Fiscal Studies (1997) vol. 18, no. 4, pp. 401–425

The Possibility of a British Earned Income Tax Credit

ROBERT WALKER and MICHAEL WISEMAN*

Abstract

The possibility of an earned income tax credit, based on the US model, is currently high up the British political agenda. This paper examines the strengths and weaknesses of the current British system of in-work benefits, before reviewing the effectiveness of the US Earned Income Tax Credit (EITC) scheme. The British and US systems are then directly compared in terms of the net income delivered and the effective tax rate (net benefit deduction rate). Although the evidence in favour of a US-style EITC is weak, two possible variants are considered. The paper concludes that the only future for an EITC is probably as a partial scheme, linked to the amalgamation of in-work and out-of-work benefits, which removes wage subsidisation from the sphere of social security by means of a semi-individualised tax credit. Even so, the same goals could be achieved through the benefit system.

JEL classification: H24, I38.

I. INTRODUCTION

Gordon Brown, the Labour Party's first Chancellor of the Exchequer in 18 years, used his first Budget speech to confirm that the Taylor review of the tax and benefit system would be considering 'at an early stage the advantages of introducing a new in-work tax credit for low-paid workers' based on the American Earned Income Tax Credit (EITC).

*Professor Robert Walker is at the Social Security Unit, Centre for Research in Social Policy, Loughborough University; Professor Michael Wiseman is at the Robert M. La Follette Institute of Public Affairs, University of Wisconsin.

Oliver Walker, Rachel Youngs, Jennifer Park, Laurence Ashman, David Love, Nigel Bilsbrough and Sharon Walker helped in the preparation of this paper but do not share responsibility for any remaining inadequacies.

In this article, we reflect on the US experience and conclude that the success of the EITC has been exaggerated in the British debate. Not only do fewer people receive a net tax credit from the scheme than is typically stated, but the method used for delivering the credit makes it more of a reward for working than a work incentive. Moreover, were it not for the existence of the US Food Stamp Program, the EITC scheme could not function successfully as part of a support package for the low-paid. We also directly compare the US system with that currently in place in Britain and conclude that the withdrawal of food stamps and other benefits, combined with the structure of earned income tax credits, means that many low-wage Americans still confront a significant poverty trap, shallower but wider than in Britain. In the light of this evidence, although the case for a British EITC is scarcely proven, two possibilities are considered. However, before doing this, we review the context in which pressure to reform the tax and benefit system has emerged.

II. CURRENT DISSATISFACTIONS

Despite an acute sensitivity to the work disincentive effects created by out-of-work benefits, the reforms of the Thatcher–Major era failed to increase the attractiveness of work over relief. While the relative and, in some cases, the real incomes of the unemployed were reduced, this was offset by changes in the labour market — the decline of manufacturing, abolition of the wages council system, erosion of trade union power, growth in part-time employment, the casualisation of employment and so on — which brought wages down as well. These developments contributed to an unprecedented increase in wage inequality, with wage rates at the bottom — at the level of entry and re-entry jobs — scarcely rising at all in real terms (Gosling, Machin and Meghir, 1994). Moreover, changes in housing subsidies — which increased the number of claimants receiving housing benefit — the growth of owner-occupation among low-income families (and thus expanded eligibility for council tax benefit) and higher indirect taxation all added to work disincentives (Walker, 1994).

Ideologically averse to job-creation and other measures designed to boost labour demand 'artificially', the Conservatives came increasingly to rely on boosting in-work incomes by means of in-work benefits. Key elements in this strategy were the introduction and later extension of family credit, aimed at working families with children, and, more recently, the trialling of earnings top-up, a parallel scheme for individuals and couples without children. This approach, which developed disparate social assistance systems differentiated by the amount of paid employment claimants were permitted to undertake, can be described either as pioneering or as eccentric, since Britain now boasts Europe's most extensive system of means-tested support to the low-paid (Eardley et al., 1996).

FIGURE 1

The Structure of Family Credit

Title: fig 1
Creator: FreeHand 7.0
CreationDate: 12/11/97 2:37 pm

Note: Family 1 has one child aged five; Family 2 has two children aged five and 12; Family 3 has two children aged five and 12, and one of the parents works for more than 30 hours per week.

