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BRIEFING PAPER

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Tax Credit changes from April 2016

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Summary

Summer Budget 2015 announced a package of welfare measures expected to yield savings of £13 billion a year by 2020-21. Changes to tax credits and to Universal Credit (UC) (which is replacing tax credits and means-tested social security benefits) taken together are expected to save £4.6 billion in 2016-17, rising to £5.8 billion a year by 2020-21.

The *Welfare Reform and Work Bill* introduced following the Budget provides for the child element in tax credits and in UC to be limited to two children for new claims and births after April 2017, and abolishes the family elements in tax credits and UC for new claims from 2017.

The draft *Tax Credits (Income Thresholds and Determination of Rates) (Amendment) Regulations 2015*, which were published on 7 September and are scheduled to be debated on the floor of the House on Tuesday 15 September, introduce two other important elements in the Budget tax credits package: the increase in the taper rate from 41% to 48%, and reductions in the income thresholds. These changes take effect from April 2016, and will deliver savings of around £4.4 billion in 2016-17. There is no transitional protection for existing families on tax credits.

These changes from April 2016 will affect almost all in-work recipients of tax credits. At April 2015, 3.3 million in-work families received tax credits, of whom 2.7 million had children. The average impact across all affected families can be roughly estimated as a reduction in the tax credit award of around £1,300 in 2016-17. The actual impact will vary from family to family however; some will lose more than this amount, others less. Some families will lose entitlement to tax credits completely.

This note outlines what tax credits are, the changes announced in the Summer Budget 2015 and how these changes will be implemented. It also estimates what impact these changes will have for families in combination with other measures announced in the Summer Budget 2015, such as introduction of the National Living Wage, the increase to the Personal Allowance and freeze in Child Benefit.

1. What are tax credits?

Tax credits – the Child Tax Credit and the Working Tax Credit – were introduced in April 2003. They replaced Working Families Tax Credit and Disabled Persons Tax Credit, which had been introduced in 1999.

At April 2015, **4.6 million families containing 7.6 million children were receiving tax credits**. 3.3 million tax credit recipients (72% of the total) were in-work families, of whom 2.7 million had children.[1]

Total expenditure on tax credits in the UK is forecast to be **£29.5 billion in 2015-16**. Expenditure on tax credits increased significantly in real terms during Labour's term in office.

Tax credits comprise:

Child Tax Credit (CTC), payable to people with children. Along with Child Benefit, it provides a single system of financial support for families with children, whether in or out of work. It also replaced the additions for children that were payable with benefits such as Income Support and income-based Jobseeker's Allowance.

Working Tax Credit (WTC), payable to people in low-paid work, including those without children. Those with children may be able to get help with childcare costs via the childcare element of the Working Tax Credit.

People may receive the CTC, or the WTC, or both. **Tax credits are claimed on a family rather than an individual basis**, so that for couples the incomes and circumstances of both partners will be taken into account.

How much a family receives from tax credits will depend on a number of factors including:

- The **number** and **age** of the children, and whether any are disabled
- The **number of hours worked** by the adults, and whether they are disabled
- Whether the family is incurring **childcare costs** for eligible childcare
- The family's **income from earnings** and other sources

Tax credits are **means-tested**; i.e. the amount received depends on income, so that in general the amount received tapers away as income increases. For families eligible for Working Tax Credit, the maximum tax credit award is withdrawn at the rate of 41p for every pound gross income in excess of the income threshold (currently £6,420 a year). For

[1] HMRC, Tax Credits Provisional Statistics: April 2015

families eligible for Child Tax Credit only[2], the income threshold is currently £16,105.[3]

Tax credits – along with means-tested benefits – are to be replaced by **Universal Credit**, but even under the most optimistic scenario for the introduction of UC, some people will still be in receipt of "legacy benefits" in 2020.

2 Many families in receipt of tax credits who are eligible for both WTC and CTC will only be in receipt of CTC because their award of WTC will have tapered to zero because of their earnings. WTC will however have been taken into account in the calculation of their overall tax credit award. The reference here to "families eligible for Child Tax Credit only" refers to families not eligible for WTC.

