

**TAX CREDITS: A CLOSE-UP VIEW**

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## **ABSTRACT**

Tax credits were introduced in 2003 as the main instrument to deliver the Labour government's commitments to increase work incentives, to make work pay, and to reduce poverty levels among working families. This article uses a case study of one family over several years to explore and illustrate the experience of being in the tax credit system. The analysis highlights the importance of tax credits to family income, but also the negative impact of late and incorrect payments, payments that varied in inexplicable ways, reductions in awards for overpayments, and the lack of detailed information about awards.

## **Tax credits: a close-up view**

Tax credits were introduced in 2003 as the main instrument to deliver the Labour government's commitments to increase work incentives, to make work pay, and to reduce poverty levels among working families. By April 2009, there were 4.3 million working families receiving tax credits, 3.1 million couples and 1.2 million lone parents (HMRC, 2009). Tax credits have made a substantial difference to employment rates, income and poverty levels for families, and especially for lone-parent families (Gregg et al, 2009). But tax credits have also proved difficult to deliver effectively, with high rates of error and with many families receiving payments that have later been clawed back (Millar, 2008).

In this article we get close-up to the tax credits system by focusing on a case study of just one family over several years, using this to explore and illustrate the experience

of being in the tax credit system. Although qualitative research has an established place in policy research, the single case study approach is rather more unusual. The case study here is drawn from a qualitative longitudinal study of lone mothers followed for about three to four years from when they left Income Support and started working and receiving tax credits. This included 50 families in 2004, 44 families in 2005, and 34 families in 2007 (see *reference to add*). In analysing these data and trying to understand processes over time, we have come to appreciate the value of very detailed in-depth analysis alongside the more usual comparative thematic approach to qualitative analysis. In particular, the case study approach allows us to explore repetition over time. We can focus on ongoing issues and problems and how people manage, or not, to cope with these. We can also get a clearer view of the relative importance of issues as time passes and situations change or settle down.

For this analysis, we have specifically chosen a family with characteristics and circumstances that should be relatively unproblematic in relation to tax credits. At the first interview this lone mother, we will call her Brenda, was in her mid-thirties and had two children aged two and thirteen. The family lived in a council house in a city in the north of England. Brenda had become a lone parent for the second time when her partner died when her youngest child was just a few weeks old. Brenda was eligible for the study because she had spent about a year on Income Support at around that time, having been made redundant while on maternity leave from her job. But apart from that year Brenda had 'always worked', both as a partnered and as a lone mother. Brenda was committed to work and said often in the interviews that she thought being in work was better for her and for her children. She had left Income

Support in May 2003, and we interviewed her in February 2004, in July 2005 and in October 2007.

Brenda started work when her current employer contacted her to say there was a vacancy. She stayed in the same job throughout the study, although the business itself was taken over by a larger company in 2006. Her family circumstances did not change over time. She had good health and so did her children. She did not move house. She worked weekdays and used reliable public transport to get to work. Her childcare arrangements were stable, with the most change between the second and third interviews when her eldest left school for college and her youngest started school but continued with the same nursery care around school hours. Her wages increased between the first and second interview mainly because she increased her hours, but after that her pay was relatively stable.

There is one further relevant point to note about Brenda's job. She worked in accounts. Her job involved 'doing all the accounts, banking in the mornings, making sure that late creditors pay, debt chasing, things like that... I've always done accounts since I left college myself and I've got my 'O's and my 'A' Levels and book keeping and accounting and everything' (third interview). She had access to the Internet at home and at work. So Brenda was not someone likely to be intimidated by form filling or by complex calculations.

### **Tax credits and family income**

Brenda must have been one of the first people to claim under the revised tax credit system which came into effect from April 2003. Her two-year old son, Peter, was in

full-time nursery care which meant that she was claiming Childcare Tax Credit alongside the Working Tax Credit and the Child Tax Credit. As with almost all of the women in the study, the financial support from tax credits were a key factor in enabling Brenda to stay in work. At the third interview we asked her to reflect on the past few years - how important have tax credits been in your finances? Her reply was unequivocal: 'I wouldn't have been able to work. No, because there is no way I'd have been able to afford.. My wages pay the bills and the general day-to-day stuff, whereas my Tax Credit really just pays for Peter's nursery. So that's.. so it's really paying for him.. well, it's paying for me to work'.

