Example 11.2
Welfare to Work – the Case of the U.K. Working Families Tax Credit (WFTC)*

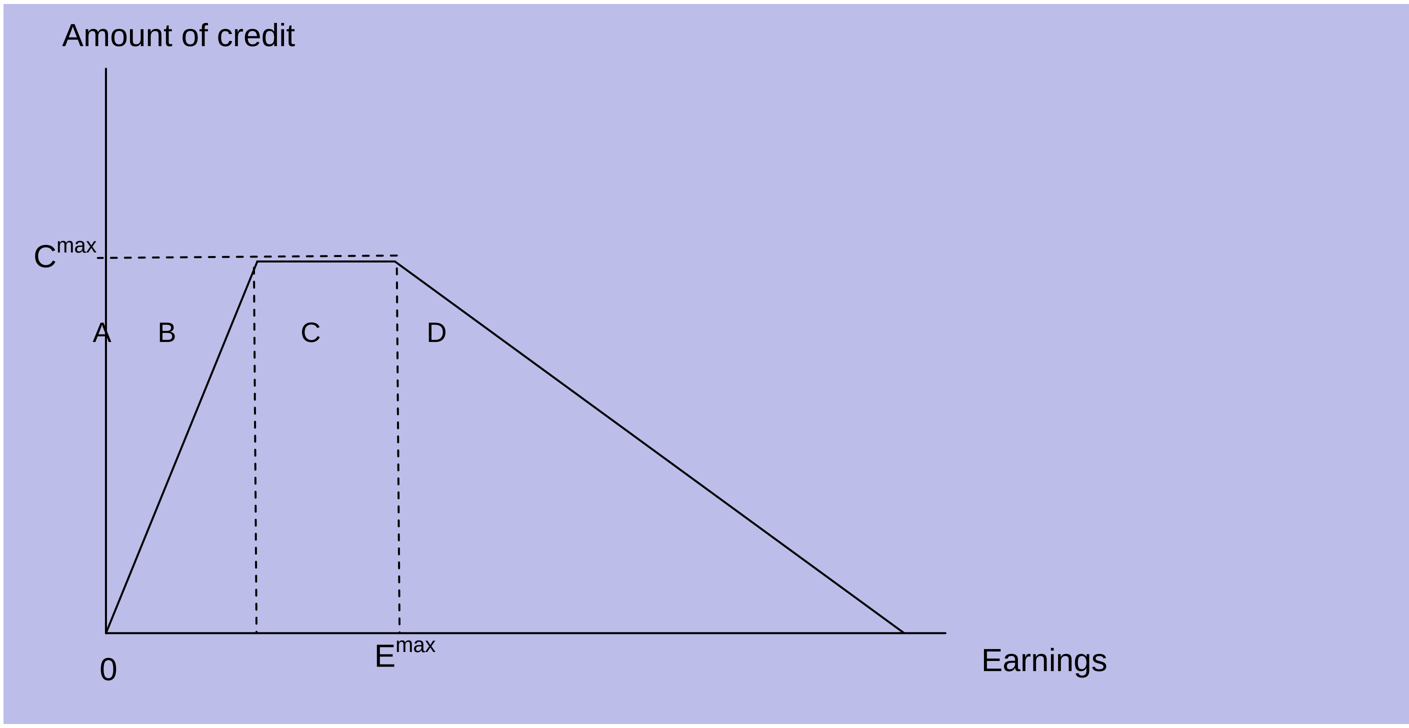
In-work tax credits, such as the Earned Income Tax Credit (EITC) in the U.S. and the Working Families Tax Credit (WFTC) in the U.K., are an increasingly important element in the program of government transfers to the poor. The way in which these credits work is shown in a very simplified form in the figure below. The amount of credit received depends on (household) earnings. So long as someone is in work with positive earnings the amount of the credit increases until it reaches a maximum (C^{max}); then, after a threshold level of earnings has been reached (E^{max}), it is gradually tapered away until zero. For the WFTC, introduced in the U.K. in 1999, the taper rate was set at 60%. In other words, for each additional pound of earnings above the threshold, the individual would lose 60 pence of credit.

In designing a system of credits, governments have to decide on a number of key parameters. First, who is eligible to receive the credits? In the U.K. receipt of the WFTC was further made conditional on working at least 16 hours a week to avoid people working only a very few hours. And it was only available to households with at least one dependent child. This was both in recognition of the additional costs of working for families with children and because of the U.K. government's priority of reducing child poverty. Second, the government has to set C^{max}, E^{max} and the rate at which to taper away the credit. This involves key trade-offs between ensuring that the benefits are generous enough at the bottom end and that the taper rate is not a punitively high marginal tax rate, and avoiding paying benefits to relatively well-off households.

How do in-work credits perform when judged against the three criteria set out in Chapter 11?

*Example prepared by Sarah Smith, University of Bristol

Figure 1 In-work Tax Credits: A Stylized Illustration



Poverty reduction

In-work credits do not succeed in getting everyone out of poverty. Since they are not paid to people who do not work they do nothing to help workless households, who are among the very poorest. Also, as with most benefits, there are problems of take up, that is, not everyone who is eligible to receive the credits actually does so. Because WFTC is administered through employers (people receive it in their pay packets rather than via the benefits office) the stigma of receipt may be less than in the case of traditional means-tested benefits, but individuals are required to put in a lengthy claim and this, together with lack of awareness of the benefits, may put some people off. It has been estimated that around one-quarter of those who are eligible for the WFTC fail to make a claim. (Refer to Example 11.1 on the take-up problem.)

