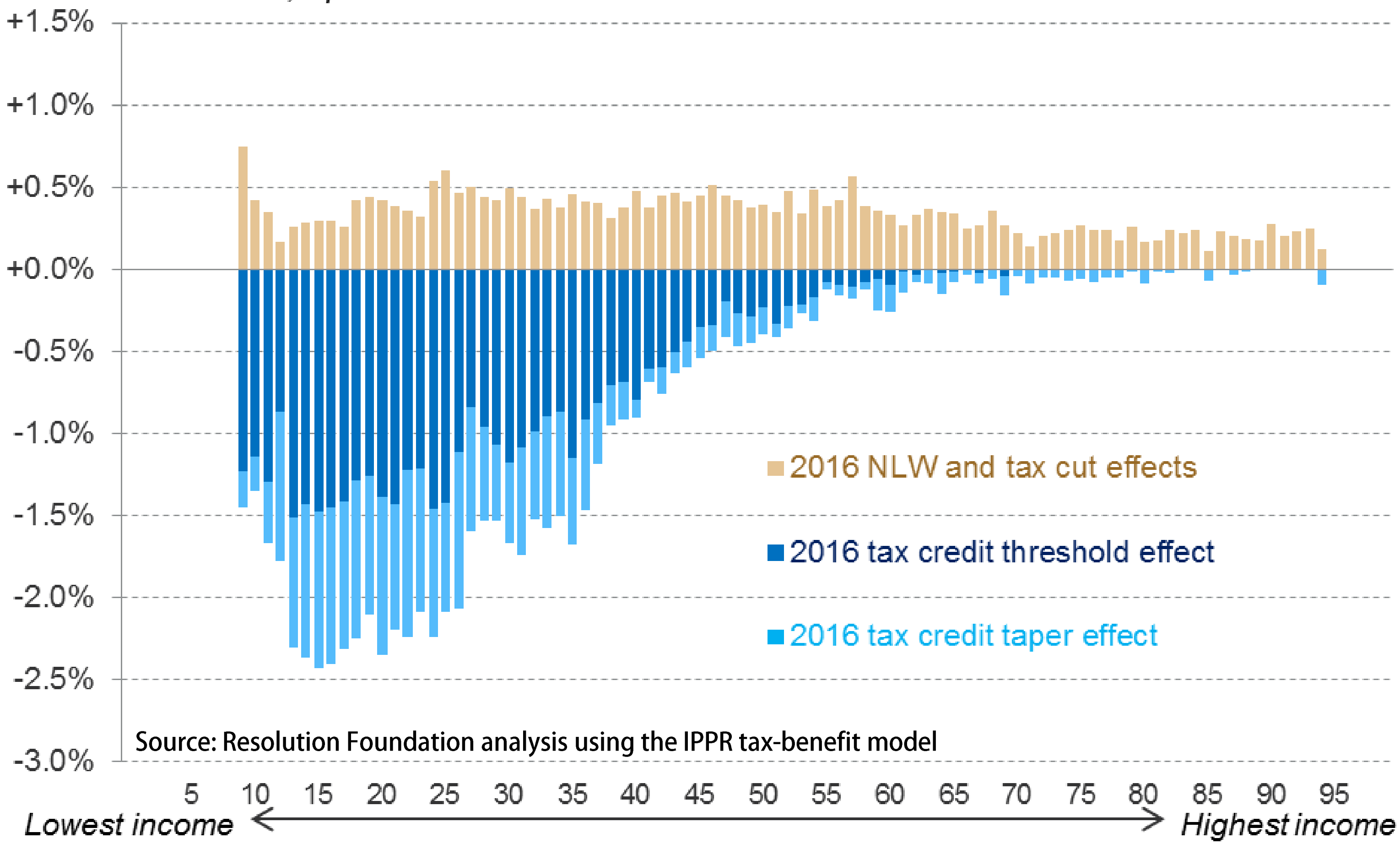
Percentage change in net equivalised household income due to Summer Budget measures: constant CPI terms, April 2016

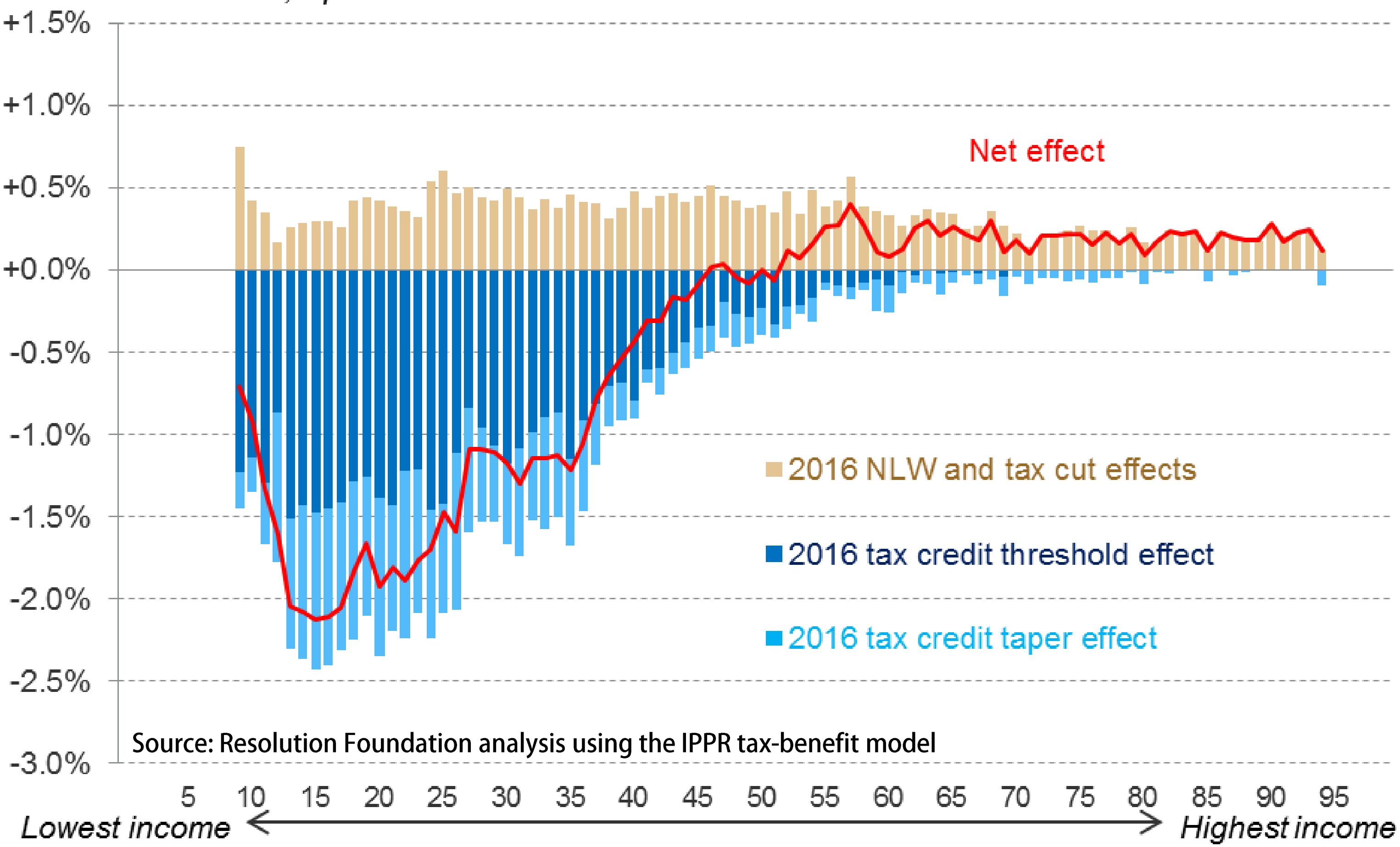


Increasing the tax credit taper produces a further drag on income in the bottom half of the income distribution

The reduction in the income threshold makes the taper cut more regressive as it applies to a greater span of income

Producing a highly regressive impact on incomes overall

Percentage change in net equivalised household income due to Summer Budget measures: constant CPI terms, April 2016



Source: Resolution Foundation analysis using the IPPR tax-benefit model

Overall, the even spread of gains and the concentration of cuts means that significant losses in the bottom half of the income distribution contrast with modest gains in the top half

Overall, around 3.3m working households will lose an average of £1,100 in April 2016

- 3.3 million working households will face an average drop in tax credit income of £1,300

- Including gains from the personal allowance and national living wage reduces this net average loss to £1,100

- These changes will push around 100,000 working households, and 200,000 children in working households, into poverty in 2016

With actual impacts in 2016 varying by family circumstance

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Selected case studies in April 2016 before and after Summer Budget changes	2016 pre-Summer Budget			2016 post-Summer Budget			Change		
	Gross earnings	Net earnings	Net income	Gross earnings	Net earnings	Net income	Gross earnings	Net earnings	Net income
Single parent with 1 child *FT @ minwage*	£ 13,350	£ 12,200	£ 17,610	£14,080	£12,740	£16,080	+£390	+£430	-£2,130
Single-earner couple with 2 children *FT @ min wage*	£ 13,350	£12,430	£20,290	£14,080	£12,970	£18,980	+£730	+£540	-£1,310
Dual-earner couple with 2 children One *FT @ £8ph; one PT @ min wage*	£ 22,760	£20,880	£25,610	£23,150	£21,320	£23,480	+£390	+£430	-£2,130
Dual-earner couple without children *Both FT @ NMW*	£ 26,690	£24,420	£24,420	£28,160	£25,500	£25,500	+£1,470	+£650	+£650

Source: Resolution Foundation analysis using the RF microsimulation model
Notes: Full-time earners are working 37.5 hours a week, the part-time earner works 20 hours a week. The NMW is assumed to be £6.70 until October 2016 at which point it rises to £6.95, in line with OBR projections for earnings growth. Estimates shown provide an annual average. Families shown have no housing or childcare costs.

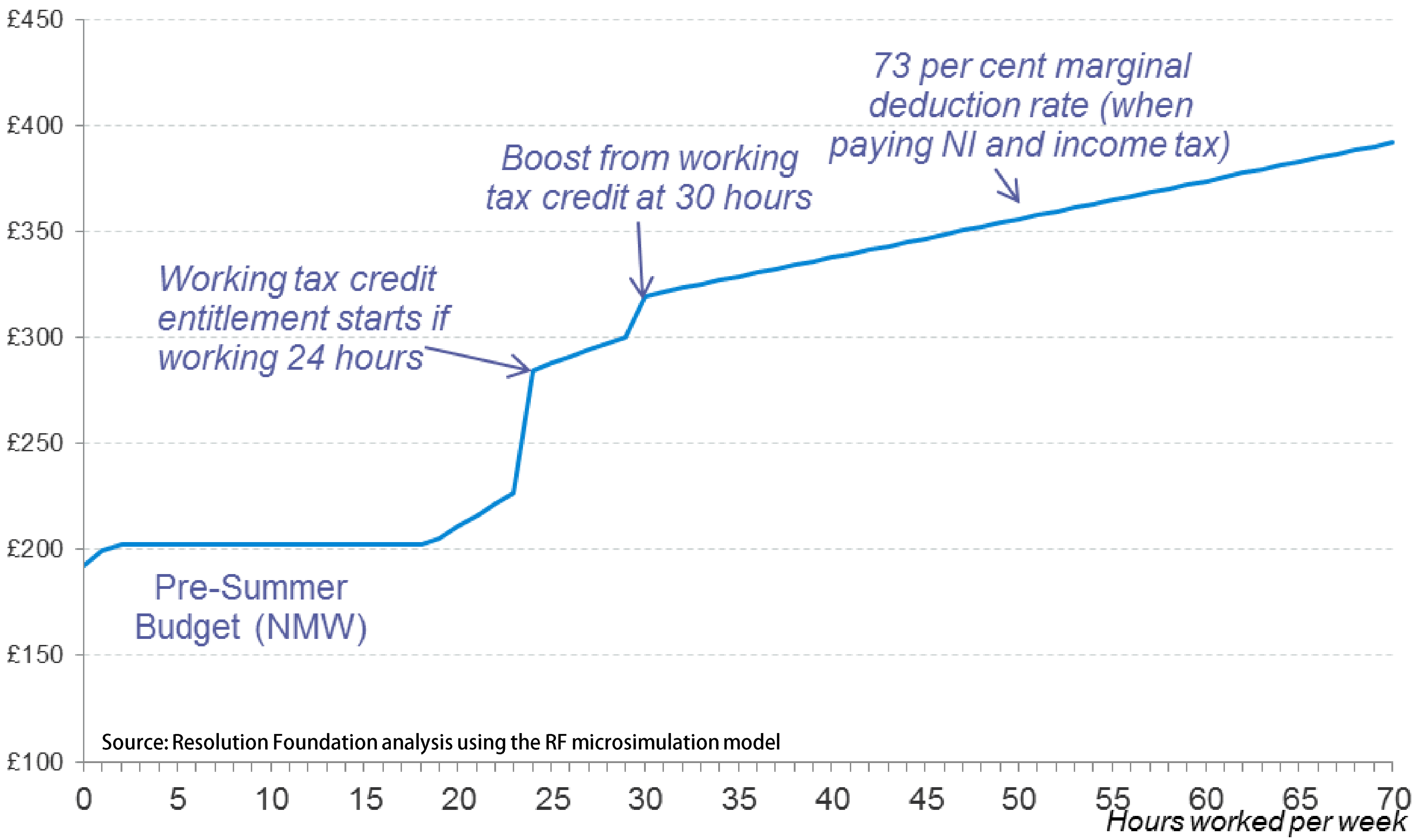
SUMMER BUDGET IMPACT II

The effect of changes in 2016

on ***incentives***

Existing tax credit system creates incentives and disincentives

*Net weekly income for a **couple with one child with a single earner** on the wage floor*



Provision of working tax credit when working specified number of hours (16 for a single parent; 24 for someone in a couple; boost at 30) incentivises working at certain points

