House of Commons

Work and Pensions Committee

A reconsideration of tax credit cuts

Third Report of Session 2015–16

Report, together with formal minutes relating to the report

Ordered by the House of Commons to be printed 9 November 2015

HC 548
Published on 11 November 2015
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Work and Pensions Committee

The Work and Pensions Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Work and Pensions and its associated public bodies.

Current membership

Rt Hon Frank Field MP (*Labour, Birkenhead*) (Chair)

Heidi Allen MP (*Conservative, South Cambridgeshire*)

Mhairi Black MP (*Scottish National Party, Paisley and Renfrewshire South*)

Ms Karen Buck MP (*Labour, Westminster North*)

John Glen MP (*Conservative, Salisbury*)

Richard Graham MP (*Conservative, Gloucester*)

Mrs Emma Lewell-Buck MP (*Labour, South Shields*)

Steve McCabe MP (*Labour, Birmingham, Selly Oak*)

Craig Mackinlay MP (*Conservative, South Thanet*)

Jeremy Quin MP (*Conservative, Horsham*)

Craig Williams MP (*Conservative, Cardiff North*)

Powers

The committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the internet via www.parliament.uk.

Publication

Committee reports are published on the Committee's website at www.parliament.uk/workpencom and by The Stationery Office by Order of the House.

Evidence relating to this report is published on the inquiry page of the Committee's website.

Committee staff

The current staff of the Committee are Adam Mellows-Facer (Clerk), Margaret McKinnon (Second Clerk), James Clarke (Committee Specialist), Rod McInnes (Committee Specialist), Rachael Savage (Committee Specialist), Abigail Slade (Committee Specialist), Andrew Wallace (Senior Committee Assistant), Alison Pickard (Committee Assistant), and Jessica Bridges-Palmer (Media Officer).

Contacts

All correspondence should be addressed to the Clerk of the Work and Pensions Committee, House of Commons, London SW1A 0AA. The telephone number for general enquiries is 020 7219 8976; the Committee's email address is workpencom@parliament.uk.

Contents

Summary

The 2015 Summer Budget proposed cuts to in-work tax credits of £4.4 billion in 2016-17. Even when combined with the welcome increase in the income tax personal allowance and the National Living Wage, these cuts would cost the average affected family £1,100, a reduction in income that many cannot afford. There is now general agreement that it would be right for the Chancellor to rethink reforms that went too far and too fast and may have most impact on those in work and striving to succeed.

The Chancellor has pledged to bring forward transitional measures in his Autumn Statement and there is widespread expectation that he may be willing to forgo some fiscal savings in the short term. In this Report, we consider the various mitigation options open to him.

Our analysis has been hampered by the inaccessibility of data about the effects of both the original proposals and potential mitigations. Government should do more to make data available, not least because it makes for better policy.

Some facts about mitigation are very clear. Increases in the income tax personal allowance and the National Living Wage should not be confused with compensation for tax credit cuts. These welcome measures help a large share of the population, but that share excludes many of those subject to the cuts. The benefits to those who are helped are generally dwarfed by the cuts, especially in 2016-17. Acceleration of those changes, or alterations to national insurance, will not wash as solutions. The Chancellor should also resist the temptation to raid Universal Credit: this would either shift the burden to different low income families or undermine the objective of making work pay. The only efficient and effective immediate means of mitigating the tax credit cuts lie within the tax credit system.

There is, however, no magic bullet in the tax credit system. Something has to give: household incomes, work incentives or fiscal savings. We recommend that, if these major changes cannot be satisfactorily mitigated now, it would be better to pause any major reforms until 2017-18. This would enable a necessary and ambitious debate about the future of working age benefits, and their position in a sustainable welfare system. This Report starts that debate.

1 Introduction

1. Tax credits are benefits paid on a family basis, taking into account combined income and circumstances. They currently comprise Child Tax Credit (CTC), which is payable to lower income families with children, and Working Tax Credit (WTC), which is payable to families in low-paid work. A childcare element enables some WTC claimant families with children to get help with childcare costs. In April 2015, 4.6 million families containing 7.6 million children were receiving tax credits. Of these families, 3.3 million (72% of the total) included someone in work, of which 2.7 million also included at least one child.[1]

2. How much a family receives in tax credits depends on factors including:

- the number of dependent children, and whether any are disabled;
- the number of hours worked by the adults, and whether those adults are disabled;
- whether the family is incurring costs for eligible childcare; and
- the family's income from earnings and other sources.

Tax credits are means-tested, so that above certain income *thresholds* the amount received falls as family income increases. The rate at which the tax credit award falls is known as the *taper rate*.

3. Tax credits, along with means-tested benefits, are to be replaced by Universal Credit (UC) but, even under the most optimistic timetables for the introduction of UC, some people will still be in receipt of tax credits in 2020.[2]

4. Total UK expenditure on tax credits is forecast to be £29.5 billion in 2015–16. Expenditure on tax credits increased significantly in real terms between 1999 and 2010.[3]

5. In his Summer 2015 Budget, the Chancellor announced several major changes to the tax credit system. The Welfare Reform and Work Bill contains provisions, in relation to new claims from April 2017, to limit tax credit and UC payments related to the number of children in a family to two children and abolish higher payments for the first child.[4] Further proposed reforms were published in draft statutory instruments.[5] These changes, effective from April 2016 and the focus of this Report, include:

- an increase the tax credit taper rate from 41% to 48%; and
- a reduction in the tax credit income threshold for working families from £6,420 to £3,850.[6]

6. The proposed April 2016 measures reduce public expenditure by around £4.4 billion in 2016-17 and contribute to the Government's manifesto commitment to reduce welfare

1 HMRC, Tax Credits Provisional Statistics: April 2015
2 National Audit Office, Universal Credit: progress update, HC 786, 26 November 2014
3 DWP, Benefit expenditure and caseload tables, September 2015
4 Welfare Reform and Work Bill 2015-16
5 Tax Credits (Income Thresholds and Determination of Rates) (Amendment) Regulations 2015
6 The draft regulations also reduce the tax credit income threshold for families eligible for CTC only (and therefore not working sufficient hours to be eligible for WTC) from £16,105 to £12,125 a measure which will affect relatively few families.

spending by £12 billion by 2020-21.[7] The Budget also included the introduction of a "National Living Wage" (NLW) for the over-25s, which will be £7.20 an hour in 2016-17, and a rise in the income tax personal allowance from £10,600 to £11,000.[8]

7. Concerns were widely expressed that the tax credit changes would result in large and sudden falls in income for some in-work families and would contradict the Government's stated objective to "make work pay".[9] The absence of adequate data about the cuts meant that many organisations were ill-equipped to analyse their effects. The Resolution Foundation and the Institute for Fiscal Studies (IFS) were two prominent exceptions and we invited them to give oral evidence to us.[10] Even they were limited in how much they could help. We are very grateful for their time and subsequent support.

8. On 26 October 2015 the Government was defeated in the House of Lords on two motions on the statutory instruments introduced to give effect to the tax credit changes.[11] The Chancellor responded by announcing he would bring forward measures in his Autumn Statement on 25 November to lessen the impact on families during the transition.[12]

9. This Report sets out the distributional effects of the package of measures announced in the Budget and explores potential options for mitigating their effects on in-work families. While none of us would design the welfare system we currently have from scratch, and our proposals of how it might ideally look would differ greatly, we seek to respond practically, pragmatically and across party lines to an immediate need. Our conclusions and recommendations are in **bold type**.

7 HM Treasury, Summer Budget 2015 Red Book, HC 264, July 2015, table 2.1 and The Conservative Party Manifesto 2015, p8

8 HM Treasury, Summer Budget 2015 Red Book, HC 264, July 2015

9 See, for example, debate in the House of Commons on Tax Credits, HC Deb, 29 October 2015, Cols 530-608

10 See, for example, Resolution Foundation, Higher ground: who gains from the National Living Wage?, September 2015 and IFS, New analysis of the potential compensation provided by the new 'National Living Wage' for changes to the tax and benefit system, September 2015

11 HL Deb, 26 October 2015, Cols 976-1043

12 HC Deb, 27 October 2015, Col 177

2 Effects of the proposed reforms

Tax credits

Losses

10. The proposed cuts would affect 3.3 million families, of which 2.7 million (including 1.2 million lone parent families) have a total of 5.2 million children.[13] On average, affected families will lose approximately £1,300 in tax credits in 2016–17 compared with 2015–16.[14]

11. The losses will not be spread evenly across affected families. The highest losses, of more than £2,600, will be incurred by families with relatively high gross incomes and circumstances that result in additional support, such as multiple children and childcare costs. Table 1 below details the example of a family with two school-age children and one earner working 35 hours per week at different levels of gross income. If the earner is paid £7.20 per hour,[15] equivalent to £13,100 per year, the family will lose £1,701 in tax credits, 7.8% of net income. Losses as a share of total net income peak at more than 10% for those with family incomes in the mid £20,000s.[16]

Table 1: Illustration of tax credit losses in 2016/17: Single-earner family with two school-age children

		Reduction in tax credit award	
Gross earnings:	*Equivalent to:*	£	% of net income (a)
£6,420	*current tax credit income threshold*	£1,234	6.5%
£10,000		£1,484	7.1%
£12,200	*35 hrs pw on £6.70 National Minimum Wage*	£1,638	7.6%
£13,100	*35 hrs pw on £7.20 National Living Wage*	£1,701	7.8%
£20,000		£2,184	9.2%
£25,000		£2,534	10.1%
£26,520	*level at which tax credit loss is maximised*	£2,641	10.3%
£27,000		£2,447	9.5%
£27,190	*Median full-time salary, UK*	£2,369	9.2%
£30,000		£1,217	4.6%

(a) Net income from earnings (after tax/NI), tax credits (no childcare element claimed) and Child Benefit.