Tax credits were a very substantial part of the family income. At the first interview, Brenda was working for 30 hours per week and was getting about £800 per month in her pay packet, which included about £650 in wages and about £154 in tax credits. She was also getting another separate tax credit payments of about £670 per month (we discuss the nature of these different tax credit payments further below). She also received £107 in child benefit per month. So Brenda's weekly income was around £395 and a substantial proportion of that – about 60 per cent – came not from her wages but from state support of tax credits and child benefit. Undoubtedly without tax credits she could not have started or stayed in work for that level of wages.

A lone parent with two children receiving Income Support would have had an income of about £175 per week in 2003, with housing costs met in addition. That was also about the level of the income poverty line (below 60% of the median, after housing costs) for that family type (CPAG, 2004). Brenda's rent and council tax was about £76 per week, so her weekly income of about £319 after housing costs was well above

what she would have received on income support and above the poverty line. But that is not really an accurate picture of her financial circumstances. In order to be able to work, Brenda needed full-time childcare for her youngest child, for 5 days per week, from 07.45 to 17.45. She was paying £670 per month, £167 per week, in childcare costs. If we deduct this necessary expenditure then the family income falls to about £152 per week. So Brenda's assessment of her financial situation at this point, when she had been in work for about ten months, was accurate: 'at the moment I am not any better off working as to what I would be if I were on Income Support. It's like even stevens.'

At the second interview, in 2005, Brenda had increased her hours from 30 to 37.5 per week and her monthly net wage had risen from about £650 to about £900. Her childcare tax credit had also risen because the ceiling had been raised from £135 to £170 (the childcare tax credit pays 70 percent of childcare costs up to that ceiling). Her childcare tax credit payment had thus come closer to her actual childcare costs. But she had only just had the childcare tax credit increase, so she was yet to really feel the effects: 'I've only just got it. It was like my last payment was like three weeks ago so that's the first time I have had it up. But before that I were really struggling, struggling to keep him in nursery but I daren't give my job up ... so I just muddled through' (second interview).

We estimate Brenda's family income at the second interview had risen to about £415 per week after housing costs. The family was thus clearly above the poverty line, which was about £222 per week after housing costs for a lone parent with two children in 2005/6 (CPAG, 2006). But again if we take out childcare costs, income

falls to £250, not much above the poverty line. Brenda herself said she was ‘just managing’ and again pointed to a small gap between her income in work and what she might get on Income Support: ‘I think if I was out of work or whether I was in work I don’t think the money situation would change drastically anyway because when I’m not working I am only given so much to live on but I wouldn’t have like Council Tax to pay, my housing ... it’s actually a bit more than what I’ve got to live on now. But it still wouldn’t make any difference, I need work, I can’t be one of those home birds that sit at home all day’ (second interview).

In 2007 at the third interview, Brenda’s wages were much the same. Her tax credits were lower because her childcare costs had fallen. She was getting about £915 in wages per month, about £660 in tax credits and about £120 in child benefits. So state support was now contributing about 45 per cent of her family income. She was paying about £330 per month in childcare during school terms and about £520 per month during school holidays. Her weekly income was around £260 after paying for housing and childcare, no difference from two years previously and still not far above the poverty line. Again she said she was ‘just managing’. Did she feel secure or insecure, we asked: ‘a bit insecure. Just every month I just manage to make ends meet every time and I’ve got no debt. It’s not as though I’ve got credit cards, overdraft or anything like that. It’s just general day-to-day living’. She had had debts at both previous interviews (discussed in more detail below), so was better off in that respect. She also recognised that work did offer better financial security than Income Support, ‘if I was on Income Support then I don’t think my kids would get as much as what they do get. I think I’ve got more scope working than if I wasn’t. It’s like if I really really needed something, I suppose I could always go and get a bank loan or

something like that. Whereas, if I was on Income Support I would not get that opportunity, so I suppose financially I've got that little bit more security working than being on Income Support' (third interview). But Brenda and her family had not had a holiday since we first met her and she had no savings.