But high marginal deduction rate tends to dis-incentivise working longer

Summer Budget changes will reduce the incentive to enter or progress at work

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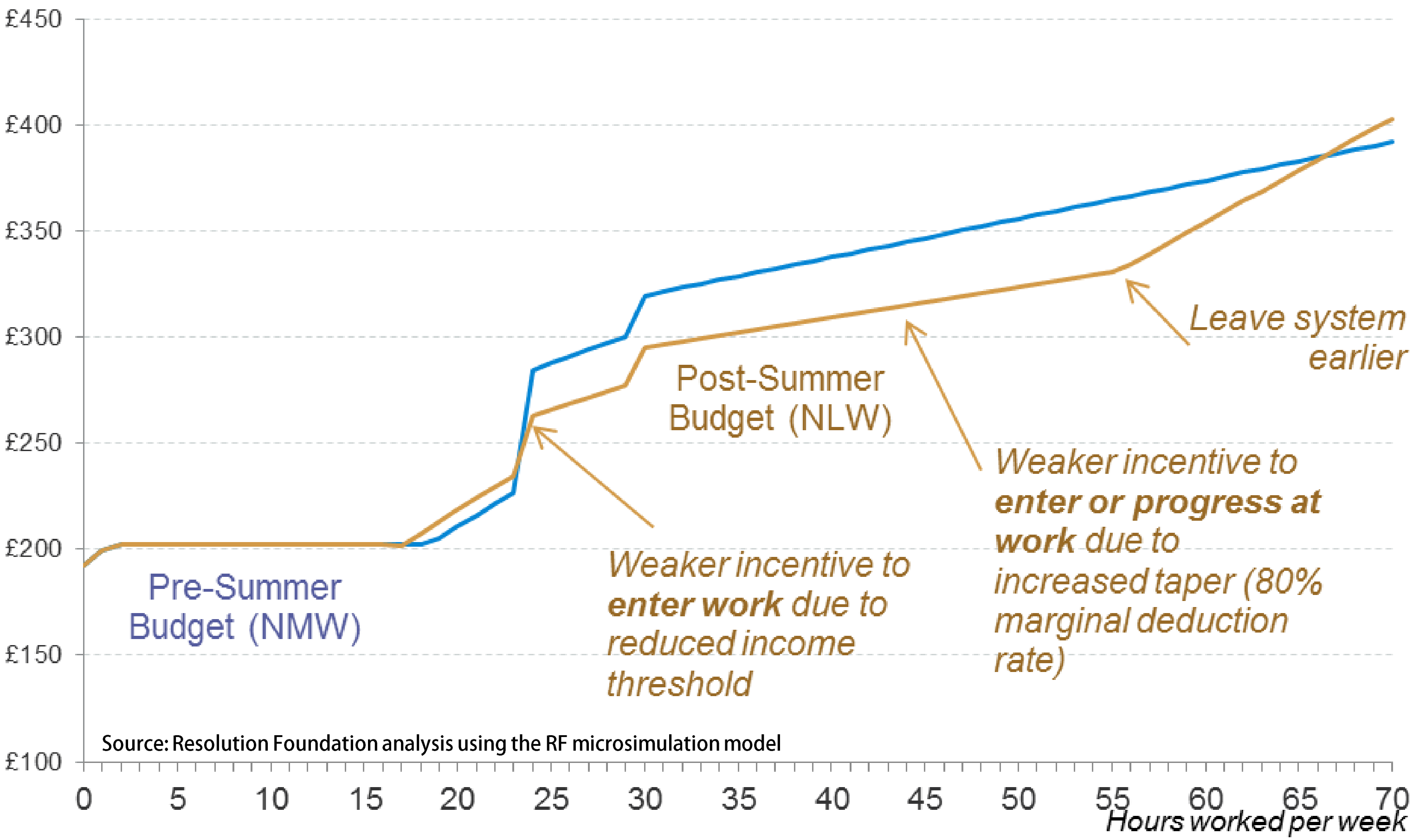
*Net weekly income for a **couple with one child with a single earner** on the wage floor*



The combined cuts (taper & income threshold) reduce the gain from starting work by up to £1,250

Raising the taper to 48% increases the already high marginal deduction rate making progression less attractive – other than for those being taken out of tax credits altogether

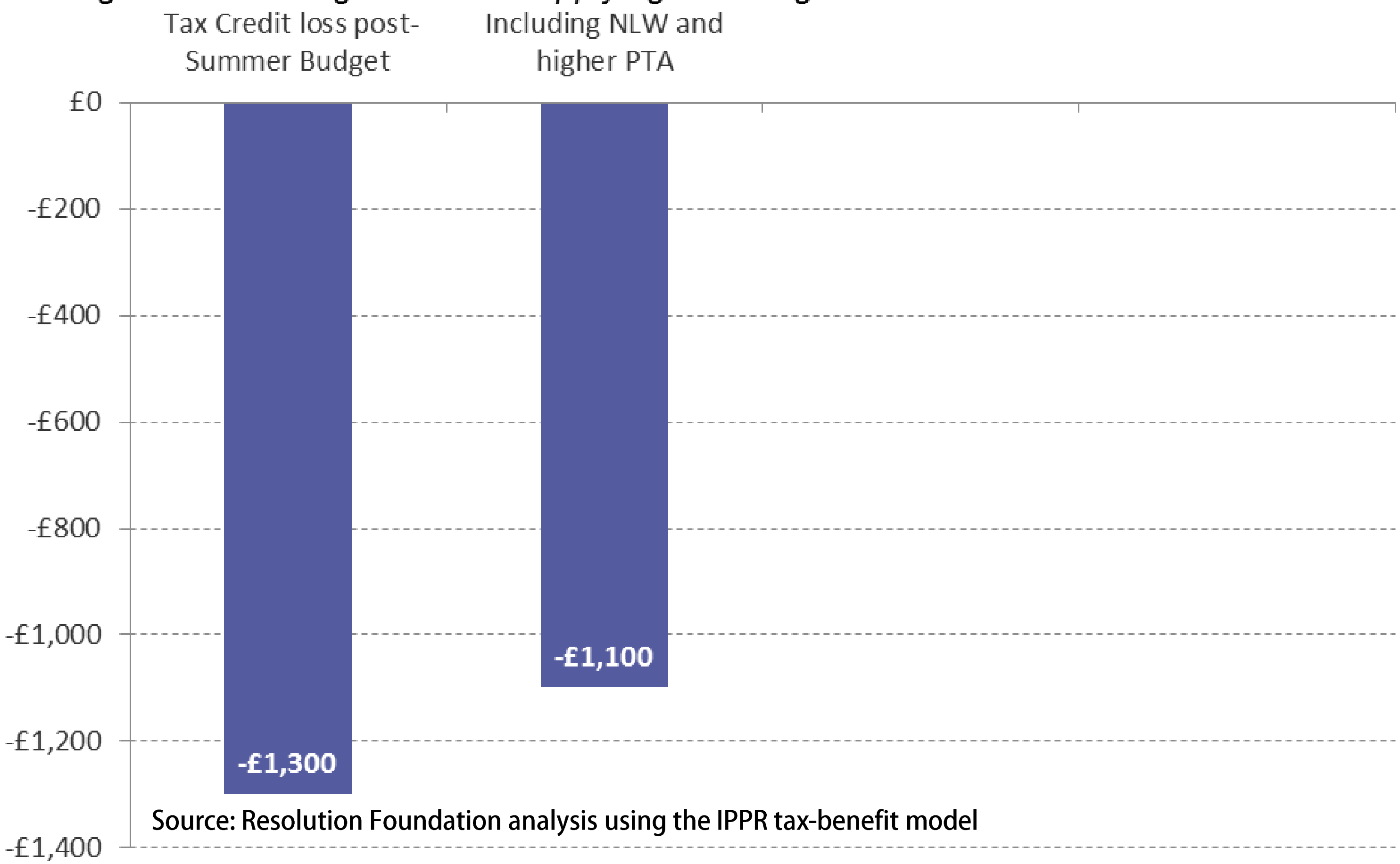
OFFSETTING THE LOSSES

Can we compensate the tax credit losers outside of the benefit system?

Options for offsetting the losses:

Bringing forward minimum wage rises and tax cuts

Average annual change in income applying offsetting measures in 2016



Source: Resolution Foundation analysis using the IPPR tax-benefit model

The increase to the personal allowance and NLW reduce gross tax credit losses on average by £200

Options for offsetting the losses:

Bringing forward minimum wage rises and tax cuts

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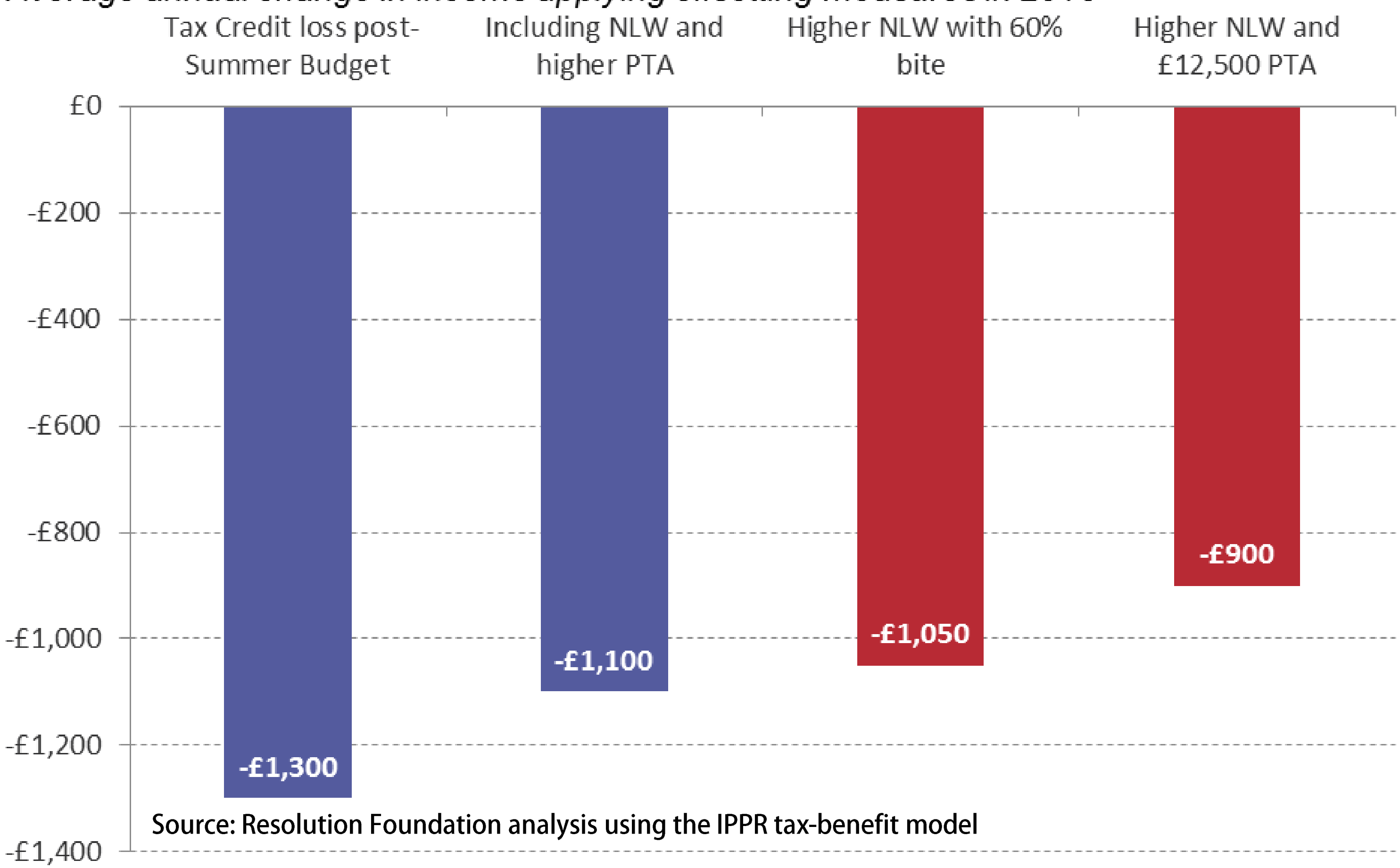

Source: Resolution Foundation analysis using the IPPR tax-benefit model

The increase to the personal allowance and NLW reduce gross tax credit losses on average by £200

A higher NLW in 2016 would do little to offset losses

Increasing the PTA to £12,500 (cost of ~£9bn if done straight away) still leaves working families on average £900 a year worse off

Options for offsetting the losses:

Bringing forward minimum wage rises and tax cuts

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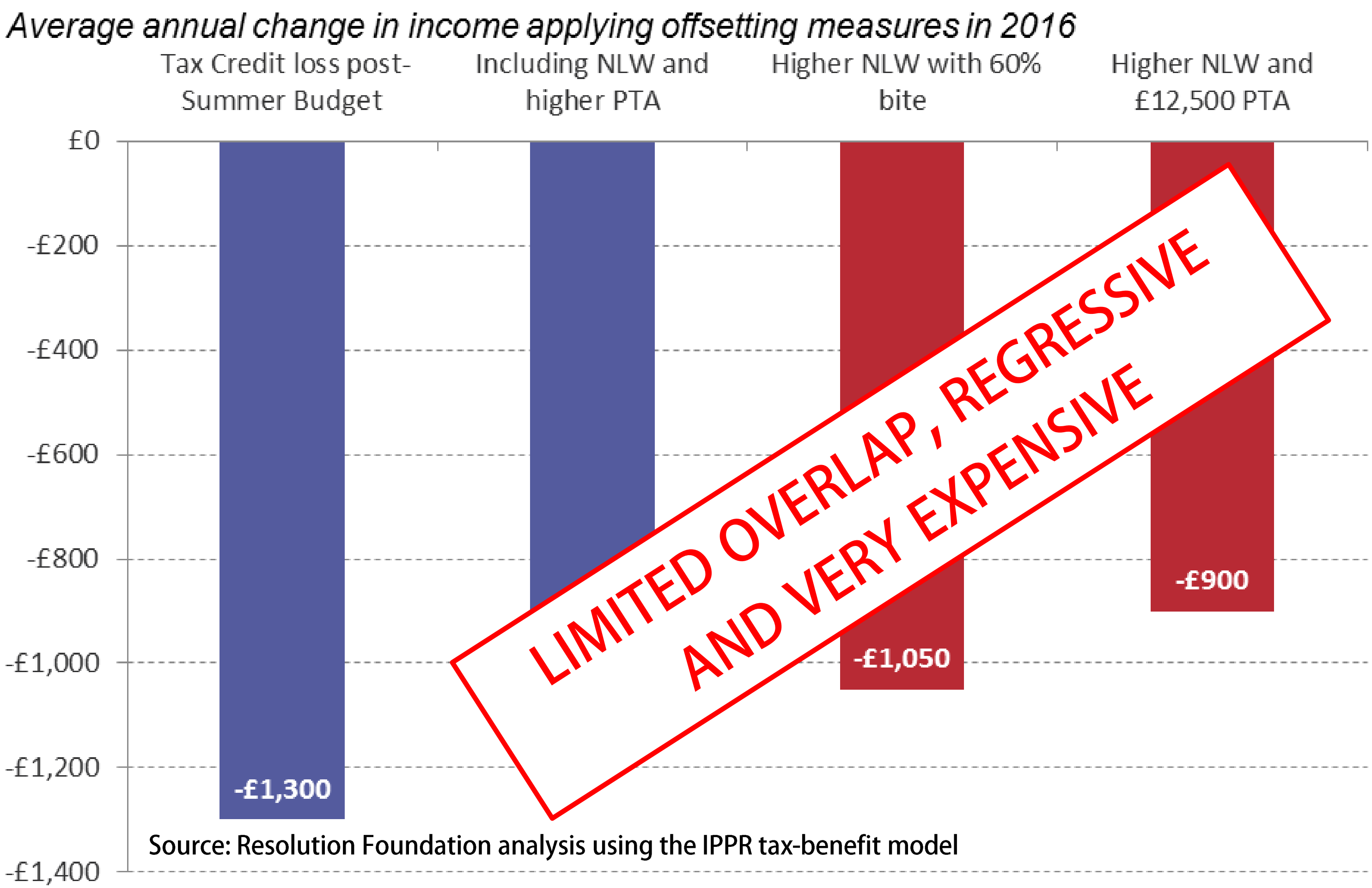

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Options for offsetting the losses:

Boosting childcare support

30 hours free childcare

- Only helps workers with a 3 or 4 year old, with full introduction not due until September 2017
- Less than 10% of Tax Credit families have a child under 5 & claim childcare support
- Tax Credit families already receive support with 70% of costs

Additional support in Tax Credits

- Childcare support in UC is set to be raised to cover 85% of costs (originally due in April 2016 but now delayed)
- Introducing this in the Tax Credit system in 2016 would cost around £500m, help 400k families and be beneficial

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ADDITIONAL SUPPORT WELCOME
BUT OF LIMITED RELEVANCE

Options for offsetting the losses:
Conclusion

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- **Making changes outside of the welfare system doesn't work**
  - **Lack of overlap** between the tax credit population and those who benefit from raising the wage floor, cutting tax or boosting childcare support
  - Potential 'solutions' **can't provide enough compensation**

DELAYING THE IMPACT

Limiting the overnight losses

Phasing: Slowing the pace of tax credit cuts would mitigate losses in the short-term

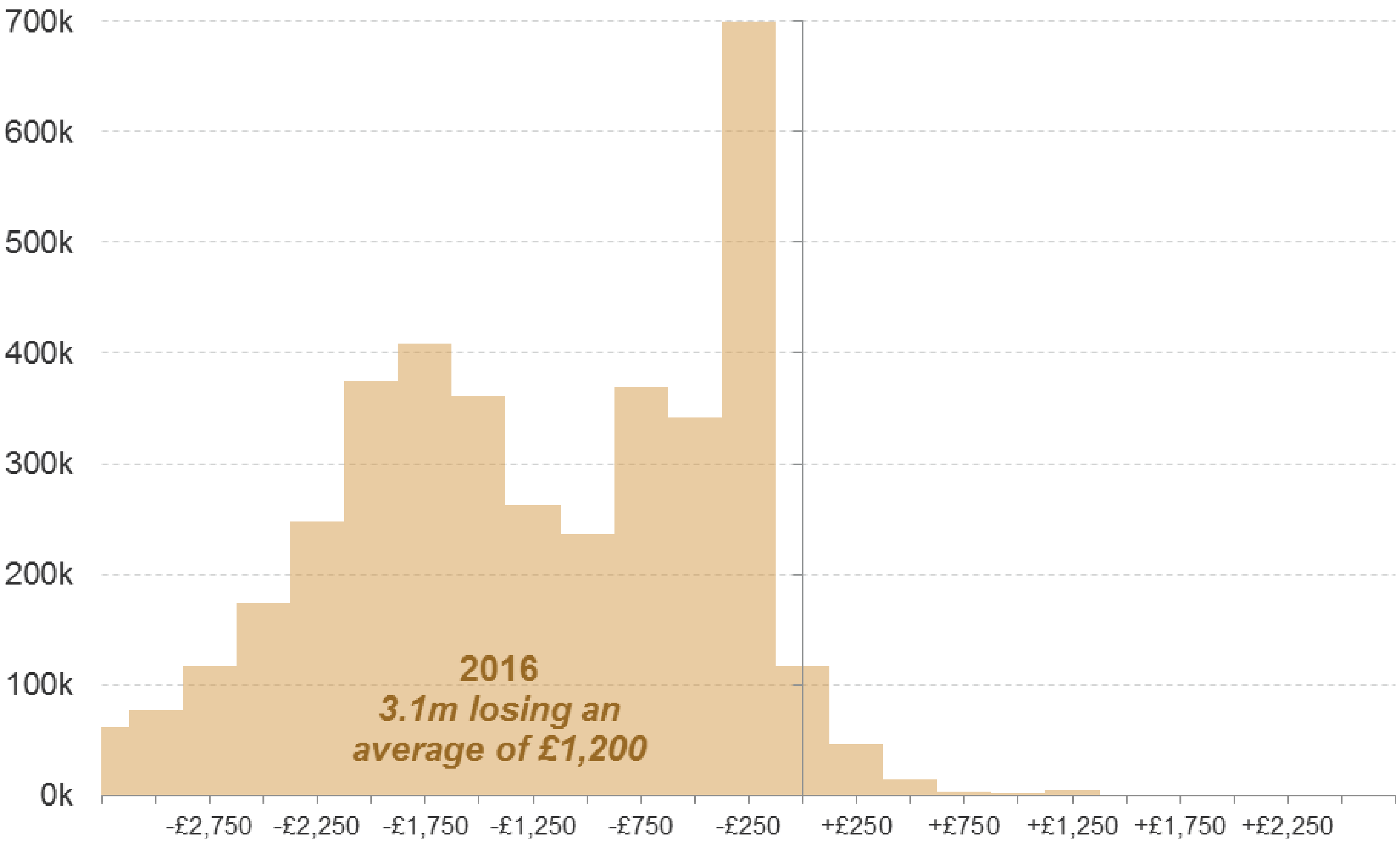
- Phasing-in the changes would provide more opportunity for recipients' incomes to rise due to:
  - real-wage gains
  - income tax cuts
  - the rising wage floor

- Phasing would reduce the overnight losses faced in 2016, but would also reduce cumulative government savings

- And, whatever the trajectory, we expect at least 2.7m families to be worse off by an average of £1,000 in 2020 (comparing pre- and post-Budget measures in 2020 in a UC steady state)

Phasing: Current plans imply big overnight losses in April 2016

Distribution of real-terms gains and losses relative to pre-Summer Budget 2016 after accounting for tax credit cuts, NLW, tax cuts and real-wage growth: CPI adjusted



Source: Resolution Foundation analysis using the IPPR tax-benefit model

3.1 million of the 3.3 million tax credit recipients are set to have their net income reduced in April 2016

Spike at relatively small level of losses, but significant numbers losing more than £1,500

Phasing: But delaying the final outcome by one year makes very little difference

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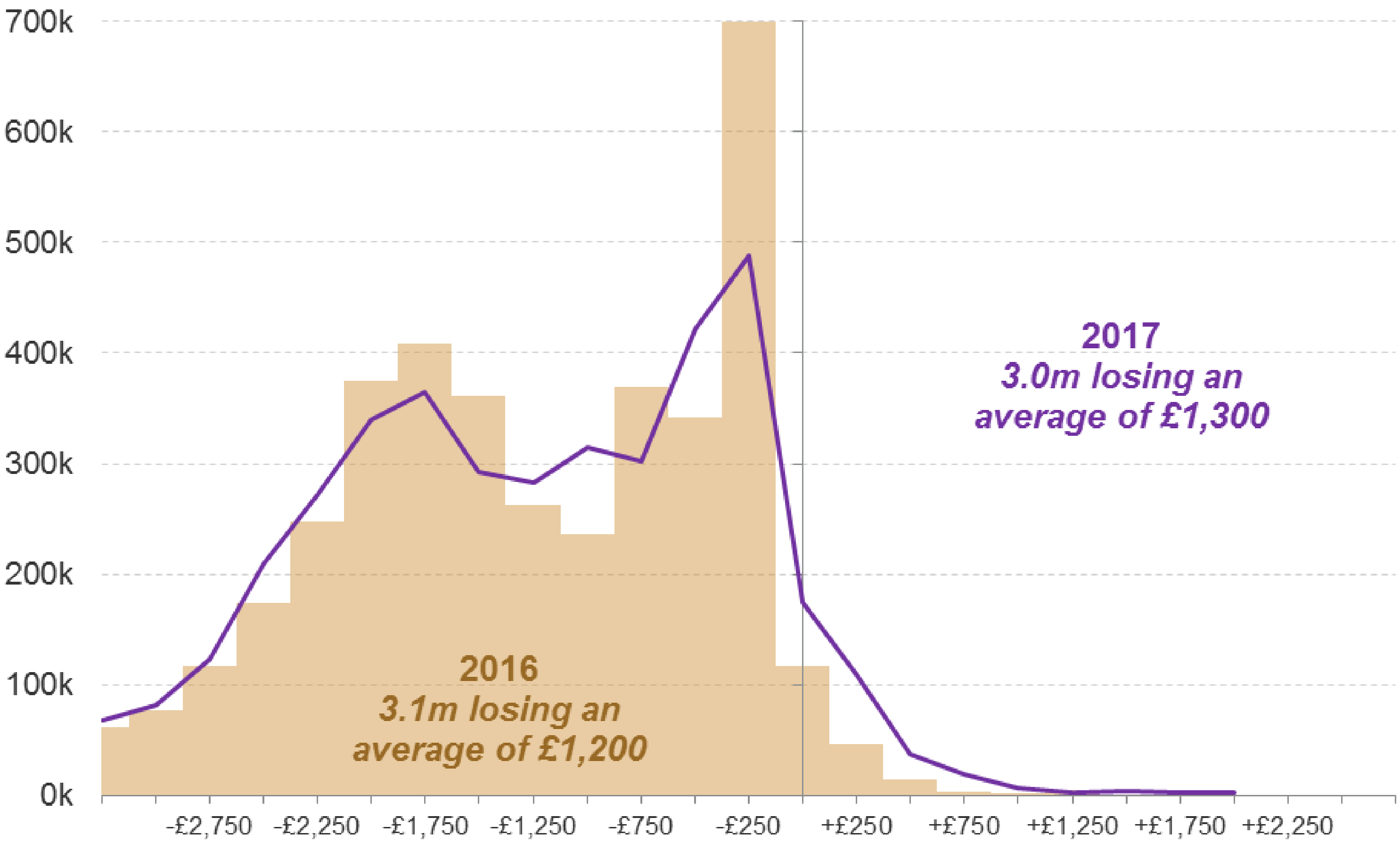
Distribution of real-terms gains and losses relative to pre-Summer Budget 2016 after accounting for tax credit cuts, NLW, tax cuts and real-wage growth: CPI adjusted



Source: Resolution Foundation analysis using the IPPR tax-benefit model

Even after allowing for wage growth, tax cuts and a rise in the national living wage, outcomes in 2017 look little altered