Source: Work and Pensions Committee calculations

13 HMRC, Tax Credits Provisional Statistics: April 2015
14 This is a simple division of the £4.4 billion savings from the reforms between 3.3 million families.
15 The National Living Wage in 2016-17
16 Q51

Incentives to work

12. The proposed changes also affect incentives to work. The IFS told us that the effects on the incentives to move *into* work were complex and varied markedly depending on individual circumstances.[17] The picture regarding the incentives to earn more, either through working more hours or being paid more per hour, was far clearer. The increased taper rate of 48% combined with income tax, national insurance (NI) and implications for housing benefit meant that many individuals would keep just 7p of an additional £1 in earnings or, put another way, they faced a *marginal deduction rate* of 93%.[18] Gingerbread told us that tax credits had been "vital in making it pay to work" in noting current record levels of employment among lone parents. The proposed cuts, they said, threatened this.[19]

Budget package

13. We explored the extent to which the tax credit cuts would be compensated for, both in 2016-17 and over the next five years, by other measures announced in the 2015 Summer Budget. These measures included:

- an increase in the income tax personal allowance from £10,600 to £11,000 in 2016-17 and the Government's pledge it will reach £12,500 by 2020;[20]
- the introduction of a National Living Wage (NLW) for those aged 25 and over, which will begin at £7.20 an hour in 2016-17 and is projected to rise to £9.35 by 2020–21;[21] and
- an increase in the free childcare entitlement for working parents of three and four year olds from 15 hours to 30 hours a week from September 2017.[22]

Personal allowance

Small gains relative to cuts

14. The gains from the personal allowance increase are small relative to the typical tax credit losses. At best, an individual can benefit by £80 in 2016-17.[23] A household with two earners with incomes over £11,000 (and therefore among the biggest cash losers from the tax credit cuts) could gain double that, £160. Should the personal allowance reach £12,500 by 2020-21, a household could gain at most £760 relative to 2015-16 from the personal allowance increase.[24]

17 Q37
18 Q37
19 Gingerbread written evidence (TXC0002)
20 HM Treasury, Summer Budget 2015 Red Book, HC 264, July 2015, para 1.131. This pledge was not costed in table 2.1 of the Red Book, the "scorecard", which followed default uprating assumptions.
21 HM Treasury, Summer Budget 2015 Red Book, HC 264, July 2015, paras 1.121 and 1.122
22 HM Treasury, Summer Budget 2015 Red Book, HC 264, July 2015, para 1.163
23 20% of the £400 increase
24 An individual could benefit by up to £380, 20% of the increase in the personal allowance. A two-earner household could therefore benefit by up to £760.

Large beneficiary population excluding many tax credit recipients

15. Those benefits are also spread across a large population which excludes a high proportion of those facing tax credit cuts. The increase in the personal allowance in 2016–17 benefits all income tax payers with incomes of up to £122,000, a total of 29 million people.[25] A large proportion of in-work tax credit recipients, however, will not benefit as they do not earn enough to pay income tax. Torsten Bell, Director of the Resolution Foundation, wrote:

> In April you will only pay income tax if you individually earn more than £11,000, but you will start to lose tax credits if your household earns as little as £3,850. In some ways these are different tribes and you cannot compensate one entirely by giving money to the other.[26]

16. The personal allowance was "a very badly targeted tool" for compensating families affected by the tax credit cuts.[27] Of households in receipt of in-work tax credits, 43% have incomes of less than £10,000.[28] Add to that single-earner households with incomes between £10,000 and £11,000 and dual-income households with combined incomes of over £10,000 but with neither earner having an income of more than £11,000, at best half of families facing tax credit cuts will benefit from the personal allowance increase.

National Living Wage

Small gains to those on tax credits

17. From April 2016, someone working 35 hours per week on the new National Living Wage (NLW) would earn £13,100, compared with £12,200 on the current National Minimum Wage (NMW). Some commentators have claimed that the NLW may also have ripple effects as wages higher up the distribution are adjusted to maintain pay differentials.[29] These spill-overs were not, however, a notable feature of the introduction of the NMW and the Chair of the Low Pay Commission, George Bain, has been reported as saying predictions of ripple effects relating to the NLW are optimistic, suggesting that the squeezing of pay differentials was more likely.[30] Even with its arguably generous assumptions, the Office for Budget Responsibility (OBR) projects that the total increase in gross wages across the economy attributable to the NLW will, on a £9.35 rate by 2020-21, be "almost £4 billion", less than the £4.4 billion cuts in tax credits in 2016-17.[31]

18. Owing to the high marginal deduction rates we set out earlier in this chapter, people on tax credits will tend to take home only a small proportion of any wage increase, including those that result from the NLW. Paul Johnson, the Director of the IFS, told us that "many of those gaining anything from the new NLW will be far from fully compensated for the

25 HMRC Policy Paper, Income Tax: personal allowance and basic rate limit for 2016 to 2017, 8 July 2015
26 Resolution Foundation blog, 21 October 2015, We can't (tax) cut our way out of the tax credit problem, by Torsten Bell
27 Q52
28 Q51
29 The Office for Budget Responsibility's forecasts of ripple effects in its Economic and Fiscal Outlook July 2015 project spill-over effects to the 25th percentile of the earnings distribution. These estimates are based on Butcher, Manning and Dickens (2012) Minimum Wages and Wage Inequality: Some Theory and an Application to the UK, Discussion Paper (Low Pay Commission; University of Sussex; London School of Economics).
30 Q15, Resolution Foundation, More than a minimum: The review of the minimum wage – Final Report (the Bain Review) and The Times, 26 October 2015, Don't drag Queen into tax credits row, PM told, by Francis Elliott
31 OBR, Economic and Fiscal Outlook July 2015, para B10, Q17 and IFS, Summer post-Budget briefing 2015

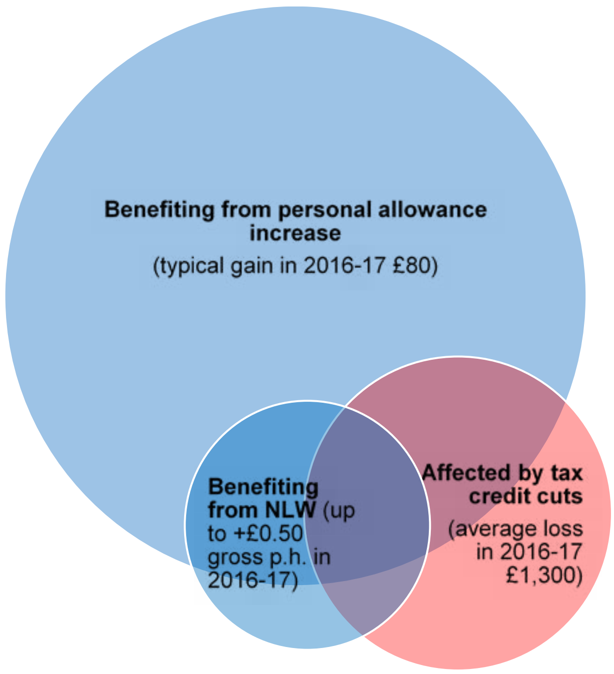
tax credit cuts".[32] For example, someone working 35 hours per week earning the NMW in 2015-16 and the NLW in 2016-17 as the single earner in a household with two school age children would see their gross pay increase by £900 in 2016-17. However, they would pay an additional £100 in income tax (after taking into account the increase in the personal allowance) and £108 in NI and under the current tax credit tapering system the family's tax credit award would be reduced by £369 as a result of their increased earnings. As a result, the £900 increase in gross pay would translate into a £323 increase in the family's net income (not taking any housing benefit implications into account). However, the Summer Budget changes to the threshold and taper result in a further £1,701 cut in the tax credit award, leaving the family £1,378 worse off in net terms.

Just a third of tax credit recipients benefit

19. We also heard that the majority of tax credit recipients will not benefit at all from the NLW: there was a "population overlap issue". Tax credit recipients who are self-employed or aged under 25 will not be entitled to the NLW so will not benefit directly. Of the working population aged over 25, just 4% are currently paid the NMW and therefore stand to gain the most from the NLW.[33] The IFS estimate that "about a third of the losers from the tax credit changes would gain" from the NLW by 2020-21.[34]

20. The Venn diagram below illustrates the limited overlap between households subject to tax credit cuts and those who benefit from increases in the personal allowance and the NLW:[35]

Working households in 2016-17: illustration of overlap between households gaining from personal allowance and/or NLW and those losing from tax credit cuts



32 IFS written evidence (TXC0001)
33 Q22
34 Q24
35 The relative sizes of the circles and degrees of overlap are approximations.

Childcare

21. We heard that the expansion of free childcare would benefit an even smaller subset of those subject to tax credit cuts. Fewer than 10% of tax credit claimants make a childcare claim for a child aged under five.[36] As the measure applies to three and four year olds only, the proportion that would benefit would therefore be far lower still. Torsten Bell explained that those tax credit recipients who benefited would already have 70% of their childcare costs funded by the taxpayer, meaning they would only stand to enjoy an additional subsidy worth approximately £385 per year. The biggest beneficiaries of the expansion of free childcare would be families with incomes *above* the limit for tax credit support. Mr Bell concluded that it was "not a compensation tool" for the tax credit cuts.[37]

Total effects of the package

22. The Resolution Foundation told us that the combination of the increase in the personal allowance and the introduction of the NLW would be worth £200 on average to WTC recipient families in 2016-17. Given average tax credit cuts were £1,300, such families would, on average, be around £1,100 worse off as a result of the package.[38] The IFS confirmed that, on average, families subject to tax credit cuts would remain worse off as a result of the Budget measures by 2020-21.[39]

23. These averages mask considerable variation between individual families. The IFS told us that it was not hard to come up with a set of circumstances that would result in a family on tax credits gaining from the combined Summer Budget measures:

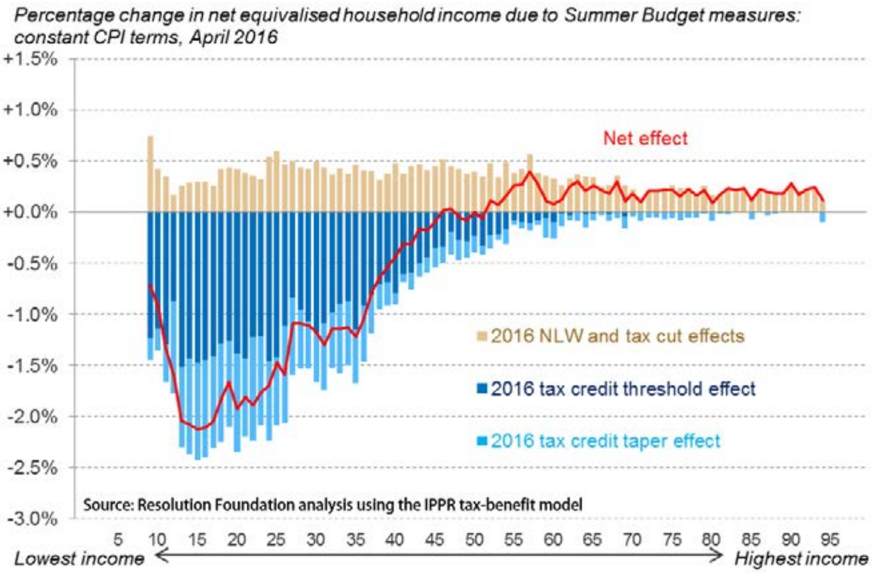
> If you have a couple both working 35 or 40 hours a week, they are going to gain from the personal allowance, they are going to gain from the increase in the living wage, and they might be right at the top of the tax credit taper and so they have a relatively small amount to lose. [40]