From the outset, family credit had multiple objectives: to provide extra support for families; to ensure that they were better off in work than not; and to reduce marginal tax (deduction) rates (Department of Health and Social Security, 1985). Nevertheless, the structure of family credit is quite straightforward (Figure 1). Where net family[1] weekly income is less than or equal to a set figure (the applicable amount is £77.15 for 1997–98), a claimant receives a maximum benefit that is determined largely on the basis of household size and composition.[2] In other circumstances, claimants receive the maximum benefit minus 70 per cent of the amount by which net income exceeds the applicable amount. In couples, the benefit is typically paid to the female partner even when only the man is employed. This last feature is inherited from family income supplement which had more explicit family support objectives. Family credit was to have been paid to employees through the wage packet, but this strategy was abandoned in light of opposition to a move that would have shifted resources from ‘the handbag to the wallet’.

Family credit was originally restricted to people working at least 24 hours per week. The hours threshold for family credit was reduced to 16 hours in April 1992

[1]Family is defined as the benefit unit comprising an adult, his or her partner and any dependent children living in the same household. Net income for employees is income less income tax and Class 1 National Insurance contributions and less set disregards for childcare and maintenance payments. Earnings from self-employment equate to net profit.
[2]Maximum benefit includes the same amount for a couple as for a single parent and varying amounts for children according to age.

FIGURE 2

Family Credit Caseload

Title: fig 2
Creator: FreeHand 7.0
CreationDate: 12/11/97 2:38 pm

and, as an incentive to work longer hours, higher benefit was introduced in July 1995 for people working 30 hours or more. Disregards on maintenance and childcare costs were added in April 1992 and October 1994 respectively. Partly as a result of these changes, the family credit caseload has risen markedly to 733,000 in February 1997 — 12 per cent of all working families with children (Figure 2).

The Conservative Government lauded family credit as a great success and Labour in opposition did not speak against the piloting of its extension to childless workers in the form of earnings top-up. In a number of respects, family credit does indeed appear to work well.

Family credit provides work incentives and support for family incomes:

- family credit ensures that the vast majority of recipient families' incomes in work are above those when not working and hence contributes directly and immediately to higher nominal living standards;[3]
- family credit plays a major role in supporting the living standards of lone parents in work — 44 per cent of those working 16 hours or more receive it;

[3]A model couple with two children aged 5 and 12 working 40 hours at £3.94 per hour will be £21 (12 per cent) better off, or £20 (11 per cent) better off for a 30-hour week (from Department of Social Security (1996)). Surveys have shown that, in 1994, lone parents were as much as £39 per week better off on average, or £10 better off if paying for childcare (Finlayson and Marsh, 1997). We refer to higher *nominal* standards because calculations such as these are not adjusted for the value to individuals of time spent not working (and therefore lost when employment begins).

- combined with maintenance, family credit means that, on average, lone parents in work have incomes 60 per cent above what they would receive from out-of-work benefits;
- the system acts as a 'parachute', enabling two-earner couples to remain attached to the labour market when one partner loses his or her job (Bryson and Marsh, 1996).

Family credit limits the 'poverty trap':

- the effective tax rate (known more formally as the 'marginal deduction rate'), which is the combined result of benefit withdrawal and direct taxation, is almost always below 100 per cent, thereby limiting the depth of the poverty trap;
- furthermore, because family credit is assessed for six months at a time, the impact of the poverty trap is deferred; the scheme therefore acts to provide a short-term income guarantee and removes the immediate disincentive effects of higher earnings.

Administration of family credit is effective:

- take-up, at 69 per cent of eligible claimants and 82 per cent of expenditure, is very high for a means-tested benefit (Department of Social Security, 1997);
- fast-track processing systems enable nine out of 10 people moving into work to receive benefit within five days of starting work, thereby lessening the financial insecurity inherent in taking work and clearly connecting the reward to the action;
- family credit provides Jobcentre staff with a mechanism to assist job-seekers back into work and an informal test[4] that claimants are truly available for employment.

Despite these achievements, there are also structural limitations that have caused strategists to look abroad for alternative ideas.

Family credit is costly:

[4]If an unemployed claimant declines to take work even in the knowledge that family credit may be payable, Employment Service staff are known to interpret this as an indication that the claimant may not truly be available for work.

- expenditure on family credit has increased threefold in little more than four years, and the combined expenditure would be substantially more if earnings top-up were to be extended nation-wide;
- there are anecdotal accounts of collusion between employers and claimants to maximise payments;
- economic theory suggests that family credit may shift part of the burden of family support from employers to the state;
- while most family credit recipients receive payments for only short periods, most expenditure goes to long-term recipients; hence the assertion in Labour's manifesto that benefits are underwriting low wages and subsidising employers (Ashworth and Walker, 1993; Walker with Ashworth, 1994).