3 For further information on how awards are calculated see "What are tax credits?" in HMRC's Child and Working Tax Credit Statistics - Finalised annual awards 2013-14

2. What was announced in the Summer Budget?

2.1 Changes announced

Summer Budget 2015 announced a package of measures aimed at "making Tax Credits and Universal Credit fairer." In presenting the measures, the Red Book emphasised the growth in spending on tax credits, and the need to focus on the "root causes of low pay":

> **1.141** Tax credit expenditure more than trebled in real terms between 1999-00 and 2010-11, with total expenditure in 2014-15 estimated to be around £30 billion – an increase of almost £10 billion in real terms over the last 10 years. UK expenditure on family cash benefits is the highest in the OECD, and was double the OECD average in 2011. 9 out of 10 families with children were eligible for tax credits in 2010. As a result of the reforms undertaken in the last Parliament, 6 out of 10 are eligible currently.
>
> **1.142** The government believes that now is the best time to address this growing expenditure if the welfare system is to be put on a sustainable footing. Tackling tax credit spending is part of properly addressing the root causes of low pay, with the new NLW [National Living Wage] and a more generous tax system to help people earn more and keep more of what they earn, rather than addressing only the symptoms of the problem by subsidising low pay through the benefit system.
>
> **1.143** The Budget will therefore reform the tax credits system (and its successor, Universal Credit) to protect existing families on the lowest incomes while favouring support to working families through the tax system and earnings growth, rather than the benefit system.[4]

The welfare measures announced in the Summer Budget are expected to **yield savings of £12 billion a year in 2019-20**, rising to £13 billion in 2020-21. The changes to tax credits and to Universal Credit taken together are expected to save £4.6 billion in 2016-17, rising to £5.8 billion in 2020-21. The **changes will see expenditure on tax credits return to 2007-08 levels in real terms**. The main savings arise from:[5]

- **Reducing the income thresholds** in tax credits and UC work allowances, so that maximum awards start to be withdrawn at a

4 Summer Budget 2015, HC 264 2015-16

5 The Budget also announced a reduction in the in-year income disregard – which allows income increases below a certain amount to be disregarded when calculating entitlement to tax credits – from £5,000 to £2,500 from April 2016, saving £170 million in 2016-17. The previous Government had already reduced the disregard from £25,000 to £10,000 in April 2011, and to £5,000 in April 2013. The further reduction will increase the number of tax credit overpayments. The draft *Tax Credits (Income Thresholds and Determination of Rates) (Amendment) Regulations 2015* provides for the reduction in this threshold, but it is not considered further in this note.

lower income level (saving £2.9 billion a year in 2016-17, rising to £3.4 billion a year by 2020-21);

- **Increasing the tax credits withdrawal rate** (taper) from 41% to 48%, so that tax credits reduce more sharply as income increases (saving £1.5 billion in 2016-17, declining to £245 million by 2020-21);
- **Limiting the child element** of tax credits and UC to two children for new claims and births after April 2017 (saving £1.4 billion a year by 2020-21); and
- **Removing the family element** in tax credits and UC (and the family premium in Housing Benefit) for new claims from 2016 or 2017 (saving £675 million a year by 2020-21)

The **Institute for Fiscal Studies** estimates that the long-run savings from some of the measures will be even greater (as transitional protection for existing families declines). It estimates the long-run savings from the abolition of the family element at around £2 billion a year, and from removing tax credit/UC support for third and subsequent children at around £3 billion a year.[6] At April 2015, just under 900,000 families (of whom 590,000 were in work) were receiving tax credits for three or more children.[7]

2.2 Implementation

The ***Welfare Reform and Work Bill*** introduced following the Budget provides for the child element in tax credits and in UC to be limited to two children for new claims and births after April 2017, and abolishes the family elements in tax credits and UC for new claims from 2017.

The changes to the tax credits taper and income threshold from April 2016 do not require primary legislation and can be made via regulations. The draft ***Tax Credits (Income Thresholds and Determination of Rates) (Amendment) Regulations 2015***, published on 7 September, makes the necessary amendments to the taper and to thresholds. The regulations are subject to the affirmative procedure.