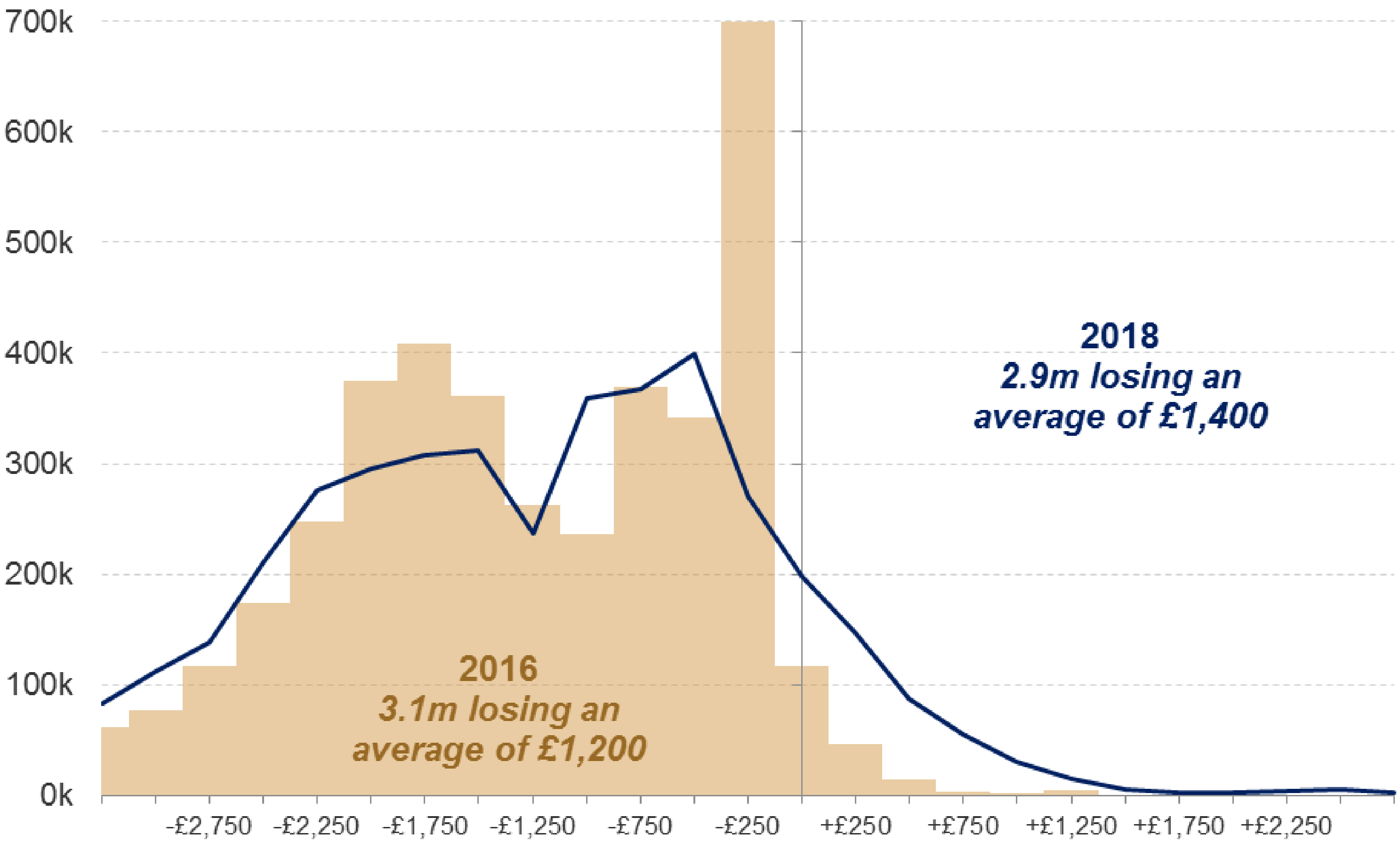
In part this is due to the high taper rate reducing gains from wage growth

And the benefit freeze offsetting income gains

Phasing: Even a two-year delay only reduces the number of losers by 200,000

Very marginal improvements by 2018, with an *increase* in those losing more than £2,250

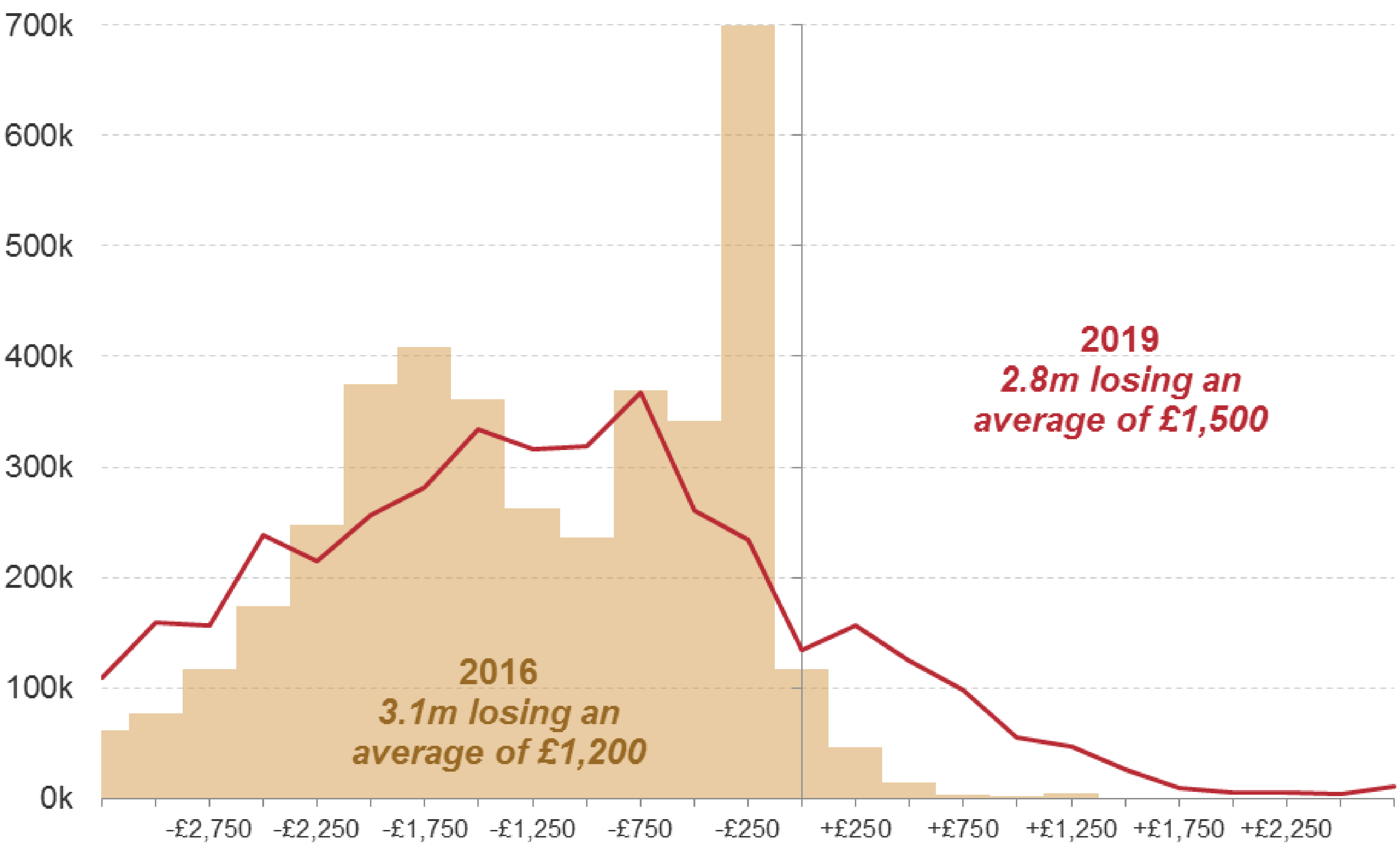
Distribution of real-terms gains and losses relative to pre-Summer Budget 2016 after accounting for tax credit cuts, NLW, tax cuts and real-wage growth: CPI adjusted



Source: Resolution Foundation analysis using the IPPR tax-benefit model

Phasing: Reaching the planned level of cuts in 2019 still leaves 2.8m worse off

Distribution of real-terms gains and losses relative to pre-Summer Budget 2016 after accounting for tax credit cuts, NLW, tax cuts and real-wage growth: CPI adjusted

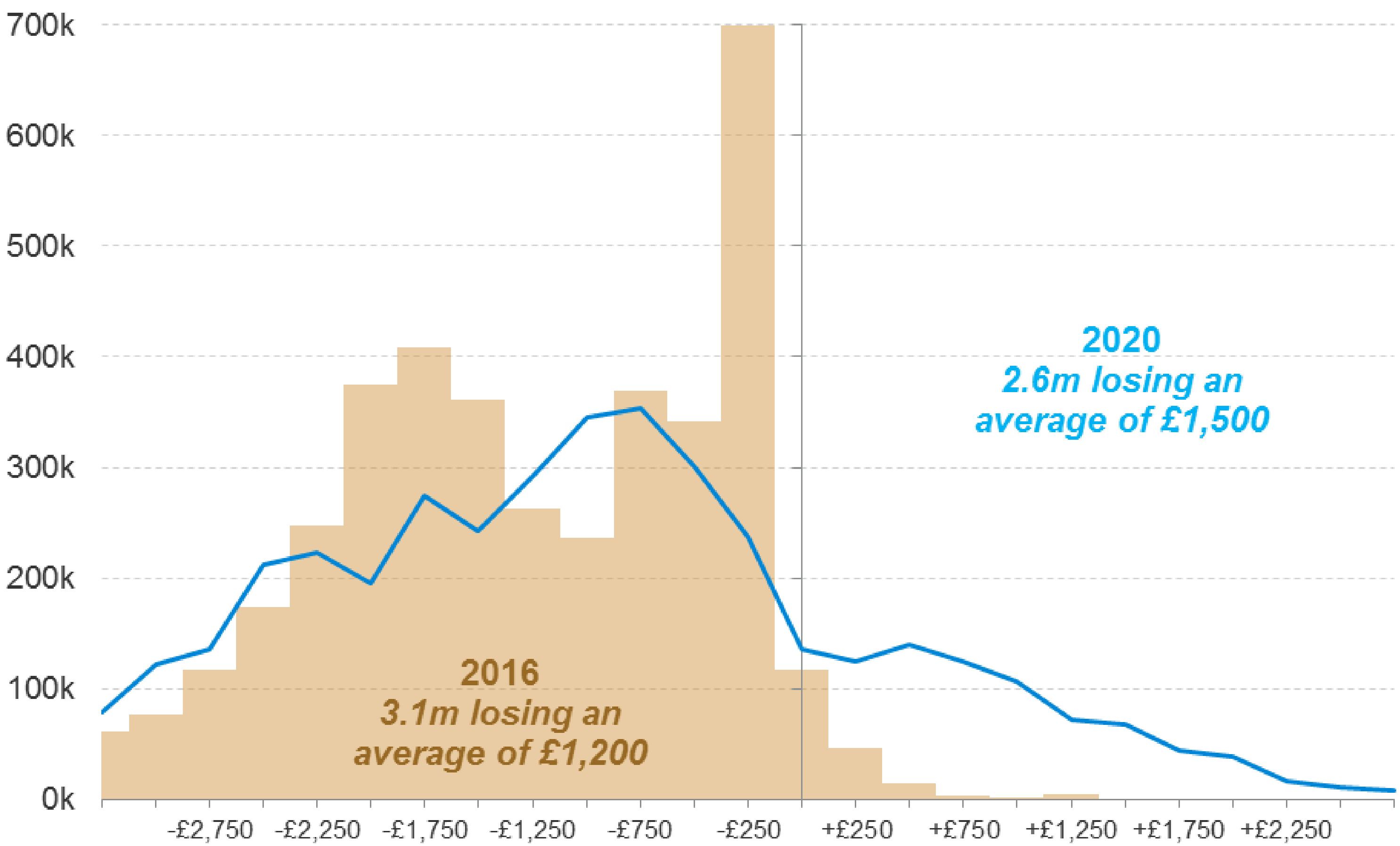


Source: Resolution Foundation analysis using the IPPR tax-benefit model

The tail of big losers grows still further in 2019

Phasing: Even phasing to 2020 will not result in losses being compensated in a meaningful way

Distribution of real-terms gains and losses relative to pre-Summer Budget 2016 after accounting for tax credit cuts, NLW, tax cuts and real-wage growth: CPI adjusted



Source: Resolution Foundation analysis using the IPPR tax-benefit model

Delaying full implementation of the tax credit cuts to 2020 – thereby allowing four years of wage growth - would still result in 2.6 million losers, facing an average drop in income relative to their 2015 level of £1,500

Phasing: Even adding in the ambition of a £12.5k personal allowance makes little difference

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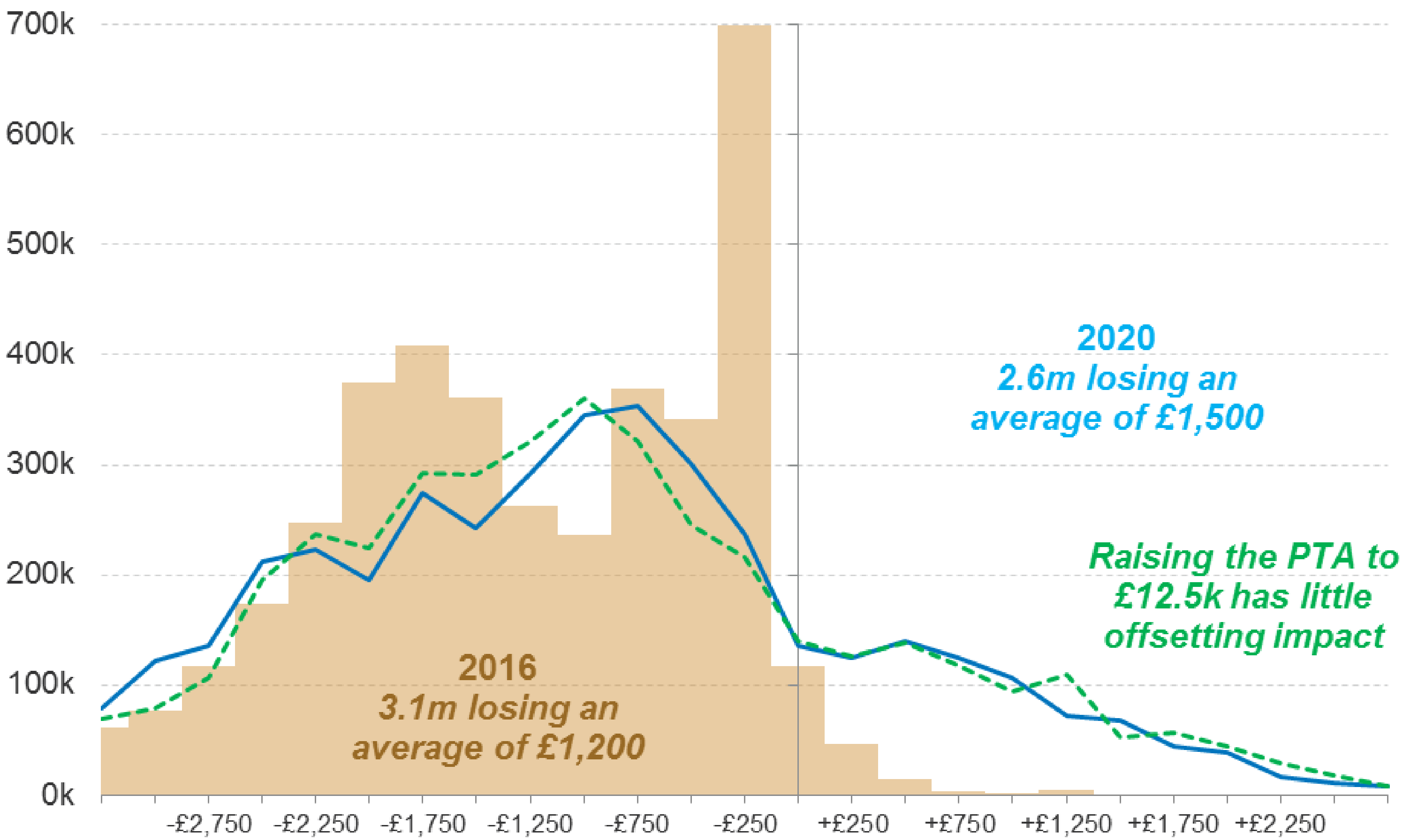