However, he stressed that such cases were the exception rather than the rule:

> There are people who will gain but they are in the minority. It is the case that the significant majority of tax credit claimants, even when you put all of those things together, will be worse off.[41]

24. The Resolution Foundation analysed the effects of the combination of the tax credit cuts, personal allowance increase and NLW in 2016, by income percentile across all households. As the chart below demonstrates, the losses from the package are concentrated towards the bottom of the income distribution.[42]

36 HMRC, Tax Credits Provisional Statistics: April 2015, table 4.4
37 Q21
38 Q5
39 Qq 10-11
40 Q17
41 Q17
42 Resolution Foundation presentation on tax credit cuts, 5 November 2015



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

25. Policy in Practice, a welfare consultancy, undertook analysis of the numbers of families that would gain and lose from the combination of the tax credit cuts, personal allowance increases and the NLW. This was based on a sample of inwork families claiming housing benefit (HB) or council tax support as well as WTC. These benefits provide some automatic cushioning of the tax credit cuts, therefore the sample is biased towards mitigation. Policy in Practice found that 67% of such recipients would still be worse off in cash terms in 2020 compared to 2015. Even in the unlikely event that all such households with children aged three or four were better off in total as a result of additional free childcare, half of the total would still be worse off in 2020, even before inflation is taken into account.[43]

26. We asked the Resolution Foundation to conduct further similar analysis covering all 3.3 million families affected by the cuts.[44] Their calculations include the April 2016 tax credit cuts and increases in the personal allowance to £12,500 and the NLW to £9.35 per hour. They do not incorporate additional free childcare, but the Foundation estimates that, on average and in aggregate, that change would offset losses by around £30 per year.[45] Other changes to tax credits due to be implemented in April 2017 are not included, meaning their estimates "are likely to understate the scale of losses".[46] The table below details their findings:

43 Policy in Practice blog, 26 October 2015, Five reasons the Lords should vote to block tax credit proposals today, by Deven Ghelani

44 Letter from Rt Hon Frank Field MP to Torsten Bell, 26 October 2015

45 Resolution Foundation written evidence (TXC0003)

46 The analysis assumes that the current Tax Credit system remains fully in place in each year to 2020. 'Flow' measures affecting new claims relating to the family element and families with more than 2 children are not accounted for, so these estimates are likely to understate the scale of losses. Modelling is undertaken on a full entitlement basis, therefore the number of families with small losses or gains may be overstated as those with low entitlements are least likely to actually claim. Estimates of the number of affected families are calibrated to match published caseload estimates by HMRC. The income tax personal allowance is uprated in accordance with table 2.1 of the Summer Budget 2015 Red Book until 2020-21, when it is increased further to £12,500. The effect of an additional 15 hours of free childcare for parents of a 3 or 4 year old are not accounted for in these estimates due to data quality, but on average and in the aggregate we would expect this to offset losses by around £30 a year. According to HMRC caseload statistics only 10% (270,000) of working families entitled to tax credits with a child under 5 receive support from the childcare element, not all of these children will be aged 3 or 4.

Table 2

Resolution Foundation estimates of the gainers and losers from Summer Budget policy measures relative to 2016 before the Summer Budget

millions	2016-17	2017-18	2018-19	2019-20	2020-21
Number of working families in receipt of Tax Credits	3.3	3.3	3.3	3.3	3.3
Number of losers	3.1	3.0	2.9	2.8	2.5
of which:					
Families with children	2.6	2.5	2.4	2.4	2.2
Families without children	0.5	0.5	0.4	0.4	0.4
Number of gainers	0.2	0.3	0.4	0.5	0.7
of which:					
Families with children	0.1	0.2	0.3	0.3	0.5
Families without children	0.0	0.1	0.1	0.2	0.2
Percentage of losers	95%	92%	87%	85%	78%
Percentage of gainers	5%	8%	13%	15%	22%

Real term gains and losses from Summer Budget policy measures relative to 2016 before the Summer Budget

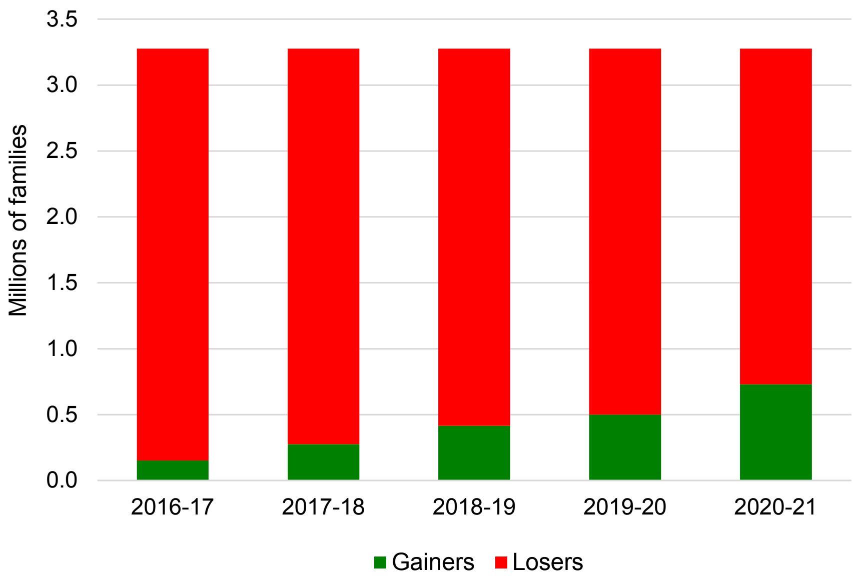
Constant CPI terms	2016-17	2017-18	2018-19	2019-20	2020-21
Average annual loss for losers	-£1,200	-£1,300	-£1,400	-£1,500	-£1,500
Average annual gain for gainers	+£200	+£300	+£400	+£600	+£700

Source: Resolution Foundation analysis for the Work and Pensions Committee, using the IPPR tax-benefit model

27. The Resolution Foundation estimates that, of the 3.3 million families affected by the tax credit cuts, around 700,000, or 22%, would be better off in real terms in 2020–21 than they would have been in 2016-17 in the absence of the Summer Budget package. The remaining 2.5 million, or 78%, would still be worse off in 2020–21.[47]

47 Resolution Foundation written evidence (TXC0003). Figures do not sum due to rounding. The data suggest just under 2.55 million losing, and around 733,000 gaining, families in 2020-21, though the data should not be considered accurate to this degree of precision.

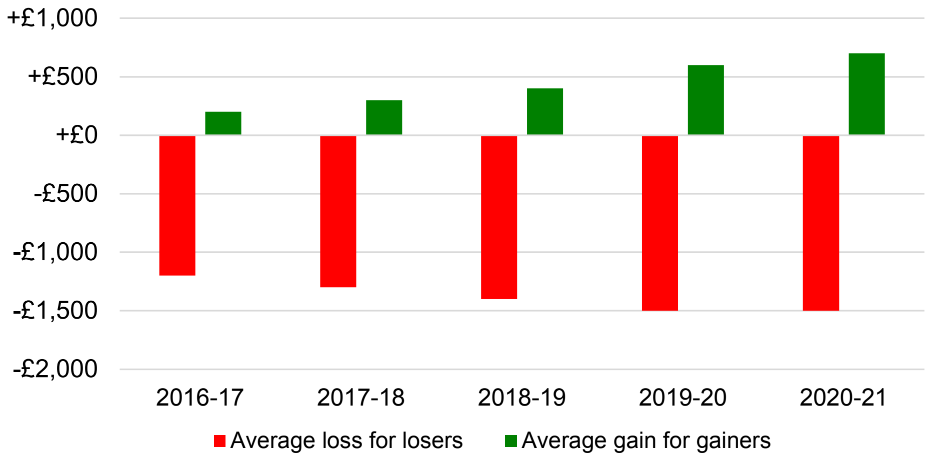
In-work families on tax credits gaining or losing in real terms from Summer Budget policy measures (relative to 2016-17 without Summer Budget measures)



Source: Resolution Foundation analysis for Work and Pensions Committee. Assumes tax credit system fully in place in each year to 2020-21. Based on cohort of 3.3 million working families in tax credits (April 2015 caseload)

28. The average income increase for families who gain from the combined package would be £200 in 2016-17. By 2020-21 this would rise to £700 in 2016-17 prices for the larger group who would be better off by that point. The average losses for families who lose out are higher: such families would experience an income fall of £1,200 in 2016-17 and £1,500 by 2020-21 in 2016-17 prices.[48]

Effect of Summer Budget measures on working families affected the 2016-17 tax credit cuts (real-terms change in income relative to 2016-17 without Summer Budget measures)



Source: Resolution Foundation analysis for Work and Pensions Committee. Assumes tax credit system fully in place in each year to 2020-21. Based on cohort of 3.3 million working families in tax credits (April 2015 caseload)

48 Resolution Foundation written evidence (TXC0003)

Treasury analysis

8 out of 10

29. The Summer Budget *Red Book* pointed to the benefits of the package of measures to working households:

> By 2017-18, 8 out of 10 working households will be better off as a result of the income tax Personal Allowance, living wage and welfare (including tax credits) changes in this Budget. On average, these households will be £130 per year better off.[49]

This statistic has repeatedly been used by Ministers in response to questions about the tax credit changes.[50]

30. We asked independent experts about the figure. Paul Johnson told us that it was "in the right ballpark because most working households will have gained a little bit" from the income tax changes. However, he continued that "most of those losing will be the tax credit recipients, which would equate to something like two in 10".[51] The eight out of ten are broadly those who will *not* be subject to tax credit cuts.