Traps and disincentives multiply with the interaction of family credit with other programmes:

- the withdrawal of family credit with rising wages, combined with loss of other means-tested in-work benefits (notably housing benefit and council tax benefit), means that, in the longer term, families gain little financial benefit from large increases in earnings: a couple with children aged 5 and 8 in 1996–97 gained

FIGURE 3

Net Income after Housing Costs
for Couples and Lone Parents with Two Children on Family Credit, April 1996[a]

Title: fig 3
Creator: FreeHand 7.0
CreationDate: 12/11/97 2:39 pm

[a]Assumes a one- or two-parent family with a child aged under five and one aged 5–10, rent of £42.17 per week and council tax of £12.10 per week.
Source: Derived from Department of Social Security (1996).

FIGURE 4

Family Credit: Net Marginal Deduction Rate, April 1996[a]

Title: fig 4
Creator: FreeHand 7.0
CreationDate: 12/11/97 2:41 pm

[a]See Figure 3 for assumptions.

£10 in net income from a £165 wage increase from an initial £50 per week (Figures 3 and 4); this could mean that workers do not seek further to reduce their reliance on state benefits;

- some people may reduce the number of hours that they work and instead rely on family credit to make up for the loss in wages (Duncan and Giles, 1996);
- there is also new evidence (Bryson, 1997) consistent with the proposition that family credit is encouraging people into jobs with limited prospects for career advancement, thereby trapping them in 'dead-end jobs' and the state into long-term financial support;
- the majority of short-term recipients leave benefit without work rather than moving into better-paid jobs (Bryson and Marsh, 1996);
- family credit places the under-25s — one of the government's target groups — at a comparative disadvantage in the job market, since most do not have children and cannot claim family credit's implicit wage subsidy.[5]

The system is inefficient:

[5]It is recognised that one objective of family credit is to help meet the cost of children not experienced by childless under-25s.

- in the system as a whole, at least some of what government gives with one hand is taken away with the other: benefits are paid to people who at the same time pay income tax and make National Insurance contributions: the tax threshold is more than £30 per week less than the gross wage received by the average claimant and about 45 per cent of people receiving family credit pay income tax (Dilnot and Giles, 1996);
- although take-up is high, there is evidence that working families would prefer to be free of all means-tested assistance (Kempson, 1996), and the complexity of the system, the disjuncture between in-work and out-of-work benefits, and the need often to claim benefits in addition to family credit undermine the message that 'people are better off working' (Shaw et al., 1996).

To summarise, while family credit is effective in enhancing the living standards of the low-paid workers who receive it, the scheme has become increasingly expensive as a result of attempts to increase its effectiveness. Its overall contribution to work incentives may be limited since the enhanced incentive to start work is offset by aspects that may discourage workers from increasing earnings through job progression or increasing hours. Furthermore, although the administration of family credit is neither unduly complex nor costly, the assessment and payment of benefits, taxes and wages are separated, adding to public sector costs and lessening the incentive signals to prospective claimants.

However, given that there is little chance of being able to establish a minimum wage at a level high enough to have much impact on the numbers of working poor, there is likely to be a continuing need for some form of wage supplementation. To better family credit, a new scheme would need to foster progress towards greater financial self-sufficiency by smoothing the transition into paid employment and encouraging higher earnings. It is also important for the new scheme to complement and reinforce New Deal, the package of welfare-to-work measures currently under development. In the next section, we consider how well the US Earned Income Tax Credit meets this specification.

III. LOOKING TO AMERICA: EARNED INCOME TAX CREDIT

Much of the inspiration for proposals for an in-work tax credit for low-paid workers comes from American experience with that country's Earned Income Tax Credit. While it is certainly true that, in the US, the EITC effects substantial transfers of cash to low-income working families, there are significant problems with the EITC that diminish its importance to policymaking in Britain.

1. How the American EITC Works

The EITC is an earnings supplement paid to low-income working taxpayers. First established by Congress in 1975, the programme has since been substantially

FIGURE 5

The US Earned Income Tax Credit, by Family Size, 1996

Title: fig 5
Creator: FreeHand 7.0
CreationDate: 12/11/97 2:42 pm

modified and expanded. Currently, three separate schedules apply: one for taxpayers with no children, one for taxpayers with one child and the third for taxpayers with two or more children (Figure 5).