### **Claiming and receiving tax credits**

Locating tax credits in the income tax system, with an annual claim based on a simple definition of income, was intended to create a system that would be easy to administer and easy to use (Millar, 2008). Brenda not only had training and experience in accounts, but she had also claimed Family Credit in the past, so she was familiar with the process. She never had any problems with filling in the forms and making the claim: 'every year assessment at the end of the day it's fine, to say you've got your full year's wages ... I don't even have to send my wages or anything now, I just sign a piece of paper, get my P60, fill in how much I've earned that year and send it off. That is easy' (second interview).

But although Brenda found the claiming process easy, complications did follow. Brenda did not receive her first payments until she had been in work for about six months. The initial delay was because her claim was lost and she had to claim again. When her payments did start they came through 'in dribs and drabs. So it's like I got a cheque through because they said they'd send me an emergency cheque out because it took so long. So I got a cheque through for about £350 and then we've got it sorted and everything, and then I got like a lump sum back pay of about £1,800, I think I got then. And then another £100 and something a couple of weeks after that, then

something like £60 a couple of weeks after that, then I got another £600 and something four weeks later. And I was like what's happening here'.

The financial impact of this initial delay was compounded by the fact that Brenda had to wait six weeks for her first wages because she was paid monthly and started work mid-way through the month. Her two weeks Income Support run-on helped but obviously did not cover the full period. Brenda got into debt with her nursery payments and at the first interview (about ten months after she started work) she still owed about two months of nursery fees. At the second interview, she was still in arrears: 'as I said before, it was six months before I even got anything so then I got into arrears with my nursery, which I am still trying to pay off now which is why I'm struggling as much as I am to keep things together, just to keep on top of keeping Peter in nursery and that's the reason I went full time, just for the extra money to try and get my arrears down'.

The initial delay in tax credit payment was caused by a problem in administration. However there were other issues that caused Brenda ongoing problems and these were features of the tax credit design rather than failures of administration. The most problematic of these is the variability in payments and the way in which awards are reduced to recover previous overpayments. The tax credit system is designed such that a provisional award is based on earnings in the previous tax year. In some circumstances those provisional awards may be adjusted during the year of the award. But the main adjustment comes at the end of the year. As just described, Brenda's payments had taken some time to settle down in the first year of her claim. Then, when it came to making a new claim at the end of the year, 'they turned around and

said they had paid me too much. They just chopped off my first three months of getting my new thing. I think I paid back about £600, £700 and they don't like [do it] gradually over the year, it was just the first three months they took so many, so well I was only getting like £300, £400 a month to what I were getting £679 a month'.

Again the consequence was debt, 'my overdraft went sky high, I went over my overdraft facility that I had and I was struggling to keep Peter in nursery again because I couldn't pay them exactly what they wanted each month so that put me behind again'. This variability continued in later years: 'It's up and down ... my wages don't change. I don't get any bonuses or anything like that. Every month I get exactly the same and sometimes they have overpaid me and then middle of the year I'll probably just get like a £7 or a £10 just put into my bank and I'm like, "Alright, what's that for?" It's just never the same every year, even though my wages have not changed ... It's just the way they've worked it out that they've overpaid me from the previous year ... and then they take it out of my first few months payments and the payments go back to normal again, which I can't see how they can, but there you go' (third interview).

Brenda's frustration was not helped by another feature of the system – the lack of detailed information about the award. She talked about this at the first interview and returned to it every time we interviewed her. Her main concern was not knowing how the award was calculated: 'it just says so much has been into your bank account and so much comes through on your wages. There wasn't a breakdown of how they come to that figure, and even when you phone up and that's all they just blurt out a full annual amount. They don't break it down to show you how they've come to that

annual amount .... you don't know how they've come to that figure to start off with and what they've took into consideration to come to that figure' (first interview). This lack of information meant that Brenda was not entirely clear which tax credits she was receiving in her two payments: 'All I get is, what is it, Family Tax Credit that comes through on your wages... And then my Family Tax Credit whatever it is, childcare, everything comes together, £670 every four weeks... That's paid into my bank account' (first interview).