Distributional analysis

31. The Treasury presentation of the effects of the Summer Budget policy changes on different income groups, the *distributional analysis*, differed from that in previous Budget analyses. Most notably, data were presented for five income *quintiles*, rather than the standard ten *deciles*, and the analysis incorporated assumptions about the performance of the economy that were not directly linked to Budget measures.

32. The Treasury has been widely pressed to produce more extensive distributional analysis. The House of Lords Secondary Legislation Scrutiny Committee asked the Treasury for more information on the regulations which contained the April 2016 tax credit cuts.[52] An Impact Assessment was published in response, which included some unconventional distributional analysis.[53] The Committee was unimpressed. In a letter to the Chancellor, the Chair wrote:

> the Committee was concerned that the assessment could have done more to set out the short-term impact on household incomes; and also that the presentation of some of the material, notably on distribution, was difficult to understand, even for those used to economic analyses.[54]

33. In response to a Treasury Committee request for the standard distributional analysis produced in previous Budgets, the Treasury published an assessment by quintile

49 HM Treasury, Summer Budget 2015 Red Book, HC 264, July 2015, para 1.66

50 For example, House of Commons written questions 12704 (answered 26 October 2015) and 10783 (answered 20 October 2015), and Rt Hon Matthew Hancock MP on BBC Radio 4 Today Programme, 26 October 2015.

51 Q2

52 Draft Tax Credits (Income Thresholds and Determination of Rates) (Amendment) 2015 Regulations

53 HM Treasury, The Tax Credits (Income Threshold and Determination of Rates) (Amendment) Regulations 2015: Impact Assessment, 12 October 2015

54 Letter from Rt Hon. Lord Trefgarne to the Chancellor, 12 October 2015

of the cumulative effect of policy measures between 2010-11 and 2017-18.[55] While this was interesting, it was not what that Committee asked for. The Chair of the Treasury Committee twice wrote to the Chancellor reiterating his request for the standard data.[56] This information has not been forthcoming.

34. We wrote to the Chancellor asking for a basic distributional analysis of the impact of the Summer Budget measures on households claiming tax credits alone.[57] This information, too, has not been forthcoming. As we note in Chapter 4, the Government has also not provided data on flows on and off tax credits, which are essential to understanding the impact of lessening the impact of cuts on existing claimants only.

35. We asked senior think tank representatives who used to work in the Treasury about the absence of the established distributional analysis. Paul Johnson noted:

> There are quite a lot of interesting numbers in the impact analysis but it is interesting that there is not the kind of straight forward distributional chart that you would expect to see.[58]

Torsten Bell concurred, noting that the Budget:

> does not provide the normal simple distributional chart over 10 deciles of what the impact will be. You take from that what you will.[59]

We heard that the Treasury's economic model could clearly produce the standard distributional analysis if they chose to do so.

Conclusions

36. **The proposed changes to tax credits in April 2016 will result in very substantial cuts to the incomes of working families, including many with children. There is now general agreement that it would be right for the Chancellor to rethink reforms that went too far and too fast and may have most impact on those in work and striving to succeed. Furthermore, by increasing the rate of withdrawal in taxes and benefits to as much as 93% of additional income, the cuts run against the Government's objective of making work pay.**

37. **The Summer Budget also included an increase in the income tax personal allowance, the gradual introduction of a higher minimum wage and an expansion of free childcare. These measures are welcome. However, they should not be confused with mitigation for the tax credit cuts; they benefit very different parts of the working population. The majority of working families affected by the proposed cuts would still be worse off in 2020-21 as a consequence of the Budget package. We therefore welcome the Chancellor's commitment to additional measures to lessen the impact of the tax credit cuts.**

55 HM Treasury, Summer Budget 15: Draft distributional analysis on previous basis
56 Letter from Rt Hon Andrew Tyrie MP to the Chancellor (HC 313, 10 August 2015) and Letter from Rt Hon Andrew Tyrie MP to the Chancellor (HC 313, 28 September 2015)
57 Letter from Rt Hon Frank Field MP to the Chancellor, 30 October 2015
58 Q27
59 Q28

38. **The Treasury has been unacceptably evasive in failing to provide data about the effects of its Summer Budget measures on different income groups. The Government ought also to have been more forthcoming with statistics about flows on and off tax credits. Their obfuscation is not consistent with effective scrutiny; nor is it consistent with effective policy-making.**

3 Mitigation

39. Following the Government defeats in the House of Lords the Chancellor announced that he would:

> continue to reform tax credits and save the money needed so that Britain lives within its means, while at the same time lessening the impact on families during the transition. I will set out these plans in the autumn statement. We remain as determined as ever to build the low tax, low welfare, high wage economy that Britain needs and the British people want to see.[60]

In this chapter we examine possible mitigation options.

Lower taxes and higher wages

Taxes

40. In the last chapter we described how the increase in the income tax personal allowance for 2016-17 was not well-targeted at those who lose from the tax credit cuts. Given that, it is unsurprising that a further, or accelerated, increase in the personal allowance would not be an effective means of mitigating those cuts. Furthermore, as it benefits nearly 30 million taxpayers, it would be extremely costly. The IFS told us:

> To add £1,000 to the personal allowance costs a couple of billion pounds. It is very expensive to do and it is also not even nearly focused on the people who are losing from the tax credit changes. The vast majority of that money will go to people who are not on tax credits and those on tax credits will gain only a very small amount from it. So I think it is probably just a mistake to think of increasing the personal allowance as a way of compensating for changes in tax credits. If you were thinking about spending additional public money to support those who are losing tax credits, you certainly would not begin by looking at things like the personal allowance.[61]

41. We also examined potential mitigation through changing the NI threshold. Employees currently pay 12% Class 1 NI contributions on earnings between £8,060, the primary threshold, and £42,385.[62] The NI primary threshold is lower than the income tax personal allowance, meaning more low-paid employees would gain from increasing it. However, the NI primary threshold remains a poorly-targeted and costly device to offset tax credit cuts, given that over 20 million working-age adults make Class 1 NI contributions each year.[63] To achieve a net income increase of £100 for employees paying Class 1 NI contributions, meaning a dual income household could gain up to £200, would cost over £2 billion.[64] These gains would be diffuse: they would be spread across all working-age employees who earn over £155 per week, and only those earning over £171 a week for the whole year, or

60 HC Deb, 27 October 2015, Col 177

61 Q52

62 Annualised figures. National insurance of 2% is paid on earnings in excess of £42,385.

63 In 2010-11, 26.3 million individuals paid Class 1 contributions (DWP Tabulation Tool). In the year ending June 2015 there were 25.4 million employees aged 16-64 in the UK (ONS Annual Population Survey via Nomis)

64 According to HMRC's ready reckoner of the direct effects of illustrative tax changes, a £2-per-week increase in the Class 1 employee primary threshold costs around £260 million in 2016-17.

over £8,892 per year, would gain in full. HM Revenue and Customs statistics indicate that one million in-work families on tax credits have annual earnings below this level.[65]

42. In general, as they operate on an individual basis, the existing tax and national insurance systems are an inefficient means of providing targeted increases in household incomes or accounting for family circumstances. While tax remains individually assessed this will continue to be the case. There may be merit in reconsidering allowances within the tax system to enable it better to take family circumstances into account. Paul Johnson was dismissive of the existing tax and NI systems as a mechanism for mitigating the tax credit cuts:

> the answer to your question of could you do anything with the tax system, could you do anything with national insurance, is no.[66]

Wages

43. Similarly, having found in the last chapter that the NLW did not provide targeted compensation for families subject to the proposed tax credit cuts, it is not surprising that faster increases in the NLW would not be an effective mitigation strategy. Torsten Bell told us that, setting aside the negative impact on employment, even if the NLW were increased to £9.35 per hour in April 2016, families subject to the tax credit cuts would still lose out in net terms. This was because the additional income would be subject to the very high marginal deduction rates in the tax and benefit systems.[67]

44. We also considered the impact of general wage growth. The OBR forecasts average earnings growth of 4% per year until 2020-21, 22% in total over the next five years.[68] If someone earning £20,000 today were to experience this level of wage growth over the Parliament, their pay would rise to around £24,400 by 2020–21. However, even without the Summer Budget measures, almost three-quarters of this increase in gross pay would be automatically withdrawn from tax credit recipients through tax, NI and tax credit tapering. When the Summer Budget cuts are factored in, income in 2020-21 is likely to be lower *in cash terms* than in 2015-16, even allowing for the planned £12,500 personal allowance. For instance, a single-earner two-child family with earnings of £20,000 in 2015-16 rising to £24,400 in 2020-21, and receiving tax credits throughout this period, would be over £600 worse off in 2020–21 than 2015–16, even before inflation is taken into account. Wage growth will not, in general, compensate for the cuts, even by 2020-21.

65 In April 2015, 753,900 in-work families receiving tax credits had income under £6,420 and 650,600 had income between £6,421 and £9,999. These figures will include some dual-earner households with total earnings above the threshold that would not benefit. HMRC Child and Working Tax Credits Statistics April 2015, table 6.