6 Andrew Hood, Benefit changes and distributional analysis, IFS presentation, 9 July 2015

7 HMRC, Child and Working Tax Credits Statistics: April 2015, Table 3.2

3. How will tax credit awards change from April 2016?

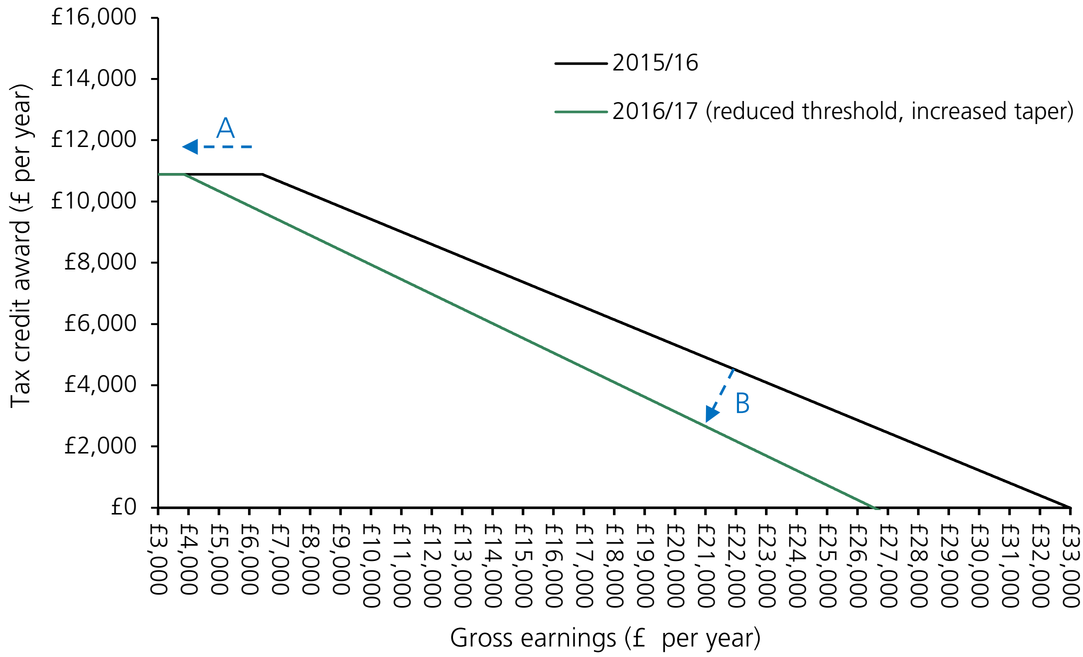
For most working families receiving tax credits, the lower threshold and increased taper rate have the combined effect of reducing a working family's tax credit award in 2016/17 by:

A- 48% of the difference between the old and new thresholds (48% of £6,420-£3,850 = £1,233.60)

B- 7% of gross earnings above £6,420 (this income is currently tapered at 41%, from 2016 at 48%)

Figure 1 illustrates the combined impact of **the increase in the taper rate** and the **reduction in the income threshold** for a working family (lone parent or couple, working 30 hours or more) with two children. It is assumed no additional amounts are payable for disability or for childcare costs.

Figure 1: Impact of threshold reduction and increased taper rate on a couple/lone parent with two children, 1 full time earner, no childcare costs



The combined impact of these changes is to reduce tax credit awards for working families and to take some families out of tax credits altogether – in this example, **the tax credit award is extinguished for earnings above approximately £26,520 instead of £32,960**.

Families who do not satisfy the conditions for Working Tax Credit – Child Tax Credit only claimants – will not be affected as by the changes as outlined above. However, the separate, higher income threshold for CTC only claimants is also to reduce in April 2016, from £16,105 a year to £12,125. These changes will impact upon families eligible for CTC only with incomes (for tax credit purposes) in excess of £12,125.

4. How many families will be affected?

The main group affected by the tax credit changes in April 2016 will be **in-work families eligible for Working Tax Credit**.[8] All such families with incomes in excess of the new, lower threshold of £3,850 will be affected.