Source: Resolution Foundation analysis using the IPPR tax-benefit model

The personal allowance is set to be around £11.8k by 2020

Raising it to £12.5k will have sizeable benefits for dual earner taxpayers, but much less (or zero) benefit for single earners and for those on the lowest earnings who don't pay tax

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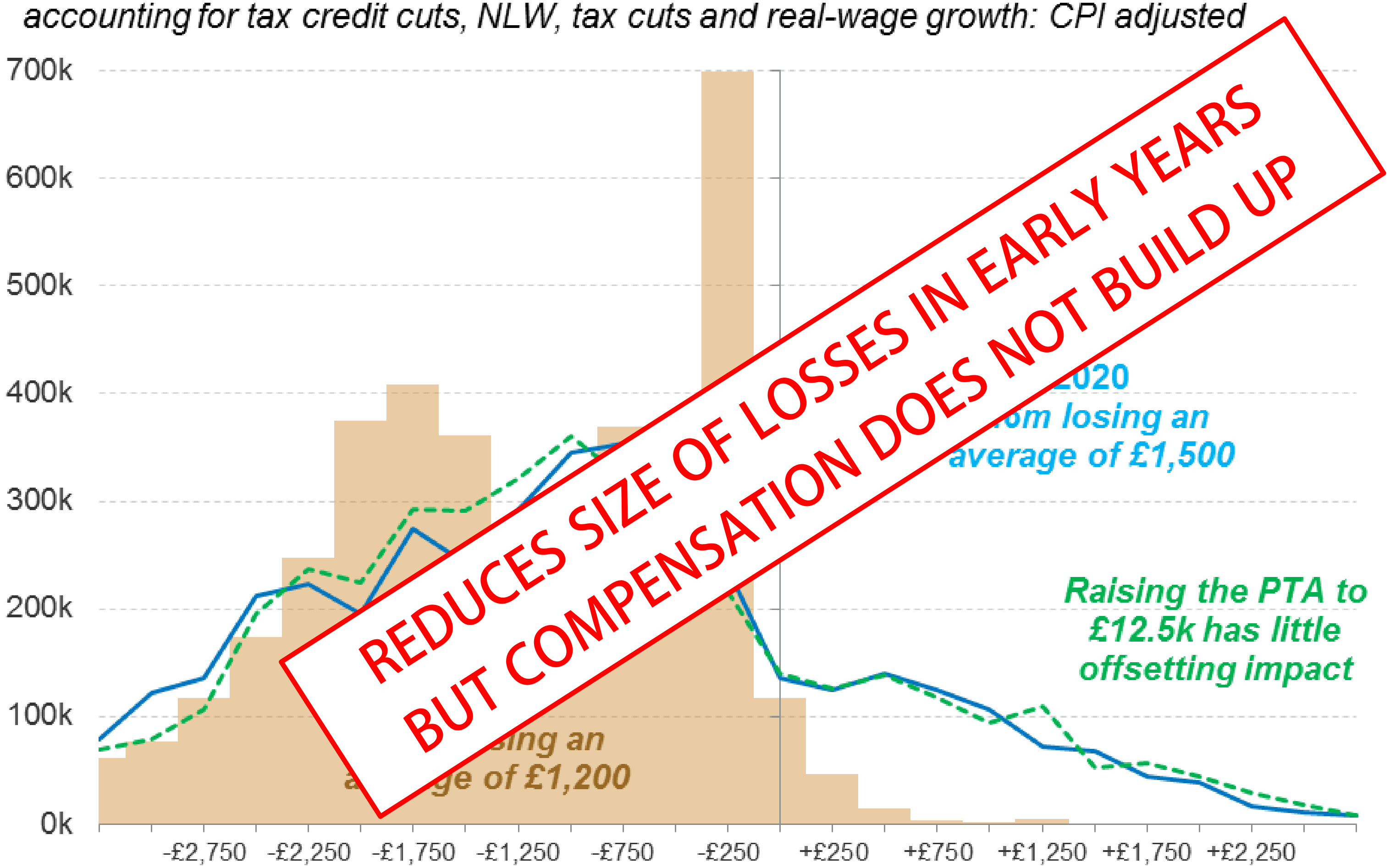

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TRANSITIONAL PROTECTION

Applying the cuts to new claimants only

Transition: Applying only to new claims will greatly reduce the number of losers

Transitional protection for existing recipients can significantly limit the overall scale of losses in a given year

- Only around 300,000 families a year make new claims

Transition: But also reduces savings and therefore effects the government's fiscal targets

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- Savings are significantly reduced with implications for the government's deficit and debt targets

Savings to 2020 from income thresholds and the taper, £ millions, cash

	2016	2017	2018	2019	2020
Planned cuts	4,400	4,100	3,800	3,700	3,700
Transitional approach	400	700	900	1,100	1,400

Source: Resolution Foundation analysis & Summer Budget policy costings document

Notes: Pace of transition and number of new claims is based on the impact of restricting the family element to new claims from 2017

Transition: Work incentives in UC still weakened & creates perverse incentives stay on Tax Credits

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- Also leaves work incentives in Universal Credit much weaker than under pre-Summer Budget plans (thanks to big reduction in the work allowances)

- And leads to perverse incentives for families to not change their circumstances in case they lose tax credit entitlement

Transition: UC work incentives weakened & creates perverse incentive to stay on Tax Credits

RF

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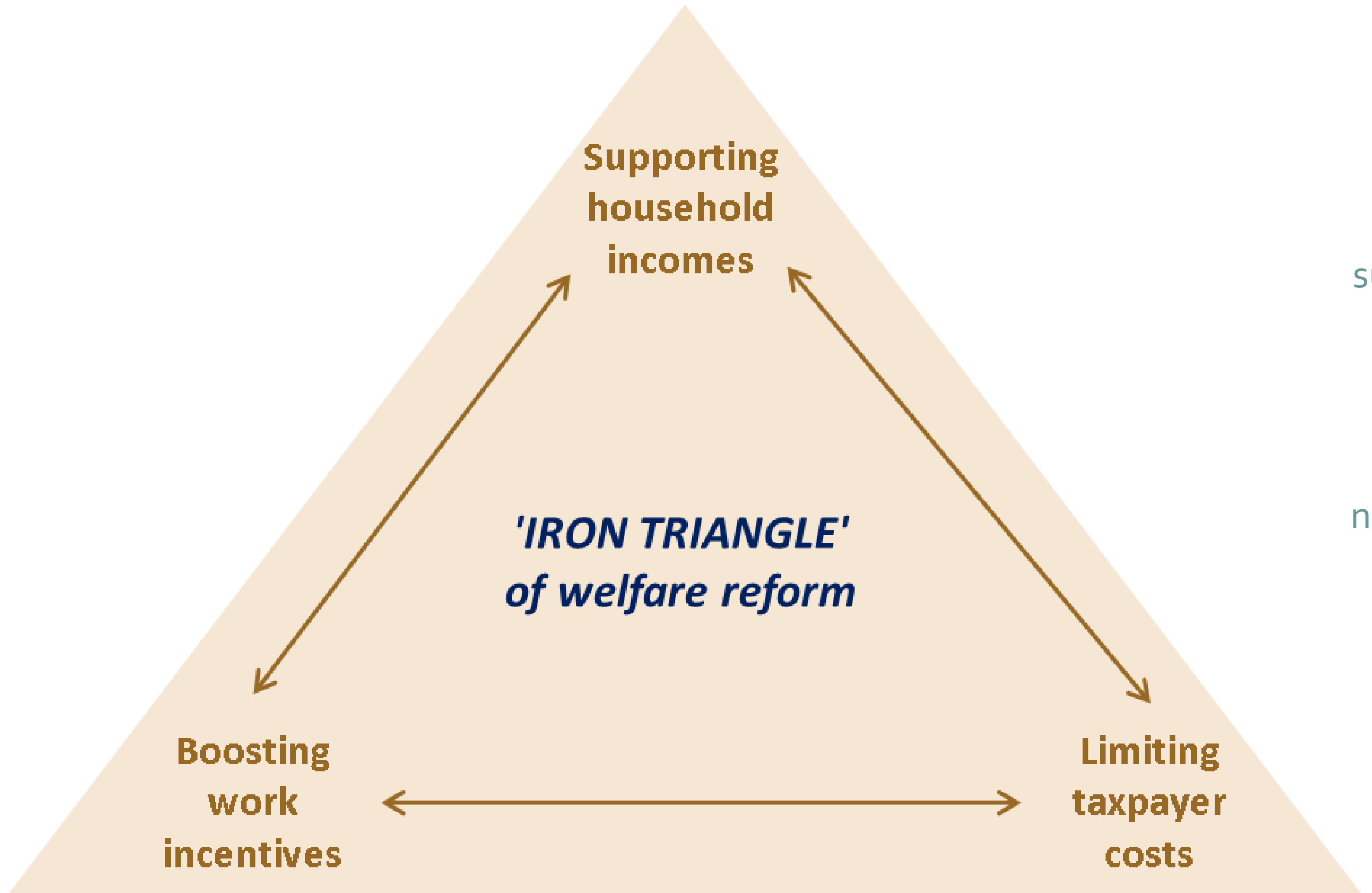
REDUCES THE NUMBER OF LOSERS IN THE NEAR-TERM BUT ALSO REDUCES SAVINGS AND CREATES PERVERSE INCENTIVES

REFORMING THE REFORMS

Mitigating the impacts by directly amending the tax credit changes

Options for reform need to balance three (often competing) demands



Summer Budget changes are firmly skewed towards saving money at the expense of supporting incomes *and* boosting work incentives

All other options need to be assessed against the same criteria

Reforming the reforms:

1) Prioritising restoration of the income threshold

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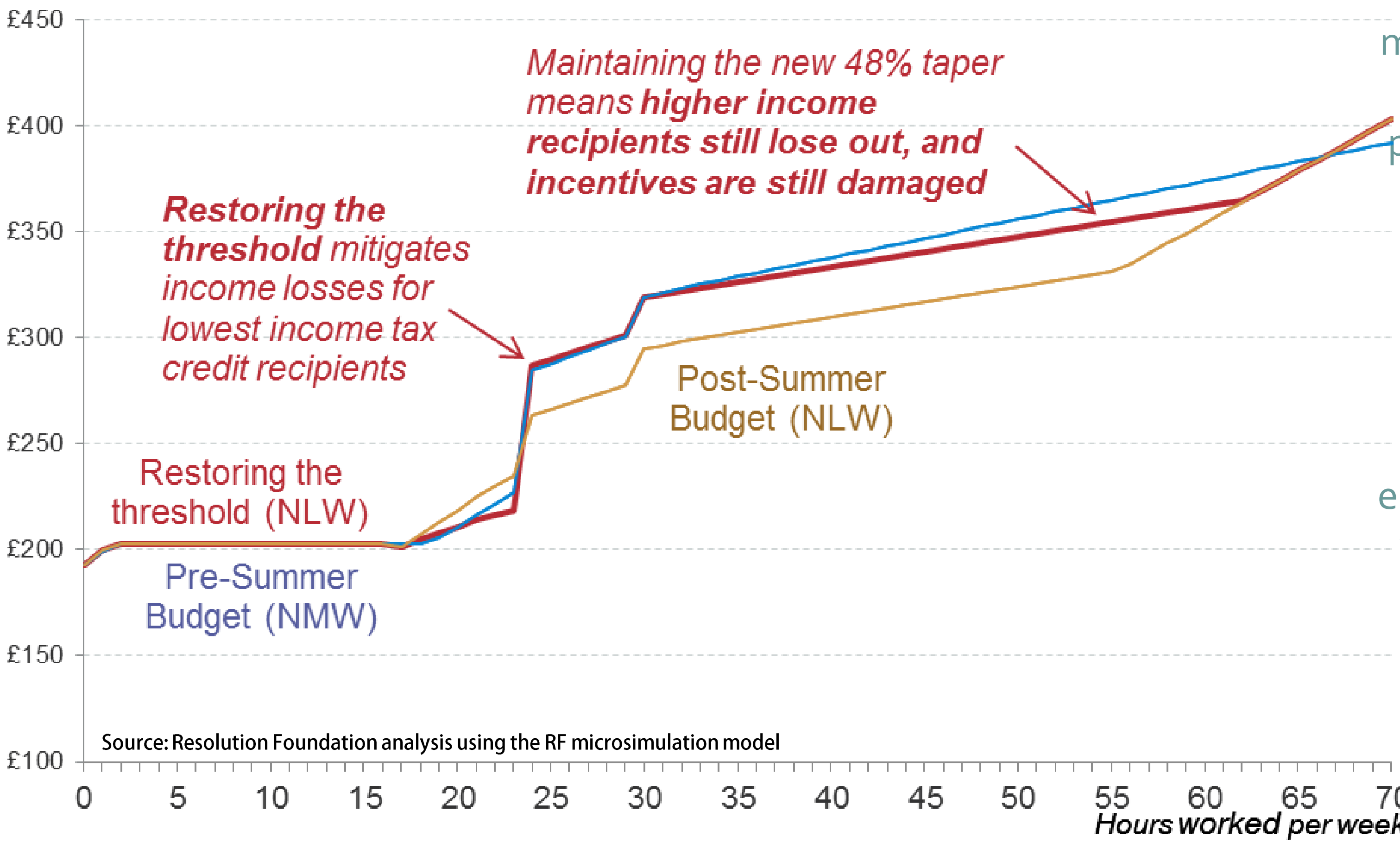
*Net weekly income for a **couple with one child with a single earner** on the wage floor*