66 Q53

67 Q52

68 OBR, Economic and Fiscal Outlook July 2015, table 4.1

Table 3: Illustration of effects of wage growth and tax credit cuts on net income

Single-earner family with two children
No childcare costs; earns £20,000 in 2015-16, rising each year with forecast average earnings growth
All figures expressed in nominal (cash) terms except where specified

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	Change, 2015-16 to 2020-21		
	£ pa	£ pa	£ pa	£ pa	£ pa	£ pa	£ pa	% cash terms	% real terms
Gross earnings	20,000	20,720	21,528	22,389	23,330	24,356	+£4,356	+22%	+12%
Net earnings	16,687	17,257	17,853	18,491	19,184	20,079	+£3,392	+20%	+10%
Tax credit award	5,317	2,787	2,400	1,986	1,535	1,252	-£4,065	-76%	-78%
Child benefit	1,794	1,794	1,794	1,794	1,794	1,828	+£34	+2%	-7%
Total net income (from earnings, tax credits and child benefit)	**23,798**	**21,838**	**22,046**	**22,270**	**22,513**	**23,159**	**-£639**	**-3%**	**-11%**

Source: Work and Pensions Committee calculations. Average earnings growth and CPI inflation in each financial year based on latest OBR forecasts. £12,500 personal allowance assumed in 2020–21

45. Another way of raising family income is to work more hours. Changing working hours can, however, be difficult, especially in the short run. For example, Gingerbread told us that single parents face barriers to working longer hours:

> juggling work and parenting whilst paying the bills including childcare costs, is a serious logistical and financial challenge. When children are younger, working hours are constrained by the greater need for parenting time. Even when children reach school age, ensuring they get to school and are looked after out of school hours and during the holidays is a major consideration.[69]

We also heard that employers, particularly small businesses, may not be able to respond quickly to offer longer working hours even if people are willing and able to work them.[70]

"The answer to tax credits is tax credits"

46. We asked our witnesses whether accelerating the planned increases in *both* the income tax personal allowance and NLW would mitigate the cuts. Torsten Bell told us that even a £12,500 personal allowance and a £9.35 NLW combined would not be sufficient to compensate for the cuts. It would be also be very expensive:

> a single earner couple on £15,000 with kids, they are working full time on the national living wage, even before you take into account the benefit cut later in the Parliament, would still lose £320 this April and it would cost the taxpayer £9 billion to do it, which is twice the savings of tax credit in the first place.[71]

69 Gingerbread written evidence (TXC0002)
70 Q46
71 Q52

47. Mr Bell concluded "tax cuts and the living wage cannot compensate for these tax credit changes. That is not an option". Paul Johnson observed that "if you want to mitigate these changes to the tax credit system you probably have to do it through the tax credit system".[72] Mr Bell concurred: "The answer to tax credits is tax credits".[73]

48. **In the same way that the increase in the personal allowance and minimum wage announced in the Budget do not offer targeted respite from the tax credit cuts, further such changes are not the Chancellor's answer in the Autumn Statement. The gains are to individuals rather than households and are too diffuse to efficiently compensate families facing tax credit cuts. The way to focus on those households is to use the tax credits system. The answer to tax credits is tax credits.**

49. All the alternatives for mitigation we put forward in this Report are therefore focused on the tax credit system.

Changes to tax credits

50. Various options for adjusting the tax credit system to mitigate the cuts are considered below. Throughout, we were aware that something has to give: "any given proposal can only achieve two of saving money, reducing poverty and improving work incentives",[74] what has often been referred to as the "iron law of welfare reform".[75]

51. We asked the IFS to validate our costings for threshold and taper adjustments. They responded:

> We have run these scenarios through our tax and benefit model and we are in broad agreement with your results – certainly close enough for you to be able to publish these as good estimates.[76]

52. The alternatives for short-term reform within the tax credit system include:

- structural adjustments to the threshold and taper rates to reduce the impact of cuts on the least well-off;
- gradual introduction of cuts;
- exempting existing claimants from some or all of the cuts; and
- combinations of the above.

Structural adjustments

53. The two major elements of the proposed cuts to tax credits in 2016-17 have different effects. The cut to the threshold is the more regressive measure as it imposes the same cash cut, £1,054, on all households receiving at least that amount in tax credits and with

72 Q53
73 Q55
74 Resolution Foundation blog, 21 October 2015, We can't (tax) cut our way out of the tax credit problem, by Torsten Bell
75 For example, General Policies to Improve Employment Policies for All, OECD Employment Outlook 2006
76 IFS written evidence (TXC0001). The costings are static and therefore do not account for behavioural effects. We assume, for example, that people work the same number of hours before and after the changes.

incomes over £6,420.[77] Poorer families lose disproportionately more. Changes to the threshold therefore offer the more effective means of lessening the impact on the worst off. Such adjustments, however, are expensive and the threshold cut accounts for £2.9 billion of the £4.4 billion planned savings.[78] The taper increase accounts for the remaining £1.5 billion. The impact of a change in the taper rises with income: it has most effect on the relatively well-off.

Protecting the least well-off

54. We explored options for protecting the least well-off families from the effects of the proposed cuts. One was to maintain the current threshold of £6,420 and keep the current taper rate at 41% for incomes of up to a second threshold of £13,100, equivalent to annual pay one earner working full time at the NLW.[79] For incomes above that level, the taper would revert to 48%. This would entirely protect families with gross incomes below £13,100 from cuts and maintain the planned cuts for families above that income level. However, we calculate this would only save £1.0 billion each year of the £4.4 billion currently planned.[80]

55. One potential means of increasing savings would be to apply a higher taper rate above the second threshold. In Example A below, the taper is 41% between the original and second threshold and 65% above the second threshold. A family earning less than £13,100 would be fully protected from the cuts, while families with incomes about that threshold would face progressively higher losses. We calculate this option would save around £2.7 billion instead of £4.4 billion.[81] The effects on an indicative family at different gross income levels are detailed in the Annex to this Report.

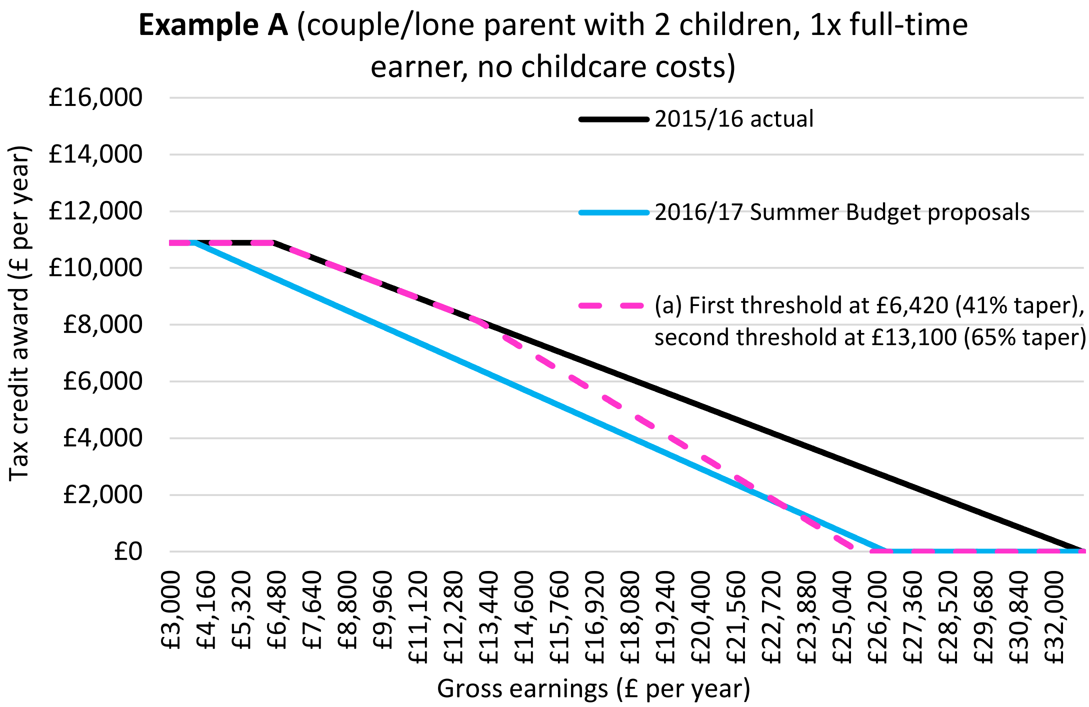
77 For example, all full-time single earner families with two children and no additional entitlements and with incomes between £6,420 and £30,390 would be subject to the same cash cut in tax credits, £1,054, as a result of the threshold change alone.

78 HM Treasury, Summer Budget 2015 Red Book, HC 264, July 2015, table 2.1

79 Calculated as 35 hours at £7.20 per hour for 52 weeks.

80 Work and Pensions Committee calculations validated by the IFS.

81 This is a static costing. Owing to the high marginal deduction rates created it may raise less as people adjust working hours downwards.

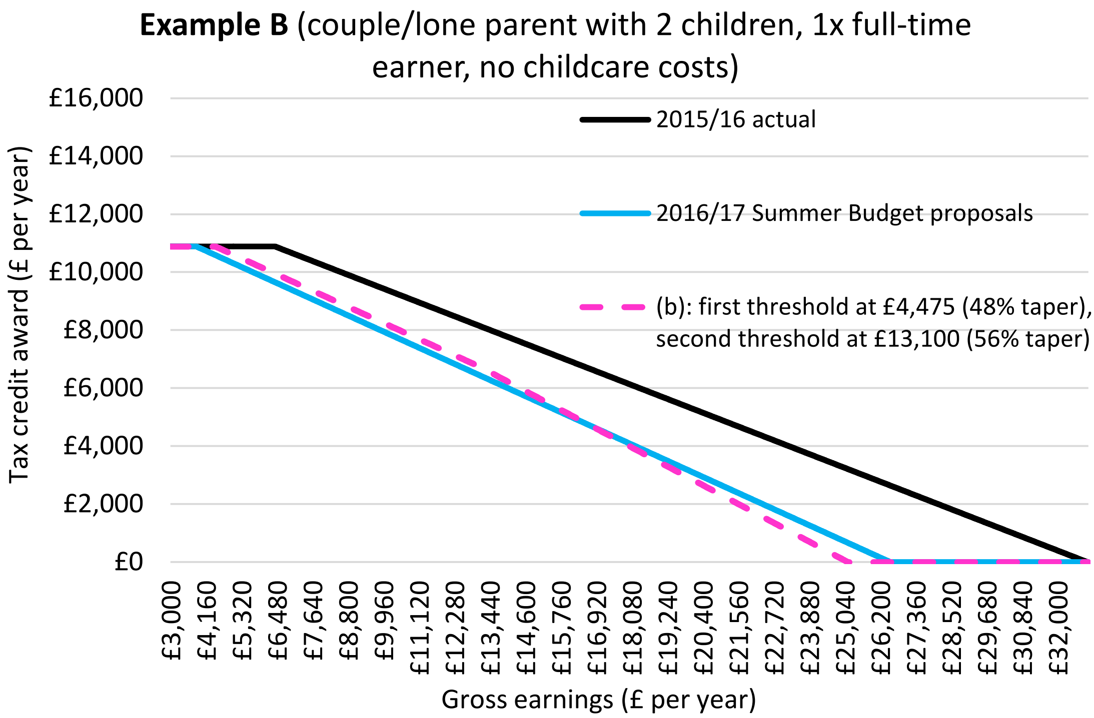


56. The increased taper for families earning above £13,100 would, however, result in a substantial deterioration of work incentives for families earning above this level: a taxpayer subject to a 65% tax credit taper would experience a 97% marginal deduction rate from each extra £1 earned, rising to 99% once housing benefit was taken into account. There would consequently be almost no financial gain from increased earnings.

