Tax Credits - Income Thresholds and Determination of Rates - Amendment Regulations 2015: Debate on Tuesday 15th August

About these regulations

These regulations, to be debated in the House of Commons on the 15 September 2015, introduce major reductions in support for low income working families. The regulations do three things: reduce the income thresholds in tax credits; increases the tax credit taper rate from 41% to 48%; and reduce the income rise disregard in tax credits. These measures would be expected to affect at least around 1.3 million working families with 2.4 million children.[1]

This briefing explores the impact of these measures on low income working families and their incentives to work.

Reducing the income thresholds in tax credits

Income thresholds specify the amount of (gross) income that a household can keep before additional earnings begin to affect their tax credit entitlement. These thresholds are crucial in ensuring that work pays for low and middle income families.

The income threshold for tax credits for working families is currently set at £6,420 per year, with earnings over this threshold deducted at a rate of 41p for each £1 earned above this threshold. In future, this threshold will be reduced to £3,850 per year – a reduction of over 40%. Currently with the deduction of 41p in the £1, this reduced threshold will cost low income working families £1,054 per year. However, the Government also intends to increase the taper rate for tax credits, meaning that the cost of this reduction in the income threshold will be higher still.

These measures will only affect working families, and will significantly reduce the incentive to work.

Sally's family:

Sally is a single parent with 2 children who is working and earning £10,000 per year. Currently she has an excess income of £3,580 over the level of her income threshold which is counted as income for the purposes of tax credits. At a withdrawal rate of 41%, this means she faces a deduction of £1,468 from her maximum tax credit entitlement.

Following the introduction of the reduced threshold Sally's income will exceed her income threshold by £6,150, at an increased taper rate of 48%, she will now face a £2,952 deduction from her maximum tax credit entitlement.

This is a reduction in entitlement of £1,484 per year as a consequence of the reduction in the tax credit income thresholds and increases in taper rates. Since these measures only affect working families, this measure will reduce the financial incentive for Sally to work by up to £1,484 per year.

[1] Our estimate is based on tax credit statistics indicating numbers of working families currently receiving a tapered tax credit award and the number of children in these families. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/424231/ChildandWorkingTaxCreditsStatistics-April_2015-tables.xls

Questions to the Minister

- What assessment has the Government done to ensure that these regulations will promote incentives to work given that many working families on low incomes will be worse off as a result of these combined measures?
- What assessment has the Government done of how the reductions in entitlements will impact on children's welfare?
- Can the Minister assure the house that families will still be incentivised to work if these measures are adopted?

Increases the Tax Credit taper rate from 41% to 48%

Taper rates are the rate at which any additional earnings (over the level of income thresholds) reduce benefit entitlements. Currently increases in earnings over the income threshold reduce tax credit entitlements by 41p in every £1. These changes will increase this to 48p in every £1.

Sally's case above indicates the impact of this on work incentives for tax credit recipients.

Tax Credits are often received in combination with receipt of other benefits, and most working recipients also pay income tax. The combination of these deductions from earnings can lead to working recipients being left with very little money from each extra £1 they earn.

Steve and Muna's family:

Steve and Muna have 2 children, rent of £400 per month, and council tax of £110 per month. Steve works and earns £11,000 per year. Currently, for each additional £1 he earns:

- 32p would be lost through additional income tax and national insurance payments
- 41p would be deducted from their tax credit entitlement
- Of the remaining 27p, 85% would be deducted from housing benefit and council tax reduction entitlements.

Muna and Steve keep 4p in the £1.

Following the increased tax credit taper rates:

- 32p would still be lost through additional income tax and national insurance payments
- 48p would be deducted from their tax credit entitlement
- Of the remaining 20p, 85% would be deducted from Housing Benefit and Council Tax Benefit entitlements.

Muna and Steve now keep just 3p in each extra £1 earned.

Both reductions in income disregards and increases in taper rates for tax credits undermine the additional financial work incentives offered by the increase in the national minimum wage.

For example, if a tax credit, housing benefit claimant moves from 30 hours per week on the current national minimum wage of £6.50 per hour, to the proposed higher rate of £9 per hour, then their gross earnings will increase from £195 per week to £270 per week (an increase of £75). However, from this, they may face the following deductions (assuming they remain below the relevant tax thresholds):

- Tax credits: £36
- Housing benefit and council tax reduction: £33.15

This leaves a remainder of just £5.85 per week that the family keep as a result of the pay increase - about £305 per year.

While we welcome the increase in the national minimum wage, in order to make sure that low income families keep the additional pay received, the Government needs to increase income disregards in tax credits and work allowances in universal credit. These regulations, however, do the exact opposite, substantially reducing non-means tested earnings within the tax credits system.

Questions to the Minister

- Has the Government considered how to ensure that gains from increases in the national minimum wage are kept by low income families, rather than lost as a result of withdrawals from benefit and tax credit entitlements?

Reducing the income rise disregard in tax credits

When incomes for tax credit purposes rise from one year to the next, currently up to £5,000 of the increase is ignored for the purposes of calculating tax credit entitlements. So for example, if a claimant household has an income of £11,000 in 2011/12 and £13,000 in 2012/13, their income for tax credit purposes in 2012/13 will be £11,000. Assuming it remains at £13,000 in 2013/14, their income for tax credit purposes will rise of £13,000 that year.

The principle purpose of this is to avoid overpayments caused by estimated income for the coming year being lower than finalised income at the year end.

This measure also helps to provide additional support to those returning to work at key points of financial strain – such as returning to work following maternity leave or illness.

Emilie's family:

Emilie is returning to work following maternity leave. Her actual gross income whilst on leave in 2014/15 is £9,000. Following her return to work her income in 2015/16 is expected to be £15,000.

In 2015/16 her income for tax credit purposes will be £10,000 (£15,000 minus £5,000 income rise disregard). However, following the introduction of this measure, someone in her situation would have an income for tax credit purposes of £12,500.

Based on a tax credit taper rate of 48%, this measure will cost Emilie's family up to £1,200. This would come at a time shortly after the birth of her child, where additional income would be vitally important to support her baby as she returns to work.

Questions to the Minister

- Has the Government considered what the cumulative impact of the changes in the regulations mean for working families and whether this will affect work incentives?

- Given the examples highlighted by The Children's Society, that families' income will be lower despite the increase in the national minimum wage, how does this align with the Government's intentions to make work pay?

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