In the two-child case, the credit supplements earnings at the rate of 40 cents per dollar up to total annual earnings of $8,890 (£5,323).[6] At this point, the taxpayer (or taxpaying couple) receives the maximum EITC credit of $3,556 (£2,129). Beyond annual earnings of $11,610 (£6,952), the credit declines at a 21.06 per cent rate until earnings reach $28,495 (£17,062).

Cast in weekly terms to aid comparisons with Britain, the maximum rate is $68.38 (roughly £41), achieved when weekly earnings reach $171 (£102). The benefit begins to decline at a weekly earnings rate of $223 (£134) and falls to zero when weekly earnings reach $548 (£328). The maximum weekly benefit for taxpayers with one child is $41.38 (£24.78); for taxpayers without children, the maximum weekly benefit is $6.21 (£3.72). Over the range $0–171 (£0–102), the EITC creates a substantial 'price' incentive for more work, for every dollar of gross earnings gains an EITC bonus of 40 cents.

[6]Based on an exchange rate of $1.67 to the pound current at the time of writing.

The EITC is currently America's only refundable tax credit.[7] If the amount of the credit exceeds federal income tax liability, the excess is payable as a direct transfer. Most taxpayers file returns in the interval between 1 January and 15 April of the year following that in which tax liabilities and credit claims are accrued. If federal taxes withheld plus EITC claims accrued (net of advanced payments, if any) exceed federal tax liability, the difference is returned as a tax refund. About 18 million single individuals and families receive the credit, but of these perhaps about 2 million receive no refund, since the credit serves only to offset partially their tax liability.

[7]The Budget Bill signed by President Clinton on 5 August includes a refundable child credit of $500. Since the administrative details of the new legislation were not available at the time of writing, we have not included the child credit in our analyses.

TABLE 1

US Federal Government Spending on Public Assistance Programmes, Fiscal Year 1996

Programme/Programme Category	*Amount ($ million)*
Family support payments (principally the federal share of costs of the Aid to Families with Dependent Children programme)	18,371
Supplemental security income (cash payments to needy aged, blind and disabled persons)	24,017
Child protection (federal share of costs of foster care for children removed from or without families; related programmes)	3,840
Child nutrition (school lunch and breakfast programmes, food assistance and nutritional screening for low-income women who are pregnant or caring for infants)	8,428
Medicaid (federal share of costs of entitlement programme providing medical assistance for certain low-income persons)	95,786
Food stamps (national income supplement intended to assure adequate nutrition)	26,220
Social services block grant (grants to states to enable provision of a broad range of social services)	2,880
Earned Income Tax Credit (earnings subsidy)	18,440
Total	197,982

Note: Fiscal year 1996 extended from 1 October 1995 to 30 September 1996. The programme coverage summaries given here are intended to give an impression of programme substance; they do not cover all facets of the programmes involved.
Source: Committee on Ways and Means, 1996, p. 1332 and elsewhere in the volume.

The EITC is costly. Table 1 summarises federal spending on various means-tested social assistance programmes in fiscal year 1996 and shows that federal costs for the EITC were, last year, roughly equivalent to federal outlays on Aid to Families with Dependent Children (AFDC), the programme traditionally seen as the heart of the American public assistance system. In practice, few AFDC families report earnings; therefore most EITC benefits went to low-income families *not* receiving cash assistance. Many of these families include two parents. Families with two able-bodied parents are, in most states, eligible for assistance only if the ‘principal wage-earner’ is unemployed or under-employed — that is, unable to find more than 100 hours of work per month. Those working more than 100 hours are ineligible, regardless of earnings or family size. Thus, in principle, the EITC fills an important gap in the US public assistance system.

In practice, it is not clear that the American Earned Income Tax Credit fills the gap well at all. A long-standing concern of public assistance is to deliver benefits when they are needed. The EITC hardly does this, since, to take the most extreme case, claims established in January may not be received for *16 months*. Since 1979, eligible taxpayers have been allowed to receive a portion of the credit in advance of annual filing of tax returns; however, this option is exercised by only about 5 per cent of claimants. The cash-flow problem that results from the lag between generation of EITC eligibility and EITC receipt is compounded by over-withholding of federal taxes.[8] The solution to the conundrum of how working families make ends meet on a day-to-day basis is provided by the Food Stamp Program.