Attempting cost neutrality

57. Saving more money through in-work tax credits, or reducing the impact on work incentives, requires acceptance of cash losses at the lower end of the income scale. Example B is cost-neutral relative to the options set out in the Budget.[82] The lowest income households receive some limited protection against the cuts through an initial threshold of £4,475 (saving poorer families £300 each a year). There is an initial taper rate of 48% and a second taper rate of 56% above a second threshold of £13,100. The effects on an indicative family at different gross income levels are detailed in the Annex to this Report.

82 Work and Pensions Committee calculations validated by the IFS.



58. This cost neutral option would still, by definition, result in average losses of £1,300 per affected family. These losses would simply be redistributed, further concentrating losses on claimant households higher up the income scale. Incentives to work would also be adversely affected above the second threshold by marginal deduction rates of 88% (96% with housing benefit). The IFS cautioned against further increasing taper rates, arguing they were "quite high enough".[83]

59. There is widespread expectation the Chancellor will consider saving less money from tax credits in the short run. Paul Johnson told us that the most obvious mitigation options were the phasing-in of changes:

> the obvious thing is just to bring this in gradually, whether that means reducing work allowances by a little bit this year, a bit more next year and a bit more the year after, or doing it just for new claimants.

It is to such options we now turn.

Gradual implementation

60. The options available to Government are a pause in implementation, slower implementation and protection for existing claimants. The first two of these approaches would give families more time to prepare for cuts to tax credits. For some, there may be opportunities to work more hours, or to benefit from wage increases. Protection for existing claimants would spare those currently reliant on tax credits from some or all of the proposed cuts.

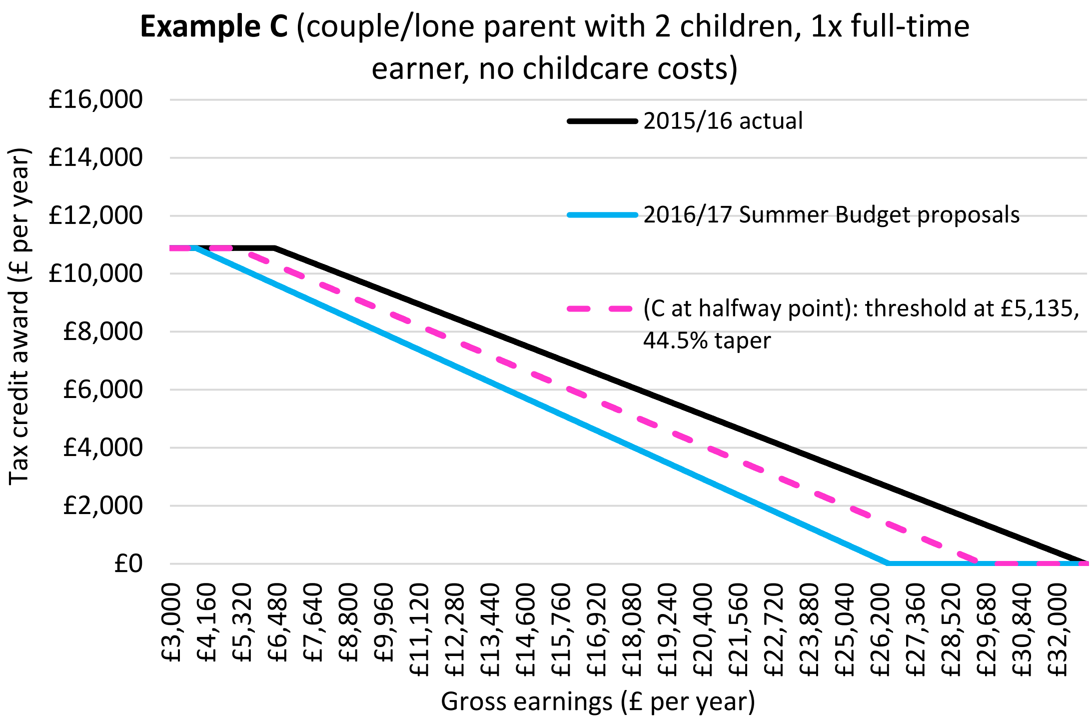
83 Q58

A pause

61. The simplest pause option is to delay the implementation of the cuts by one year. This would mean the Exchequer forgoing the £4.4 billion of savings in 2016-17, before reverting to the planned savings trajectory. Though the announcement of delayed cuts would have some behavioural impacts, the total distributional effects would be very similar to those should the cuts be introduced this year.

Gradual introduction

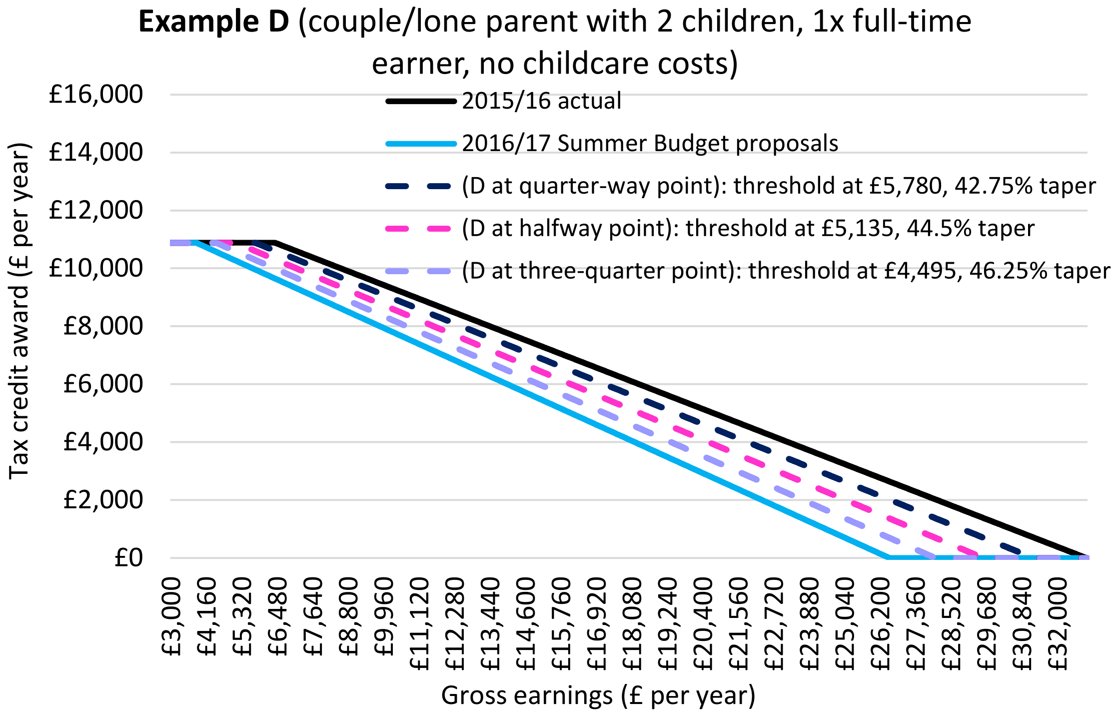
62. In Example C, the changes to the threshold and taper are introduced evenly over two years. So, in 2016-17, the threshold is cut from £6,420 to £5,135 (rather than £3,850) and the taper is increased from 41% to 44.5% (rather than 48%). The cuts would then be made in full in 2017-18. For the vast majority of tax credit recipient families, this would simply halve the cash reduction in their tax credit award in 2016–17. The average income loss per family would be around £650. Commensurate with this, the savings to the Exchequer in that year would halve from £4.4 billion to around £2.2 billion.[84] In subsequent years they would revert to the Budget projections. The effects on an indicative family in 2016–17 at different gross income levels are detailed in the Annex to this Report.



63. An alternative would be to make the cuts incrementally over four years. This option was suggested by, among others, the Centre for Social Justice (CSJ) in a recent paper.[85] In Example D, a quarter of both the threshold cut and taper increase are made in 2016–17, half in 2017-18 and three-quarters in 2018-19, before the changes are made in full in 2019–20. The average cuts for affected families would be around £300 in 2016–17 and would increase each year. The CSJ argued that this would avoid a "cliff edge" drop in incomes while giving "families more time to adjust to the changes and to benefit as the

84 Work and Pensions Committee calculations validated by the IFS.
85 Centre for Social Justice, Reforming Tax Credits, November 2015

National Living Wage and income tax thresholds rise".[86] While £3.3 billion of the £4.4 billion of savings in 2016-17 would be foregone, the difference between new and existing plans would fall year-on-year before being eliminated to enable the single year savings planned in the Summer Budget by 2019–20.[87] The effects on an indicative family at different gross income levels in each of the four years are detailed in the Annex to this Report.