Brenda continued to try and get more information: 'You try and phone them up ...because they don't tell you how they have come to the figure they have got. You know, they don't break it down on paper. They just say, right this is how much you are getting this year, this is how much you are going to get every four weeks. That's it. And then you ask them how did you come to this and they just give you a load of jargon and you think, alright you're no better off than from when before you phoned, so I just don't bother any more'(second interview).

Brenda was also able to compare the tax credits system with the previous Family Credit system: 'we've been on the old Family Tax Credit system when it first set up to this one. I do prefer the old system. You knew where you were, even though you were having to do it every six months. You knew exactly what you were doing. There were no, hardly any fluctuations between it and it did work a lot better for me, but this ... There's no consistency between the way they're working it out to what you're getting, which I like, consistency. I like to know exactly what I'm getting day in ... each month and everything, but with this way you can't. You like work it out for one year and you come next year and they've changed it altogether' (third interview).

The lack of basic information about tax credit awards which led Brenda to the point of ‘just not bothering anymore’ meant that she could never be sure whether she was getting the right payments and, as she said at the first interview, ‘how can you put in an appeal, if you don’t know what you are appealing against?’ Lack of information and variability in payments also made budgeting difficult, as we have seen, and could lead into debt.

As a footnote to the tax credit story, at the third interview Brenda’s daughter, Eva, had left school and started a two-year college course. Brenda had claimed the means-tested Educational Maintenance Allowance (EMA) for Eva but they were experiencing problems: ‘it’s costing me a fortune, because they still haven’t got her EMA sorted out ... I sent it all off and then they sent it back saying I’d not filled in this form for the bank to say that it’s Eva’s bank account and that it can take BACs payments. So, I went to the bank to get all that sorted out and then they said they’d post it ... He’d stamped it and everything else, then the postal strike... I’ve got to phone them back because they are saying that if she has not claimed it within twenty-eight days of her start date, she’s not entitled to it. I’m hoping that they’re going to be lenient because of the postal strike’.

Being enmeshed in the means-tested system has the capacity to create what must feel like a never-ending set of challenges and difficulties beyond your control, but which may have severe consequences for you.

### **Tax credits and advancement at work**

Brenda had moved from part-time to full-time hours in order to increase her pay, but she was also well aware that the wages/tax credits link limited the extent to which she could improve her income: ‘What I get in one hand I get took off in the other, so at end of day it don’t really make any difference at all because what if they put my wages up, which I had the opportunity to do, and then Family Tax Credit will take it off because I’m only allowed to earn so much anyway so at the moment, while my son is at the age he is. It doesn’t really make any difference to me whether I get a pay rise or not. We do get pay rises every year but it doesn’t make any difference to me really, I mean I’m in that bracket where it doesn’t make much difference, I’m only allowed to bring so much into house anyway’ (second interview).

But Brenda was interested in advancing her situation at work: ‘I weren’t going for more money I just wanted a more fulfilled job, I wanted to get my teeth into’ (second interview). She had threatened to leave her job and at that point had been given greater responsibility. At the third interview, her youngest child had started school, she felt, ‘as he gets older and does not need me as much, then I’ve more time to put into work’. On the other hand, later in the interview, she also said: ‘It’s hard work full time and a full-time family. So, yes, if I could make it work I really would love to go part-time. It won’t be as draining’. But part-time work often means lower-paid work with fewer opportunities for advancement (Millar et al, 2006). Brenda was thus facing a dilemma – part-time work which would be less fulfilling against full-time work with greater opportunities - which relates more to the way the part-time and full-time labour market works than it does to the way the tax credit system works.

### **Issues for policy and research**

At the third interview, after four and a half years in continuous employment, we asked Brenda what, if anything, she had worried most about over that time. She replied, 'I don't think I have worried about anything really. I just plod along anywhere. I just go at my own pace and things, but no. Financially I struggle every month, so I just get used to doing that. But I suppose all parents do, no matter whether you are a single parent or whether there's two of you'.