Restoring the £6,420 income threshold mitigates losses, with the greatest protection flowing to lower income tax credit recipients

Incentives to progress at work (or enter at higher hours) will still be damaged

Savings will be reduced

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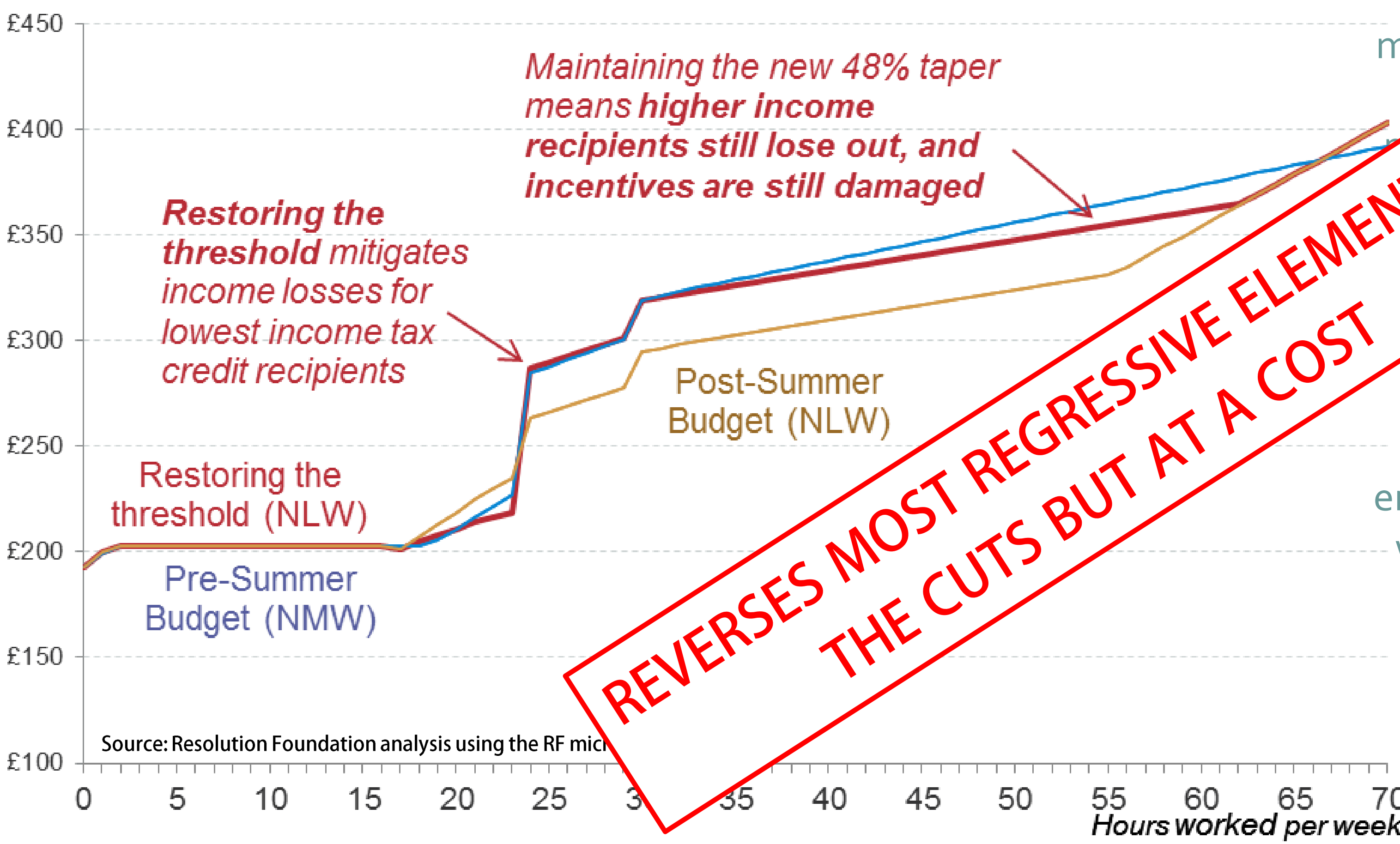

REVERSES MOST REGRESSIVE ELEMENT OF THE CUTS BUT AT A COST

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Incentives to progress at work (or enter at higher hours) will still be damaged

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Reforming the reforms:

2) Prioritising restoration of the taper rate

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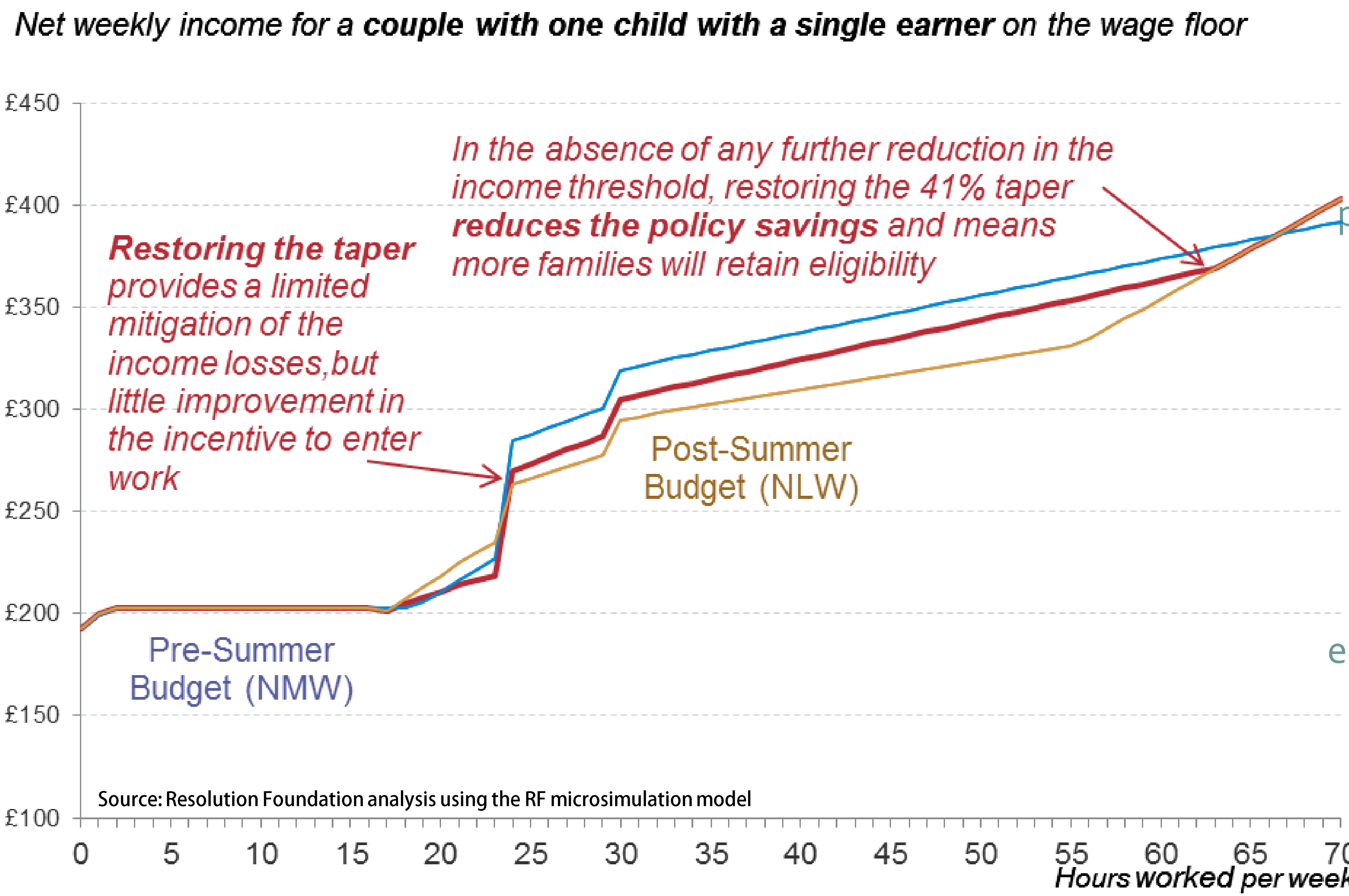
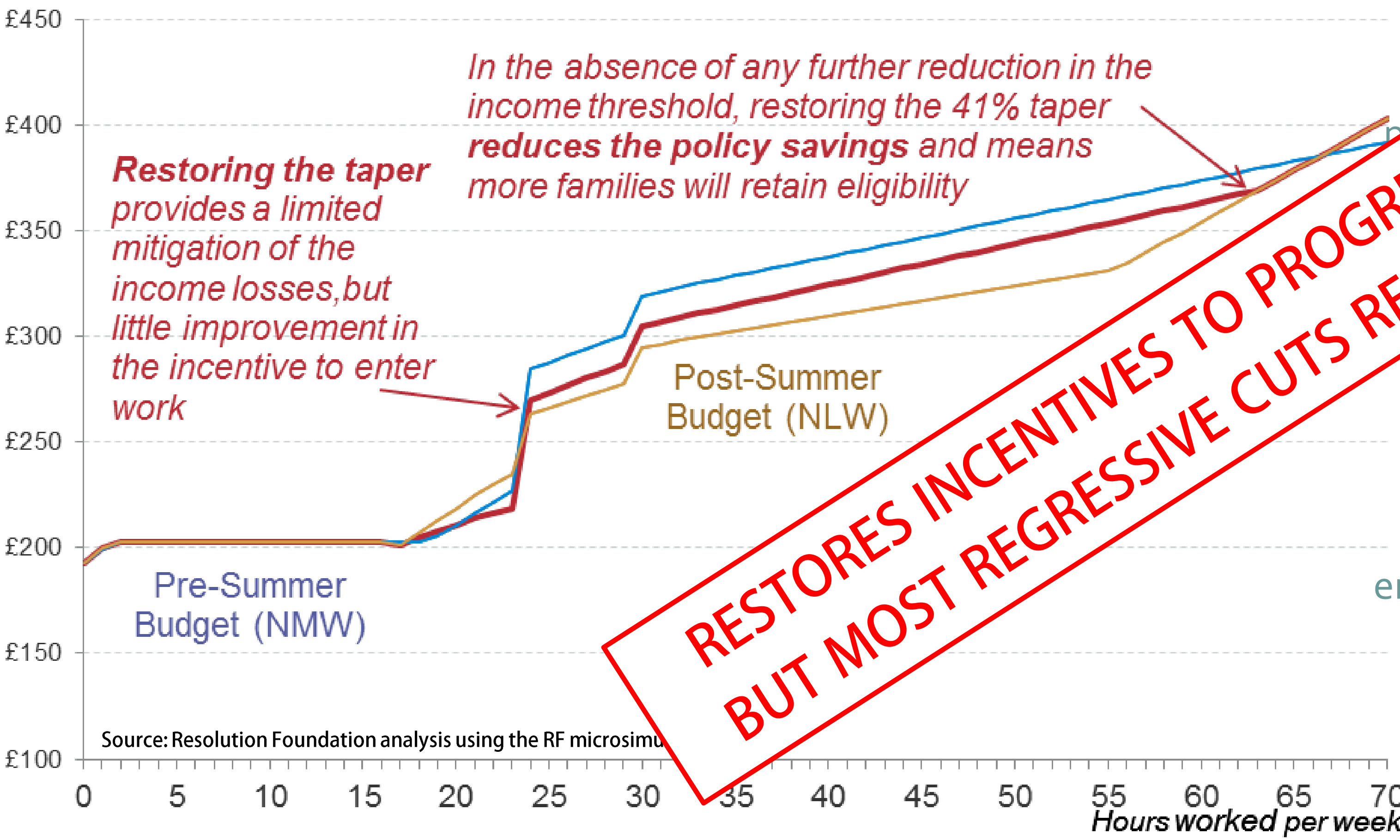


Restoring the 41% taper mitigates losses slightly, but with the greatest protection flowing to higher income tax credit recipients. Those on the lowest incomes will face very little difference

Incentives to progress at work (or enter at higher hours) will be improved (though still weak), but short-term savings will be reduced

Reforming the reforms:
2) Prioritising restoration of the taper rate

Net weekly income for a ***couple with one child with a single earner*** *on the wage floor*