Protecting existing claimants

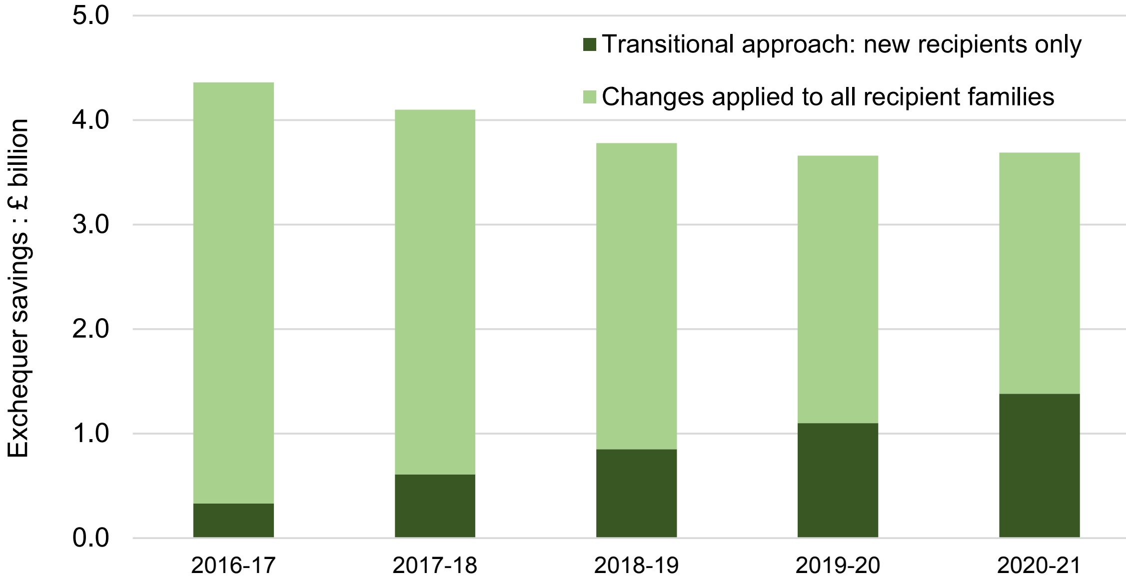
64. A further option is to protect existing tax credit claimants from some or all of the cuts. Estimating the costs of this relies on an understanding of the rates at which families flow on and off tax credits, as well as the typical duration of a claim. Surprisingly, especially given other planned tax credit changes have been restricted to new claimants, these data are not readily available. The Treasury failed to provide information in response to Parliamentary Questions.[88] We also wrote to Ministers in both the Treasury and the Department for Work and Pensions, which has responsibility for the transition from tax credits to UC, but even basic information has not been forthcoming.[89] The Government either does not have this important information or has chosen not to share it with us. Both of these alternatives are worrying.

65. In Example E, we model the potential impact of exempting existing claimants from the cuts over the next four years. This is based on our best available estimate of flow rates, derived from the Treasury's Impact Assessment of restricting access to the family element

86 Centre for Social Justice, Reforming Tax Credits, November 2015
87 Work and Pensions Committee calculations validated by the IFS.
88 House of Commons Parliamentary Questions 13615; 13616; 13617; 13649; 13650; 13651; 13728; 13729; and 13730
89 Letter from Rt Hon Frank Field MP to Damian Hinds MP, 3 November 2015 and letter from Rt Hon Frank Field MP to Rt Hon Lord Freud, 4 November 2015. See also oral evidence by Lord Freud on Benefit delivery, Qq 248-252, HC 372, 4 November 2015

of CTC to existing claimants from April 2017.[90] This suggests that new claimants typically comprise 7.5% of total claimants in a given year. The costs to the Exchequer of this option would be greater, and less certain, than from the alternatives we have considered. We estimate that approximately £300-350 million of the £4.4 billion savings would be realised in 2016-17. The savings in 2017-18 would be approximately double that, £600-£700 million. Similar additional savings would be made in each subsequent year, with the actual path dependent on the progress of UC implementation.[91]

Example E:
Applying the threshold and taper changes to new tax credit/UC recipients only would achieve just under two-fifths of the planned savings by 2020-21



Source: Work and Pensions Committee calculations based on HM Treasury Summer Budget 2015 table 2.1 lines 41 & 42 (threshold and taper changes as announced). Transitional approach costed using projections of caseload on-flow/build up presented in HM Treasury Impact Assessment of changes to family element restriction from 2017 onwards (published 20 July 2015)

66. Applying the cuts to new claimants only would protect existing claimant families from sharp drops in income. However, the IFS cautioned that it would create "a very big incentive to stay on tax credits at the moment rather than risk moving off and coming back on again".[92]

Fiscal wriggle-room

67. Mitigating the effects of the planned cuts to tax credits will most probably reduce the Chancellor's savings in the short run. We heard, however, that providing the savings are made by 2019-20, the Chancellor can make short-term concessions and still meet his fiscal commitments. The IFS told us:

> I think if you do the same thing more gradually the answer is it has very little effect on the long-run public finances. The Chancellor has a target to get to

90 HM Treasury and DWP, Welfare Reform and Work Bill: Impact Assessment of Tax Credits and Universal Credit, changes to Child Element and Family Element, July 2015
91 The Resolution Foundation came to very similar costings in their Presentation on tax credit cuts, 5 November 2015
92 Q53

> budget balance by the end of the decade and so what happens, whether it is £4 billion or £2 billion next year as long as it still has the £4 billion at the end, makes not a great deal of difference.[93]

Torsten Bell added that a budget surplus of £10 billion was projected in 2019–20, meaning that the Chancellor had some "headroom" in meeting his commitments.[94] Continuing low interest rates may also provide flexibility.[95]

Conclusions

68. **There is no magic bullet within the tax credit system. One of three things has to give: the impact on poverty, work incentives or the cost. If one accepts both that the proposed cuts to some families are too great and that the limits of damage to incentives to work have been reached with deduction rates of up to 93%, then a reduction in fiscal savings is inevitable.**

69. **We note that the Government's commitments, both to cut working-age welfare expenditure and to achieve overall fiscal balance, are to be achieved by the end of the current Parliament. Their achievement would not be compromised by the phasing-in of the tax credit cuts.**

70. **In this Report we have set out a range of broad options that the Chancellor may wish to consider in formulating his Autumn Statement. In turn, our analysis should better equip the House to scrutinise the proposals he brings forward.**

71. **Given the scale of the proposed changes, there is no simple way to mitigate them. We recommend that if, indeed, the effects cannot be satisfactorily mitigated, the Government pause any reforms to tax credits until 2017–18. This would allow a broader discussion of the options in their proper context.**

93 Q70
94 Q70
95 FT, 9 November 2015, Low interest rates hand Osborne option to scale back cuts, by George Parker, Chris Giles and Jim Pickard

4 Wider context

Universal Credit

72. The proposed cuts to tax credits take place in the context of the ongoing rollout of Universal Credit (UC). This is expected to result in a more coherent welfare system with improved incentives to work.[96] The Government expects rollout to be complete by 2020–21.[97] Should this planned timetable be met, the argument about tax credits is a short-term one.[98] However, there are considerable risks to the rollout schedule which should caution against relying on UC to come to the rescue.[99]

73. Even in UC, however, marginal deduction rates will reach 76% and, following the Summer Budget, more earnings will be subject to tapering.[100] We heard concerns that the changes to UC were tantamount to accidentally making a "very, very large removal of the original purpose of that entire project".[101] Rt Hon Iain Duncan Smith MP, Secretary of State for Work and Pensions, countered that the highest marginal deduction rates in UC were still lower, and therefore provided greater incentives to work, than those in tax credits.[102] Though work incentives in UC have been eroded, that is undeniably true.

74. It has been reported over recent days that the Chancellor is considering cuts to UC funding as an alternative fiscal saving to some of the tax credit cuts.[103] Again following the iron law of welfare reform, he could only achieve this through either imposing cuts on low income groups or reducing work incentives. A further reduction in UC thresholds would be a regressive move that would disproportionately affect poorer claimants. The *Daily Telegraph* reported on 5 November 2015 that the Chancellor is considering increasing the net income taper in UC from 65% to 75% "and perhaps even higher".[104] A 75% taper would result in the marginal deduction rate faced by taxpayers claiming UC rising from 76.2% to 83.0%. Under such a system, only housing benefit claimants would face lower marginal deduction rates in UC than in the existing tax credit system. For other striving families, additional work would pay even less.

75. **We are concerned by reports that the Chancellor is considering further cuts to Universal Credit as a means of covering adjustments to his tax credit plans. Any such change would either just shift the burden of cuts to different low income families or further undermine the objective of making work pay by removing a higher share of earned income. The Government's flagship welfare reform will struggle to survive further dilution and still achieve its aims.**

96 DWP, Universal Credit: welfare that works, Cm 7957, November 2010
97 Oral evidence by Lord Freud on Benefit delivery, Qq 223-234, HC 372, 4 November 2015
98 National Audit Office, Universal Credit: progress update, HC 786, 26 November 2014
99 Oral evidence by Lord Freud on Benefit delivery, Qq 223-234, HC 372, 4 November 2015
100 Q40
101 Q73
102 Oral evidence by the Secretary of State on the Department for Work and Pensions Annual Report and Accounts, HC 507, 28 October 2015, Q5
103 For example, The Times, 4 November 2015, Hands off Universal Credit warns Duncan Smith, by Sam Coates
104 The Daily Telegraph, 4 November 2015, Why does George Osborne have it in for the workers?, by Fraser Nelson

The wider welfare system

76. Various proposals for how the wider working age welfare system might be used to mitigate the cuts have been made. The CSJ suggested discretionary payments could be used to provide short-term support to affected families.[105] We are currently conducting an inquiry into the local welfare safety net.[106] It is, however, already clear to us that relatively small sums of the order currently devolved to local authorities would not be adequate to compensate for such large cuts to so many families.[107]

77. We asked our witnesses whether there were other credible means of reaching the Government's objective of cutting £12 billion from working-age welfare expenditure by 2020-21. Paul Johnson was clear that there are no easy alternatives in, for example, housing benefit or disability living allowance. He suggested that more ambitious, but contentious, reforms might be considered:

> You could abolish child benefit or roll it up within tax credits or universal credit. That would probably be the least distributionally regressive thing that you could do, but again there are lots of very good reasons why you might not want to do that.[108]

Beyond working age benefits

78. There are limitless possible fiscal savings beyond working age benefits. We did not seek to conduct our own Budget or Spending Review. However, the notable option of reviewing the tax treatment of pensions stood out. Paul Johnson told us:

> The way we treat pension savings for national insurance contributions is staggeringly generous in the sense that no national insurance contributions are ever paid on employer contributions to pensions. You could charge that upfront or you could charge it on pensions in payments and you could start doing that relatively quickly".[109]

79. Within the welfare system, it is clear that repeated savings are being sought from working age benefits while pensioner benefits remain protected. A combination of the generous "triple lock" system of state pension growth and the ageing population mean that pensioner benefits are projected to make up an ever greater proportion of both the welfare bill and total public expenditure.[110]

105 Centre for Social Justice, Reforming Tax Credits, November 2015
106 Work and Pensions Committee, Local welfare safety net inquiry
107 Emergency local welfare assistance is now devolved to local authorities, replacing elements of DWP's discretionary Social Fund. In 2015-16 the Government identified £130 million for local welfare provision in grants to upper-tier local authorities in England, however, such services were to be met from existing budgets. In response to a consultation, the Government allocated an additional £74 million to such schemes. However, this funding was again not ring-fenced and local authorities are free to spend more or less as they see fit. Written Statement (HCWS246) by the Parliamentary Under Secretary of State for Communities and Local Government, Kris Hopkins MP, 3 February 2015.
108 Q67
109 Q69
110 OBR, Fiscal sustainability report and Welfare trends report, both June 2015