At 3 April 2015, of the 4,567,000 individuals and families in receipt of tax credits, 3,277,000 were in-work, of whom 2,719,000 were working families with children, and 558 were people without children who were receiving Working Tax Credit.[9]

In 2016-17, the increase in the tax credit taper rate to 48% and the reductions in the income thresholds is expected to result in **savings totalling £4.355 billion**. Assuming savings accrue only from in-work families (ie ignoring the impact of the reduction in the threshold for CTC only families) gives a rough estimate of the **average loss across all in-work families in the region of £1,300 in 2016-17**. This is an average figure however – for some families, the loss will be greater, for others less.

In general, losses from the combined effect of the threshold reduction and taper increase will be greater for tax credit claimants with relatively higher incomes (as indicated by the diverging lines in the chart above. However, for some families at higher income levels the changes will reduce their tax credits entitlement to nil.

The impact in constituencies – constituency level data

Constituency data on the impact of welfare measures announced in the Summer Budget 2015 is available from the Library's Summer Budget 2015: a summary briefing paper. The attached spreadsheet shows the number of families receiving Child and Working Tax Credits by constituency, including a breakdown for in- and out- of work families and families with children. The spreadsheet also shows the number of children in these families.

Almost all in-work families will be affected by the changes to tax credits discussed above. Therefore, the number of in-work families in a constituency is a reasonable guide to the number of families in a constituency that will be impacted by these changes.

8 While Child Tax Credit only claimants may be affected by the reduction in the income threshold for that group from £16,105 to £12,125, only 35,000 of the 1,290,000 families receiving CTC only at April 2015 were receiving less than the maximum CTC because they had income in excess of the £16,105. This suggests the impact of the lower threshold for CTC only families may have less of an impact than the lower threshold for those eligible for WTC.

9 HMRC Child and Working Tax Credits Statistics April 2015

5. What about other measures announced in the Summer Budget?

The Summer Budget 2015 included other measures that will impact upon the income of individuals and families. These included:

National Minimum Wage & National Living Wage

An increase in the National Minimum Wage for people aged 25 and over. From April 2016 the "National Living Wage" (NLW) is to be set at £7.20 an hour. The intention is to increase the NLW so that it reaches 60% of median hourly wages by 2020. Based on Office for Budget Responsibility estimates, the NLW would rise to £9.35 an hour by April 2020.

Personal Allowance increase

An increase in the income tax Personal Allowance to £11,000 in 2016-17. It is the Government's "ambition" to increase the Personal Allowance further to £12,500 by 2020.[10]

Child Benefit frozen

A freeze in Child Benefit for the duration of the Parliament, after which time it shall be uprated by CPI.

5.1 Impact of combined Budget measures on a single-earner couple with two children

Figure 2 shows the combined impact of these measures – together with changes to tax credits - on **a single-earner couple with two children, neither of whom is in childcare, working 35 hours a week on the National Minimum/Living Wage**. It compares the impact of these measures ("Scenario 1a") to a "counterfactual" scenario ("1b") in which the Summer Budget 2015 did not occur and policy inherited from the Coalition government is extrapolated to the end of this Parliament unchanged.

[10] HM Treasury, Summer Budget 2015: key announcements, 8 July 2015

Figure 2: Final tax credit award, child benefit and net income of a single-earner couple (with two children) working 35 hrs a week