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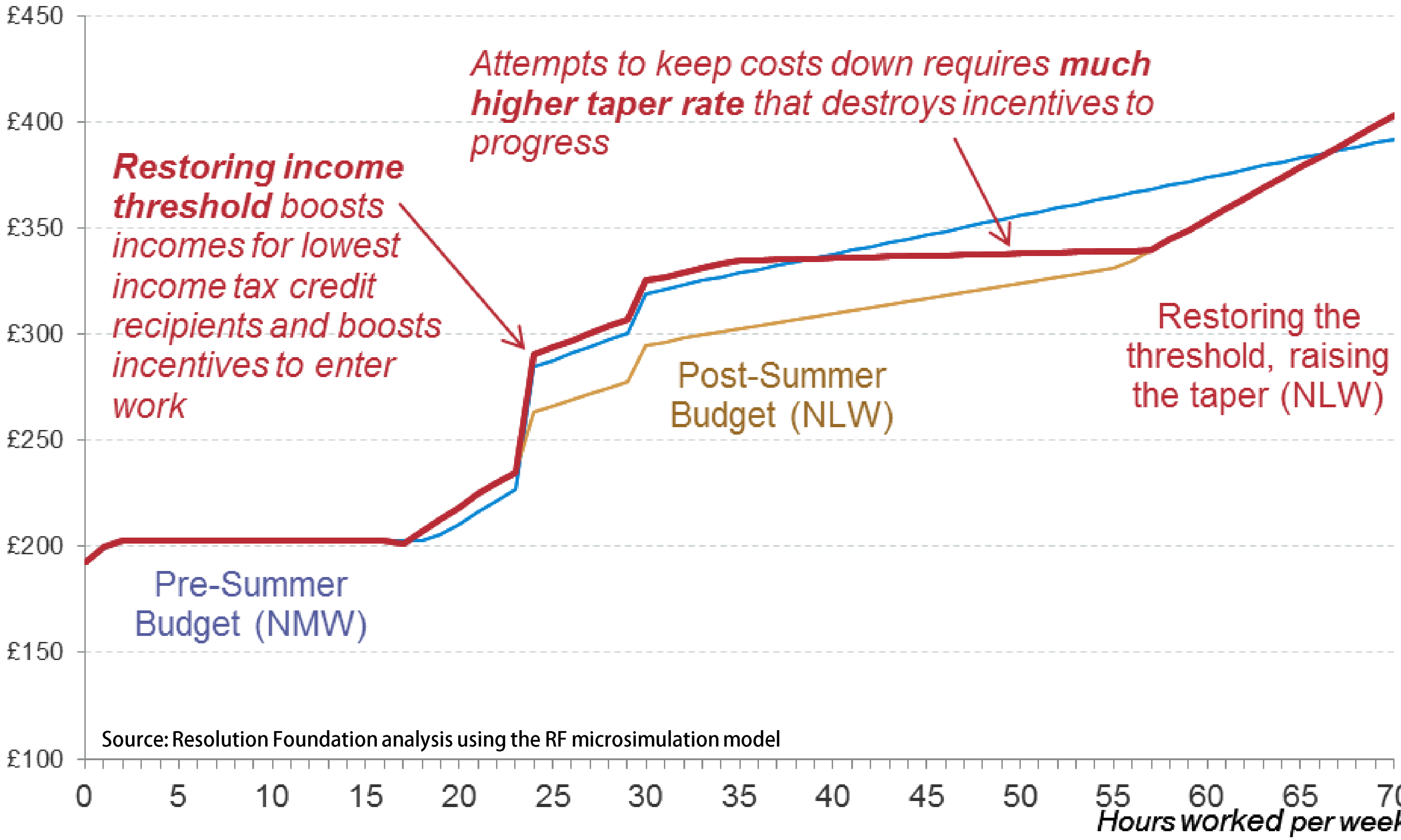
Reforming the reforms:

3) Offsetting the cost within the tax credit system

Net weekly income for a **couple with one child with a single earner** on the wage floor



The threshold cut is the key driver of reducing incomes and damaging incentives to enter work

But, paying for its restoration by raising the taper rate results in marginal deduction rates of close to 100% for large parts of the population

And would not cover the full cost to restore the threshold

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Reforming the reforms:

3) Offsetting the cost within the tax credit system

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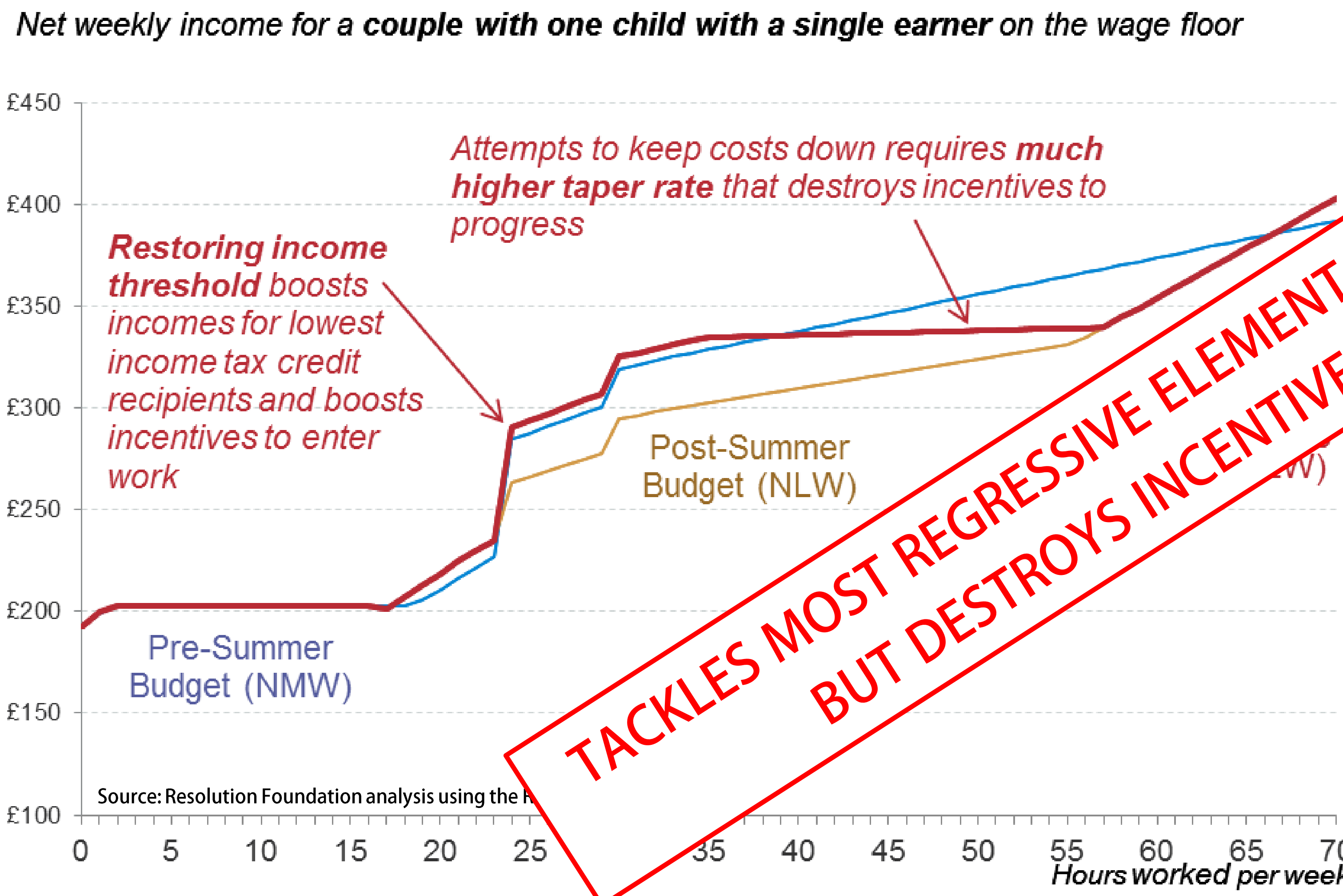

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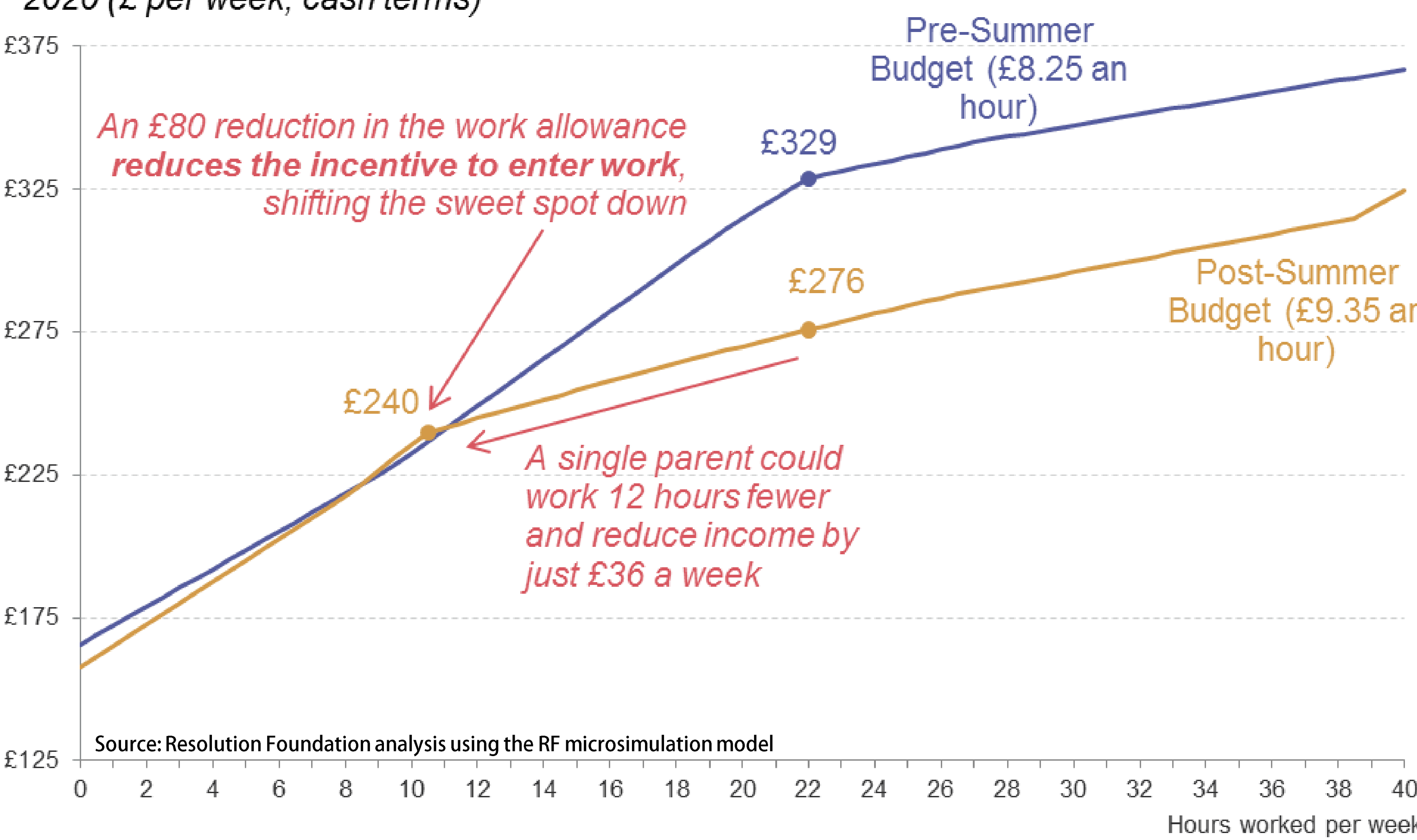
Reforming the reforms:

4) Universal Credit – work incentives are undermined by the Summer Budget measures

Net income for a single parent earning on the wage floor with one child
2020 (£ per week, cash terms)



Source: Resolution Foundation analysis using the RF microsimulation model

The large reductions to the UC work allowances announced at Summer Budget significantly weaken incentives to work

Single parents and second earners may become trapped at low earnings with little return to earning beyond the work allowance

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Reforming the reforms:

4) Universal Credit – offsetting the cost from within Universal Credit

Net income for a single parent earning on the wage floor with one child
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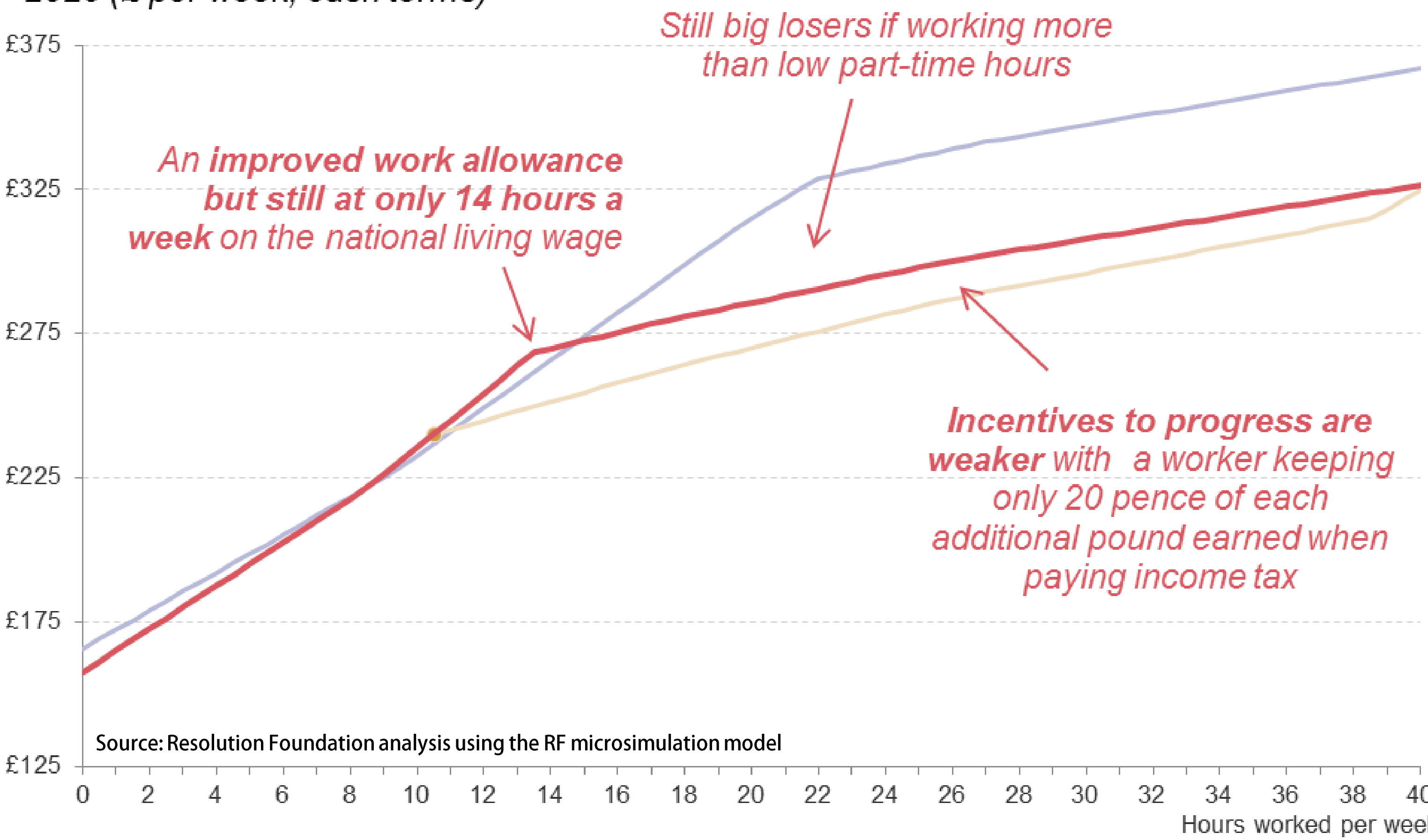