A debate on the future of welfare

80. **A pause of a year in the implementation of any major reforms to tax credits would enable a necessary debate about the future of working age benefits, and their position in a sustainable welfare system. This would enable ambitious reforms, going beyond tweaks to a creaking system, to be considered.**

81. **This short inquiry has demonstrated that the Government is reaching the limits of cuts that can be made to the working-age welfare system, and particularly on those who are strivers. At the same time, spending on pensioner benefits will continue to rise sharply and, arguably, unsustainably. We will investigate the generational balance of welfare expenditure over the course of this Parliament.**

Conclusions and recommendations

Effects of the proposed reforms

1. The proposed changes to tax credits in April 2016 will result in very substantial cuts to the incomes of working families, including many with children. There is now general agreement that it would be right for the Chancellor to rethink reforms that went too far and too fast and may have most impact on those in work and striving to succeed. Furthermore, by increasing the rate of withdrawal in taxes and benefits to as much as 93% of additional income, the cuts run against the Government's objective of making work pay. (Paragraph 36)

2. The Summer Budget also included an increase in the income tax personal allowance, the gradual introduction of a higher minimum wage and an expansion of free childcare. These measures are welcome. However, they should not be confused with mitigation for the tax credit cuts; they benefit very different parts of the working population. The majority of working families affected by the proposed cuts would still be worse off in 2020-21 as a consequence of the Budget package. We therefore welcome the Chancellor's commitment to additional measures to lessen the impact of the tax credit cuts. (Paragraph 37)

3. The Treasury has been unacceptably evasive in failing to provide data about the effects of its Summer Budget measures on different income groups. The Government ought also to have been more forthcoming with statistics about flows on and off tax credits. Their obfuscation is not consistent with effective scrutiny; nor is it consistent with effective policy-making. (Paragraph 38)

Mitigation

4. In the same way that the increase in the personal allowance and minimum wage announced in the Budget do not offer targeted respite from the tax credit cuts, further such changes are not the Chancellor's answer in the Autumn Statement. The gains are to individuals rather than households and are too diffuse to efficiently compensate families facing tax credit cuts. The way to focus on those households is to use the tax credits system. The answer to tax credits is tax credits. (Paragraph 48)

5. There is no magic bullet within the tax credit system. One of three things has to give: the impact on poverty, work incentives or the cost. If one accepts both that the proposed cuts to some families are too great and that the limits of damage to incentives to work have been reached with deduction rates of up to 93%, then a reduction in fiscal savings is inevitable. (Paragraph 68)

6. We note that the Government's commitments, both to cut working-age welfare expenditure and to achieve overall fiscal balance, are to be achieved by the end of the current Parliament. Their achievement would not be compromised by the phasing-in of the tax credit cuts. (Paragraph 69)

7. In this Report we have set out a range of broad options that the Chancellor may wish to consider in formulating his Autumn Statement. In turn, our analysis should better equip the House to scrutinise the proposals he brings forward. (Paragraph 70)

8. Given the scale of the proposed changes, there is no simple way to mitigate them. We recommend that if, indeed, the effects cannot be satisfactorily mitigated, the Government pause any reforms to tax credits until 2017-18. This would allow a broader discussion of the options in their proper context. (Paragraph 71)

Wider context

9. We are concerned by reports that the Chancellor is considering further cuts to Universal Credit as a means of covering adjustments to his tax credit plans. Any such change would either just shift the burden of cuts to different low income families or further undermine the objective of making work pay by removing a higher share of earned income. The Government's flagship welfare reform will struggle to survive further dilution and still achieve its aims. (Paragraph 75)

10. A pause of a year in the implementation of any major reforms to tax credits would enable a necessary debate about the future of working age benefits, and their position in a sustainable welfare system. This would enable ambitious reforms, going beyond tweaks to a creaking system, to be considered. (Paragraph 80)

11. This short inquiry has demonstrated that the Government is reaching the limits of cuts that can be made to the working-age welfare system, and particularly on those who are strivers. At the same time, spending on pensioner benefits will continue to rise sharply and, arguably, unsustainably. We will investigate the generational balance of welfare expenditure over the course of this Parliament. (Paragraph 81)

Annex: detailed analysis of effects of reform options on an indicative family

Illustration of the effect of different structural tax credit reform options in 2016-17 (Examples A-C)

Scenario: Single-earner family with two school-age children, working full-time, no childcare costs

		Current system	Summer Budget measures		Reform example A		Reform example B		Reform example C	
		threshold: £6,420 taper: 41%	threshold: £3,850 taper: 48%		thresholds: £6,420 and £13,100 tapers: 48% and 65%		thresholds: £4,475 and £13,100 tapers: 48% and 56%		threshold £5,135 taper: 44.5%	
Gross earnings:	*equivalent to:*	Award (£)	Award (£)	compared to current (£)	Award (£)	compared to current (£)	Award (£)	compared to current (£)	Award (£)	compared to current (£)
£6,420	*current tax credit threshold*	£10,885	£9,651	-£1,234	£10,885	£0	£9,949	-£936	£10,313	-£572
£10,000		£9,417	£7,933	-£1,484	£9,417	-£0	£8,231	-£1,187	£8,720	-£697
£12,200	*35 hrs pw on £6.70 NMW*	£8,515	£6,877	-£1,638	£8,515	-£0	£7,175	-£1,341	£7,741	-£774
£13,100	*35 hrs pw on £7.20 NLW*	£8,146	£6,445	-£1,701	£8,146	-£0	£6,743	-£1,404	£7,341	-£806
£15,000		£7,367	£5,533	-£1,834	£6,911	-£456	£5,679	-£1,689	£6,495	-£872
£17,500		£6,342	£4,333	-£2,009	£5,286	-£1,056	£4,279	-£2,064	£5,383	-£960
£20,000		£5,317	£3,133	-£2,184	£3,661	-£1,656	£2,879	-£2,439	£4,270	-£1,047
£25,000		£3,267	£733	-£2,534	£411	-£2,856	£79	-£3,189	£2,045	-£1,222
£26,000		£2,857	£253	-£2,604	£0	-£2,857	£0	-£2,857	£1,600	-£1,257
£27,000		£2,447	£0	-£2,447	£0	-£2,447	£0	-£2,447	£1,155	-£1,292
£27,190	*Median full-time salary, UK*	£2,369	£0	-£2,369	£0	-£2,369	£0	-£2,369	£1,071	-£1,299
£30,000		£1,217	£0	-£1,217	£0	-£1,217	£0	-£1,217	£0	-£1,217

Source: Work and Pensions Committee calculations

Staggered implementation of tax credit threshold and taper changes over four years (Example D)

Scenario: Single-earner family with two school-age children, working full-time, no childcare costs

		Current: 2015–16	Quarter-way point: 2016–17		Halfway point: 2017–18		Three-quarter way: 2018–19		Full implementation: 2019–20	
		threshold: £6,420 taper: 41%	threshold: £5,780 taper: 42.75%		threshold: £5,135 taper: 44.5%		threshold: £4,495 taper: 46.25%		threshold: £3,850 taper: 48%	
Gross earnings:	*equivalent to:*	Award (£)	Award (£)	compared to current (£)	Award (£)	compared to current (£)	Award (£)	compared to current (£)	Award (£)	compared to current (£)
£6,420	*current tax credit threshold*	£10,885	£10,611	-£274	£10,313	-£572	£9,995	-£890	£9,651	-£1,234
£10,000		£9,417	£9,081	-£336	£8,720	-£697	£8,339	-£1,078	£7,933	-£1,484
£12,200	*35 hrs pw on £6.70 NMW*	£8,515	£8,140	-£375	£7,741	-£774	£7,321	-£1,194	£6,877	-£1,638
£13,100	*35 hrs pw on £7.20 NLW*	£8,146	£7,756	-£391	£7,341	-£806	£6,905	-£1,241	£6,445	-£1,701
£15,000		£7,367	£6,943	-£424	£6,495	-£872	£6,026	-£1,341	£5,533	-£1,834
£17,500		£6,342	£5,875	-£468	£5,383	-£960	£4,870	-£1,472	£4,333	-£2,009
£20,000		£5,317	£4,806	-£511	£4,270	-£1,047	£3,714	-£1,603	£3,133	-£2,184
£25,000		£3,267	£2,668	-£599	£2,045	-£1,222	£1,401	-£1,866	£733	-£2,534
£26,000		£2,857	£2,241	-£616	£1,600	-£1,257	£939	-£1,918	£253	-£2,604
£27,000		£2,447	£1,813	-£634	£1,155	-£1,292	£476	-£1,971	£0	-£2,447
£27,190	*Median full-time salary, UK*	£2,369	£1,732	-£637	£1,071	-£1,299	£389	-£1,981	£0	-£2,369
£30,000		£1,217	£531	-£686	£0	-£1,217	£0	-£1,217	£0	-£1,217

Source: Work and Pensions Committee calculations

Formal Minutes

Monday 9 November 2015

Members present:

Rt Hon Frank Field, in the Chair

Heidi Allen	Mrs Emma Lewell-Buck
Mhairi Black	Craig Mackinlay
Ms Karen Buck	Steve McCabe
John Glen	Jeremy Quin
Richard Graham	Craig Williams

Draft Report (*A reconsideration of tax credit cuts*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 81 read and agreed to.

Summary agreed to.

Annex agreed to.

Resolved, That the Report be the Third Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Wednesday 18 November at 9.15 a.m.

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry page of the Committee's website.

Monday 26 October 2015

Question number

Paul Johnson, Director, Institute for Fiscal Studies, **William Elming**, Research Economist, Institute for Fiscal Studies, **Torsten Bell**, Director, Resolution Foundation, and **Adam Corlett**, Economic Analyst, Resolution Foundation — Q1–76

Published written evidence

The following written evidence was received and can be viewed on the inquiry page of the Committee's website.

1 Gingerbread (TXC0002)

2 Institute For Fiscal Studies (TXC0001)

3 Resolution Foundation (TX0003)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website.

Session 2015–2016

First Report	Pension freedom guidance and advice	HC 371
Second Report	Welfare-to-work	HC 363