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Scenario 1a - Transfer from the NMW to the NLW in 2016-17, Summer Budget 2015 changes applied						
Gross Earnings p.a.	£12,227	£13,139	£14,052	£14,964	£15,968	£17,063
Net earnings p.a.	£11,402	£12,102	£12,769	£13,441	£14,179	£15,120
Final tax credit award	£8,504	£6,426	£5,988	£5,550	£5,068	£4,753
Child benefit receipt	£1,794	£1,794	£1,794	£1,794	£1,794	£1,828
Net Income p.a.	***£21,699***	***£20,322***	***£20,551***	***£20,785***	***£21,041***	***£21,700***
Scenario 1b - Counterfactual, ignoring changes announced in the Summer Budget 2015						
Gross Earnings p.a.	£12,227	£12,774	£13,231	£13,778	£14,417	£14,964
Net earnings p.a.	£11,401	£11,774	£12,116	£12,539	£13,026	£13,693
Final tax credit award	£8,504	£8,280	£8,223	£8,183	£8,131	£8,132
Child benefit receipt	£1,794	£1,794	£1,815	£1,846	£1,880	£1,914
Net Income p.a.	***£21,699***	***£21,847***	***£22,153***	***£22,568***	***£23,037***	***£23,738***
Comparison of scenarios 1a and 1b						
Gross Earnings p.a.	+£0	+£365	+£821	+£1,186	+£1,551	+£2,099
Net earnings p.a.	+£0	+£328	+£653	+£902	+£1,153	+£1,427
Final tax credit award	-£0	-£1,853	-£2,235	-£2,633	-£3,063	-£3,379
Child benefit receipt	£0	£0	-£21	-£52	-£86	-£86
Net Income p.a.	+£0	-£1,525	-£1,603	-£1,783	-£1,996	-£2,038

Source
House of Commons Library calculations

Scenario 1a shows that in 2015-16 the annual gross earnings of someone working 35 hours a week on the **National Minimum Wage** (£6.70 an hour from October 2015) will be **£12,227**.

In 2016-17 the **National Living Wage** will be £7.20 per hour, equivalent to an **annual gross earnings of £13,139** for someone aged 25 or over working 35 hours a week. This will increase to approximately £9.35 per hour in 2020-21 according to forecasts in the Summer Budget 2015, equivalent to an **annual gross earnings of £17,063** for someone (aged 25 or over) working 35 hours a week.

Given these assumed changes in earnings a single-earner family with 2 children and 1 adult (aged 25 or over) working 35 hours a week will **receive £8,504 in tax credits in 2015-16**, falling to £6,426 in 2016-17 and to **£4,753 in 2020-21**.

Child Benefit will be frozen for the duration of the Parliament, after which time it shall be uprated by CPI. Therefore, the family shall receive **£1,794 in child benefit each year 2015-16 to 2019-20** and £1,828 in child benefit in 2020-21.

Net income of this family, accounting for changes to tax credits, the Minimum Wage, Child Benefit and the Personal Allowance announced in the Summer Budget, will **fall from £21,699 in 2015-16 to £20,322 in 2016-17**. In 2020-21 the family's net income shall be £21,700.

Comparison of these projections to a "counterfactual" scenario shows that **in 2016-17 the family's net income would be £1,525 below**

what it would otherwise have been had changes announced in the Summer Budget 2015 not been applied.

5.2 Impact of combined Budget measures by household working status and whether or not a household contains children

The **Institute of Fiscal Studies** has analysed the combined impact of changed announced in the Summer Budget 2015. **Figure 3**, based on the IFS's 10 September 2015 briefing note, shows the impact of forthcoming tax and benefit changes and gains from the new National Living Wage by household working status and whether or not the household contains children.

Average gains from the NLW are based on a "better case" calculated by the IFS. This assumes the overall increase in gross wages due to the NLW to be £5.6 billion, compared to £4 billion suggested by the Office for Budget Responsibility (see page 10 of the IFS briefing note for further details).

Figure 3: Estimated impact of forthcoming tax and benefit changes and "better case" gains from the new NLW, by household working status and whether or not the household contains children