Brenda had a steady full-time job, which she enjoyed and was good at, she was a valued and reliable employee. Her responsibilities at work increased, at her own request. But she was not well paid and her hourly rate, lower than average to start with, fell further behind in relative terms over time. In 2003 we estimate her hourly gross to have been about £6.75, rising to about £7.45 per hour in 2005 and the same in 2007. The median hourly gross earnings for women were £7.68 in 2003, £9.82 in 2005 and £10.46 in 2007 (ONS, various years). Tax credits were making up that low pay and were a significant contribution to her family income. But tax credits were not fully covering the cost of her childcare and it was this, more than anything, which meant that the family struggled financially. As Brenda said, 'all parents do' struggle and certainly most parents who pay for full-time childcare find this to be a substantial cost. Bryson et al (2006), in their survey of about 8,000 parents in 2004/5, found that about 37 per cent of lone parents said that they found childcare costs were difficult or very difficult to meet. Day nursery care, at an average of £3.39 per hour, was the most expensive form of care. Brenda was paying that sort of amount in 2004 and paying for childcare put her into debt, threatened her capacity to stay in work, and led her to increase her working hours sooner than she really wanted. It is not surprising that

when we asked Brenda what she would change, if she could, it was paying for childcare that was her first thought: ‘Childcare would be free. I think that’s the only bugbear. As I say it’s costing me more for childcare than what I earn. And that’s the only thing that gets to me. How can they charge what they do charge when they know it’s a necessity for people to actually work, because there’s more and more mothers now that work than don’t work’ (second interview).

Although we could not completely understand the reasons for the variations in Brenda’s tax credit payments, it is likely that the childcare tax credit was a significant part of the cause. The complexity of the system is greatest for families claiming all three elements – child tax credit, working tax credit and childcare tax credit – and it is among these families that over and underpayments are most likely to be found (Millar, 2008a). Meeting the full costs of childcare, and taking this out of the tax credit system, would be a significant step towards a system that would better meet the needs of working parents, and would help to encourage and sustain full-time employment.

Brenda’s experience also highlights an important point about measuring family income poverty. If we measure poverty in the usual way – income after housing costs - then Brenda and her family were above the poverty line throughout the study. But if we also take into account the costs of childcare then the family income was barely above the poverty line at any time during the four or so years from when she started work. Should childcare costs be treated in the same way as housing costs in estimating family poverty rates? For working families these costs are essential and, like housing costs, they vary across the country and according to the amount and

quality of care. It would be useful to have some further research on the impact of the costs of childcare on poverty.

Turning to administration and delivery of tax credits, Brenda's ongoing experience included: late and incorrect payments, payments that varied in inexplicable ways, reductions in awards for overpayments, and lack of detailed information that would have helped her to understand what she was getting and why. The consequences for her included: getting into debt and the additional expense of paying interest on this, having to negotiate arrears with her childcare provider, anxiety about whether she could stay in work, and an increase to full-time hours when this was not what she really wanted. This is one case study, but several other families in our study faced the same sorts of problems and the same sorts of consequences, especially debt (*add reference*, see also Griffin, 2007; Hall and Pettigrew, 2009). The extent of these problems should be further explored in survey data. The annual 'Families with Children Survey' has some questions about receipt of tax credits and knowledge of the rules (Philo et al, 2008). Including additional questions to explore the experience and impact of tax credits would be useful. Bennett et al (2009) note that HMRC have started a panel survey of tax credit recipients to explore claimants' needs, attitudes and preferences, and they also suggest using this to ask about the costs of compliance for recipients. Research of this sort will improve the basis for future developments in policy and administration. Returning to a system based on a fixed award for a set period of time would be likely to reduce many of the problems we have seen. Such a change should be given careful consideration on the basis of further evidence.

As they do for many working families, tax credits did help Brenda to work, they did help to make work pay, and they did help to keep her family above the poverty line. But there was also stress, insecurity and uncertainty. Someone less committed to work than Brenda may well have given up. She was doing everything that is expected under the current policy regime but even after several years of employment her family was not much better-off and still experiencing financial insecurity. Improving the design and delivery of tax credits to resolve these problems would ensure that tax credits are better able to fulfil their important policy aims.

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