Increasing the taper to 70% would allow around half of the work allowance cut to be restored

But lead to an 80% marginal deduction rate when paying tax , reducing incentives to progress

The incentive to earn no more than the work allowance would be reinforced

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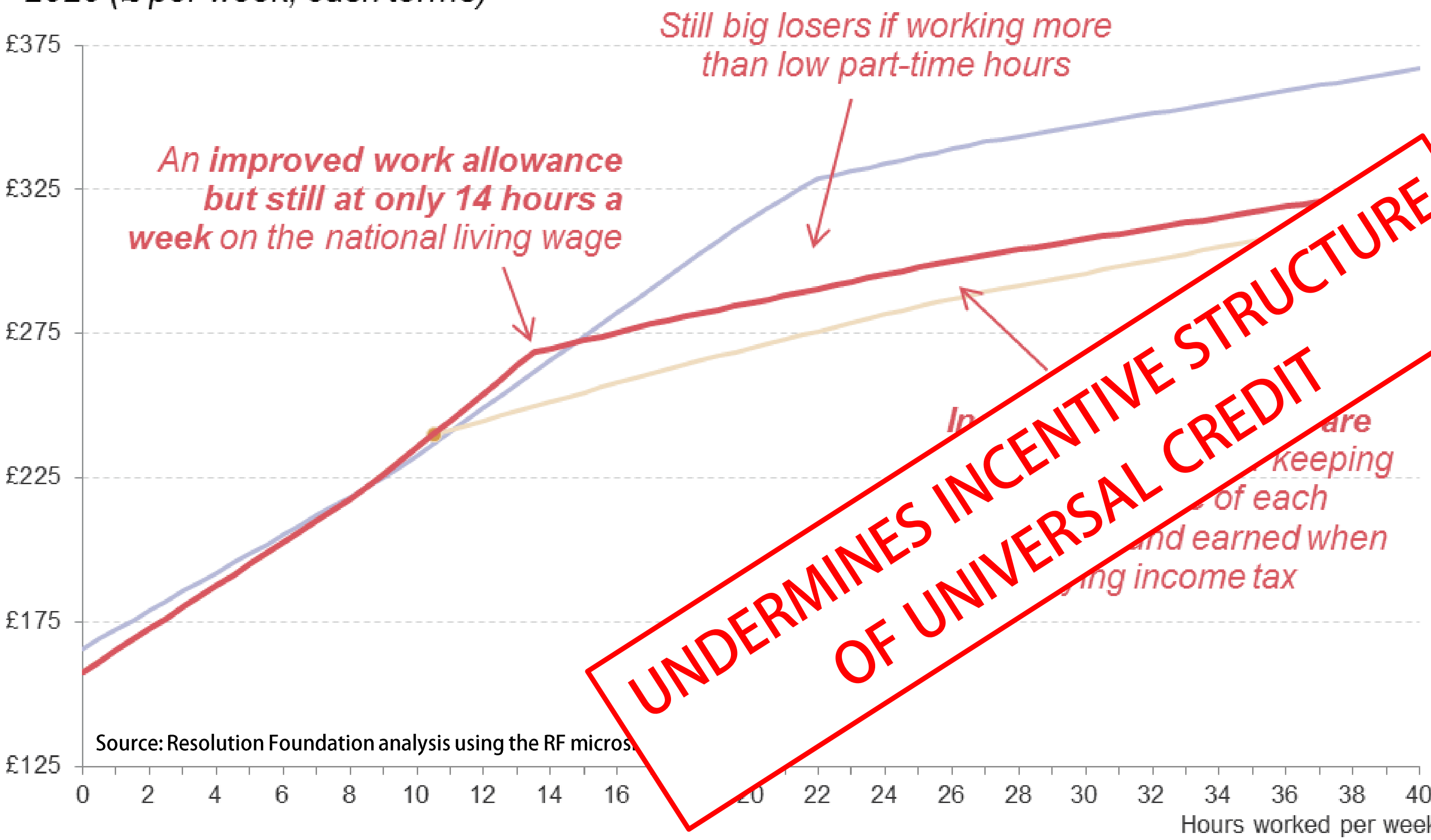

Source: Resolution Foundation analysis using the RF micros

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Reforming the reforms:
Conclusion

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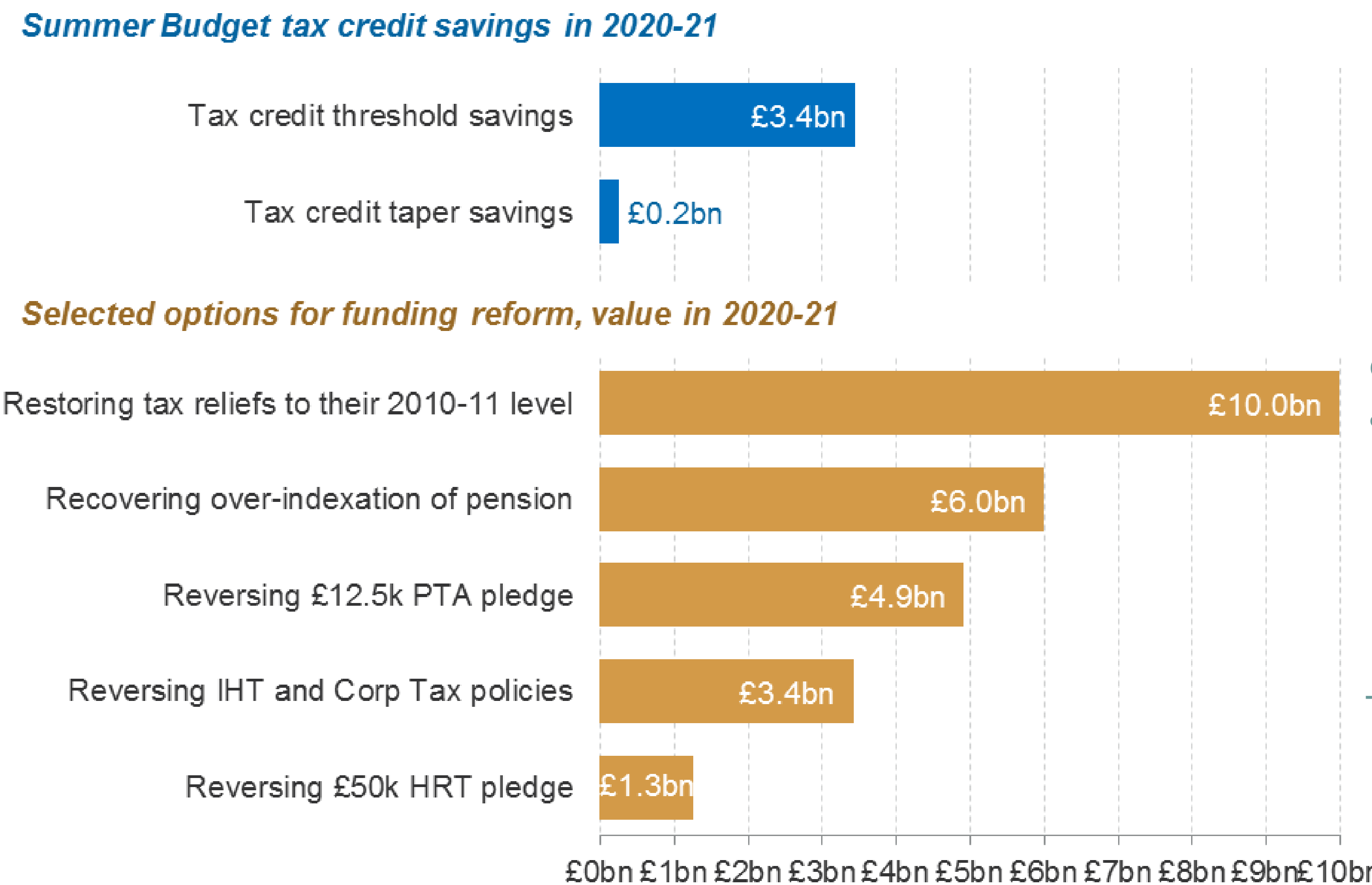
- Efforts to restore the income threshold appear more progressive than those which focus on the taper
- But, pushing the taper higher in tax credits to pay for restoring the income threshold pushes marginal deduction rates too high
- More scope in UC to increase the taper but the higher overall marginal deduction rate created fundamentally damages work incentives

REVERSING THE CUTS

Options for raising equivalent funds

Sourcing new funds to reverse the cuts can be met from within existing fiscal plans



Source: Summer Budget policy costings, Resolution Foundation analysis using the IPPR tax-benefit model & author's calculations

The tax credit threshold and taper savings amount to around £3.6bn in April 2016

Equivalent amounts could be achieved in any number of ways. For example, cancelling income tax pledges would raise £6.2bn

The Chancellor could also choose to reduce the near-£12bn surplus in 2020

Cancelling the proposed tax cuts reverses a very regressive policy

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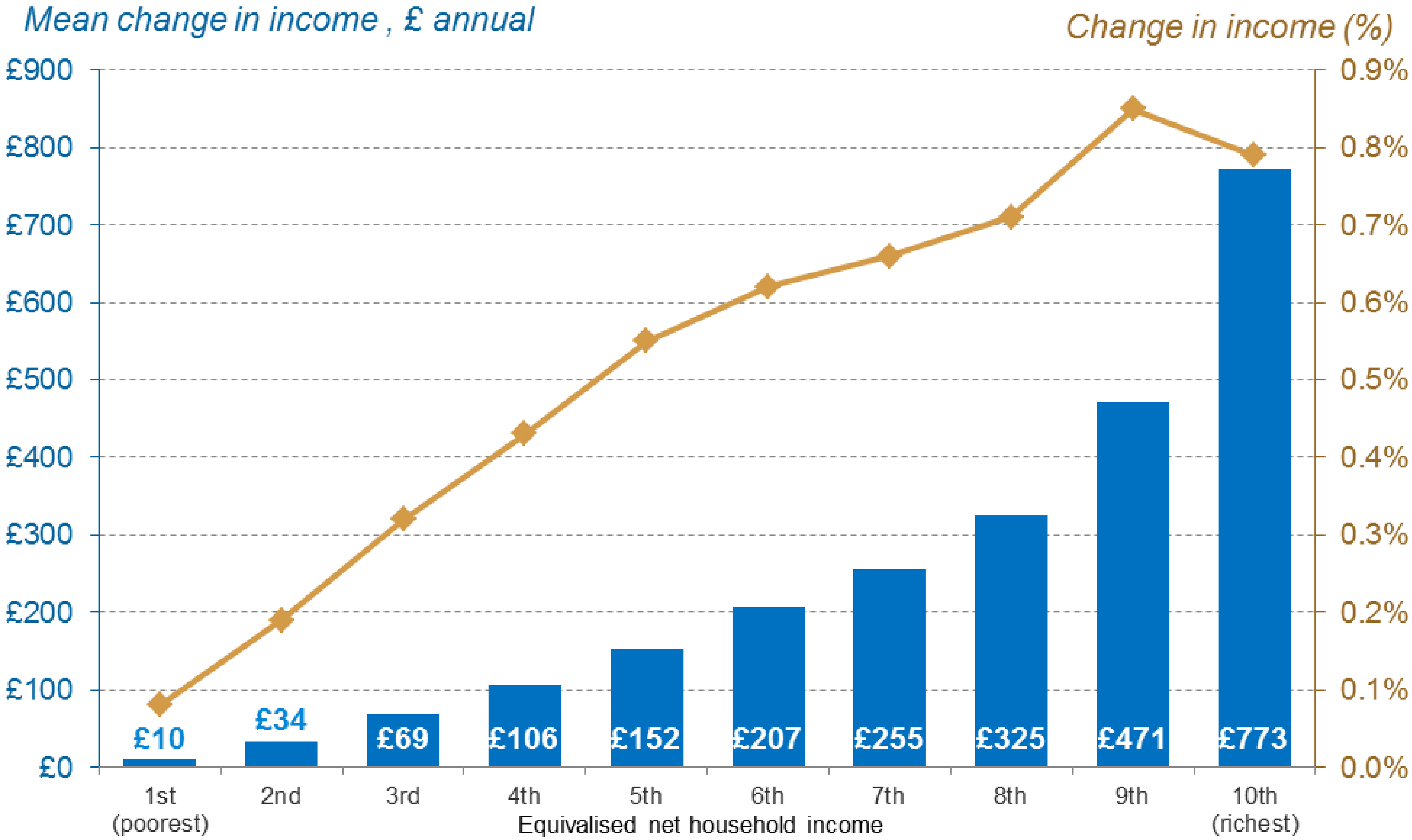
Impact of increasing the PTA to £12,500 and the HRT to £50,000 in 2020



Further cuts to income tax will see four-fifths of the gains going to the top half of the income distribution

Savings over and above those needed to reverse tax credit cuts could be better utilised by increasing the NI threshold

Source: Resolution Foundation analysis using the IPPR tax-benefit model

DEALING WITH THE CRUNCH

Some concluding thoughts

There are no simple – or free – solutions to the tax credit problem

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- Policies on tax, the minimum wage and childcare will make very little difference to the typical tax credit losses faced by families next April
- Phasing-in the changes will reduce the overnight income shock, but make no difference to the final outcome, with 2.6m households still worse off in 2020 relative to 2016 pre-Summer Budget
- Transitioning would protect existing recipients, but results in a much slower build up of savings. It also creates a perverse incentive to remain on tax credits and fundamentally damages incentives in UC
- Funding to reverse the cuts can be secured in a variety of ways. Using funds earmarked for future tax cuts to reverse the tax credit cuts would be both progressive and good for incentives