The system of in-work credits in the U.K. has recently been heavily criticized after the government attempted to claim back money that was overpaid to households. Payments are fixed for six months but people need to notify the government of any change in their circumstances that would result in a change in the amount they are entitled to. Failure to do so results in under- or overpayment of credit that the government must make up or take back. The amounts involved were fairly substantial – both in aggregate terms (nearly £2 billion out of a total of £14 billion paid out was estimated to be overpayment) and for the individual households who were asked to pay back hundreds or even thousands of pounds.

Cost

Because in-work credits are targeted they are likely to be less costly than universal benefits. The cost depends heavily on the choice of C^{max}, E^{max} and the taper rate.

Incentives

The main selling point of in-work credits compared with traditional means-tested benefits has been their positive work incentive effects. Means-tested benefits are effective at targeting resources but create strong disincentives to work because any earnings result in lost benefits. On the face of it in-work credits avoid this problem because eligibility is conditional on employment. As is clear from the discussion in Chapter 11, however, the work incentive effects created by in-work credits are not unambiguously positive.

The work incentive effects of introducing in-work credits depend on (pre-reform) earnings. In the figure above, the letters A–D correspond to different effects:

- For someone at A (currently out of work), in-work credits have a positive substitution effect which will tend to increase work and no income effect. The overall effect is unambiguously positive.
- For someone at B, in-work credits have a positive substitution effect which tends to increase work but also a positive income effect, which tends to reduce work. The overall effect is ambiguous.
- For someone at C, there is no substitution effect and a positive income effect. The overall effect is unambiguously negative.
- For someone at D, there is a negative substitution effect and a positive income effect. Again, the overall effect is unambiguously negative.

If there is no one else in the household working (that is, lone parents or single-earner couples) then the negative incentive effect could reduce hours worked, but not cause exit from employment because this would lose entitlement to the credit. For this group, therefore, the overall effect of the credit should be to increase the rate of employment (this is known as an increase along the extensive margin), but possibly to reduce hours (known as a reduction along the intensive margin). Partners of working spouses, however, remain eligible on the basis of their partners' earnings and so may have an incentive to withdraw from the labour market altogether.

A number of studies have looked at the effect of the WFTC on employment. Most have focused on lone parents and most have considered changes in the extensive margin (that is, changes in the rate of employment). They have typically used a "difference-in-differences" approach, which involves comparing the employment of lone parents before and after the reform (the first difference) and contrasting this with the change in employment over the same period of another group to control for other factors (particularly labour-market conditions) that might have caused employment of lone parents to change over time (the second difference). There are two obvious control groups – one is single women with no kids and the other is married women with children, although employment among the latter group is arguably also affected by the introduction of the reform:

$$\text{Effect of WFTC} = \Delta\text{ (employment of lone parents)} - \Delta\text{ (employment of single women with no kids)}$$

These studies indicate that the effect of WFTC was to increase employment among lone parents by around 10% (representing an additional 60,000–85,000 lone parents in work). Studies which have looked at rates of employment among women in couples have found either no effect or a small, but statistically insignificant, negative effect.

Less widely discussed, but also very important, are the possible incentive effects of in-work credits on partnership and childbearing. Particularly in the U.S. where many benefits have been targeted at lone parents, government programs have been widely criticized for encouraging female headship. Crudely characterized, women may be better off "married to the state" rather than married to a low-earning or unemployed partner. This is also a possible area of concern in the U.K., given the growing interest in government policies to support the family. Like work incentives, however, the incentive effects of in-work credits for partnering are ambiguous and depend on household circumstances. While they penalize dual-earner couples and support working lone parents, thereby reducing the financial incentive to re-partner, in-work credits support one-earner couples and make low-earning (male) partners more attractive, at least financially. A detailed study by Dan Anderberg (2008) shows that the introduction of the WFTC was associated with an increase in the number of couples who faced partnership bonuses (that is, financial rewards from the government for being together) rather than partnership penalties. Further work presented by Paul Gregg and co-authors (2007) shows that there is no evidence that there was an increase in the number of lone parents attributable to the introduction of in-work credits in the U.K.

Finally, the introduction of in-work credits for families with children may have an effect on childbearing. Increases in the generosity of government support for children reduce the "price" of children, which should increase the demand for children all other things being equal. The positive effect on household income should also increase the demand for children assuming they are a normal good, although Gary Becker[1] has argued that higher incomes raise the demand for the quality of children, with parents choosing to have fewer children but investing more resources in each one. If in-work benefits encourage employment, this may reduce childbearing since the opportunity cost is now

[1] Gary Becker (1991): *A Treatise on the Family,* Massachussetts: Harvard University Press

higher. But, as we have seen, for women in couples this was less the case and indeed the opportunity cost may be lower for many. In line with these theoretical predictions, there is some preliminary evidence from Mike Brewer and colleagues (2007) showing that childbearing among women in couples did respond positively to the introduction of the WFTC. And while this may seem unlikely to some, it is worth considering that the introduction of WFTC caused the value of benefits to a household with one child to increase by more than £1,000 a year (or 10% of income). Is it plausible that such large changes would not have an effect on childbearing?

Sources and Further Reading

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