	Number of households (millions)	Av. Annual impact of tax & benefit changes (£ per year)	Av. "better case" annual gain from the new NLW (£ per year)	**Av. "better case" net change (£ per year)**	*"Offset" (impact of NLW as % of impact of benefit & TC changes)*
All households	27.1	-£478	£129	**-£348**	*27%*
All working age HH eligible for benefits/tax credits	11.3	-£1,089	£147	**-£942**	*13%*
Of which:					
with somone in paid work	8.4	-£754	£198	**-£556**	*26%*
w/o someone in paid work	2.9	-£2,069	£0	**-£2,069**	*0%*
All working age HH eligible for benefits/tax credits with children	7.0	-£1,272	£144	**-£1,127**	*11%*
Of which:					
with somone in paid work	5.9	-£909	£172	**-£737**	*19%*
w/o someone in paid work	1.1	-£3,159	£0	**-£3,159**	*0%*
All working age HH eligible for benefits/tax credits w/o children	4.3	-£796	£153	**-£643**	*19%*
Of which:					
with somone in paid work	2.6	-£400	£257	**-£142**	*64%*
w/o someone in paid work	1.8	-£1,374	£0	**-£1,374**	*0%*

Source
Based on table 2 page 13, IFS Briefing Note BN175 (10 September 2015)

Figure 2 shows that:

- Among the **2.9 million working age households eligible for benefits or tax credits and not containing anyone in work** the average loss from the cuts to benefits and tax credits is estimated at **£2,070 per year**, with no offsetting compensation from the NLW.

- Among the **8.4 million working age households who are currently eligible for benefits or tax credits who contain someone in paid work** the average loss from the cuts to benefits and tax credits is **£750 per year**. Gain from the NLW among this group, according to the IFS' "better case" scenario, is estimated at **£200 per year** – offsetting **26%** of losses.

- Among the **4.3 million working age families who are eligible for benefits or tax credits but do not have children** the average loss from cuts to benefits and tax credits is **£800 per year** and the average gain from the NLW (under the "better case" scenario) **£150 per year** – offsetting **19%** of losses.

- Among the **7 million working age families who are eligible for benefits or tax credits and who have children** the average loss from cuts to benefits and tax credits is **£1,270 per year** and the average gain from the NLW (under the "better case" scenario) is **£140 per year** – offsetting **11%** of losses.[11]

[11] These findings are summarised from pages 12 to 14 of the IFS briefing note BN175 (10 September 2015)

6. What has the Social Security Advisory Committee said about the draft Regulations?

The **Social Security Advisory Committee** (SSAC) is an independent statutory body that provides impartial advice on social security and related matters. Comprised of Chair Paul Gray, Vice Chair Les Allamby and up to 13 other members, it scrutinises most of the secondary legislation that underpins the social security system.

On 10 September 2015 the SSAC expressed concern at the lack of evidence to support the government's plans to cut tax credits, while recognising the challenging timescales officials had been working within. In a letter to the Financial Secretary to the Treasury, the SSAC explained it was "disappointed that HM Revenue and Customs officials were not in a position to share with us their observations on:

- The potential impact the introduction of the national living wage might have on the proposals.
- Whether there were likely to be any behavioural impacts brought about by the proposals.
- The degree to which the proposals are likely to impact upon the successful transition of Tax Credits to Universal Credit
- The likely or actual effects of the policy on people of 'protected characteristics' and the evidence considered in reaching that view
- The evidence that had resulted in a view that the proposals will have no impact on charities or the voluntary sector."[12]

[12] Letter to David Gauke MP, Financial Secretary to the Treasury, from Paul Gray, Chair of the Social Security Advisory Committee; "The Tax Credits (Income Thresholds and Determination of Rates (Amendment) Regulations 2015" (10 September 2015)

7. Further comment and analysis

For further comment and analysis see:

- Welcome boost on low pay but severe welfare cuts will mean big losses for many low-income working families, Resolution Foundation press release, 8 July 2015
- Social Market Foundation, Will the new Living Wage make up for the cuts to Tax Credits? Yes and No, July 2015
- Unison, Don't take the (tax) credit: How a pay rise becomes an income cut, September 2015

Further tax credit statistics are available from HMRC, including:

- Personal tax credits statistics (HMRC Tax Credits statistics landing page)
- Child and Working Tax Credits Statistics April 2015 (latest available, provisional, UK Tax Credit statistics)
- Child and Working Tax Credits statistics: provisional awards geographical analyses (latest available, provisional, geographic data)
- Child and Working Tax Credits statistics: finalised annual awards 2013 to 2014
- Child and Working Tax Credits statistics finalised annual awards geographical analysis

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