For most families, food stamps operate like a social assistance cash benefit. There are: a 'guarantee' — the amount paid to the household with no other income, which varies by family size; a 'disregard' — the amount of earnings and other work expenses that is ignored in calculating benefit; and a 'benefit reduction rate' — the rate at which benefit declines as income increases. The difference between food stamps and a cash benefit is, of course, that the payments in this scheme are made with special vouchers (or, in a growing proportion of cases, by use of an electronic benefits debit card) usable only for food purchases. While the restriction nominally placed on uses of this benefit is symbolically and politically important, dollars saved on food can be spent elsewhere. The consensus among authorities is that, evaluated in terms of effects on household consumption, food stamps amount to cash.

The amounts paid are not trivial. In fiscal year 1996, the maximum monthly food stamp benefit for a family of four persons was $397,[9] while a family of the same size with a monthly income of $1,000 would receive $197 alongside $289 in EITC payments.[10] From the standpoint of timeliness, the key difference between EITC and food stamps is that food stamps are issued monthly by local welfare offices. In the US, food stamps are the most important source of immediate income supplementation for the working poor.

2. Interactions with Tax and Other Benefits

As is true of the UK system, the American system of transfers to the poor has many components. It is always important in assessing individual programmes — including the EITC — to consider interactions with other benefits and taxation.

[8]A very important difference between the US and UK income tax systems is that the US relies much more heavily on the filing of end-of-year tax returns and the use of this process to reconcile accumulated tax obligations and EITC claims. Virtually all households with earnings or other non-transfer income are required to file. In contrast, the UK system is pay-as-you-go, with taxes on wages in each payroll period levied on the basis of accumulated earnings over the year and earnings in the current period. Only about 20 per cent of taxpayers file annual returns.

[9]Benefits are reduced as income rises, but both the disregard and the benefit reduction rate are generous: the disregard is $134 per month plus 20 per cent of earned income, and the benefit reduction rate is 30 per cent. Thus a family of four with a monthly income of $1,000 would be eligible for $397 – 0.30(1000–134–200) = $197.

[10]EITC payments are not treated as income in computing food stamp benefits.

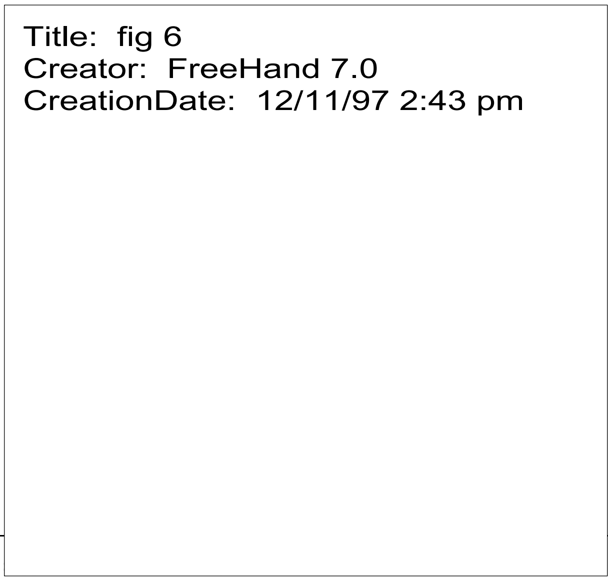
This is particularly relevant when seeking to distil policy lessons for Britain from the American system.

The effect of the EITC on spendable income is, to a varying extent, offset by positive taxes charged against wages. Employers in the US withhold 7.65 per cent of wages for social insurance (called Old Age, Survivors and Disability Insurance (OASDI)) contributions. In addition, earnings are withheld to cover accumulated federal income tax liability. Most low-income workers accrue no positive federal tax liability (a four-person household would begin to owe federal taxes only when earnings reach around $325). However, below this income ($325), taxes are generally over-withheld, so that, as a rule of thumb, take-home pay can average less than 90 per cent of gross earnings. This loss is experienced immediately. Since the offsetting Earned Income Tax Credit is not generally collected until annual tax returns are filed, in practice the EITC acts more as an end-of-year reward than a real-time incentive for undertaking a few more hours of work.

The combined effect of federal programmes on the income of an illustrative family of two adults and two children is depicted in Figure 6. This diagram mimics the UK data in Figure 3 and takes account of the EITC, food stamps, OASDI contributions and federal income tax liability.[11] Gross weekly earnings are plotted on the horizontal axis and net income including transfers appears on the vertical. There are three lines in the figure. One — the reference line — simply shows gross earnings. The lower of the other two lines shows earnings plus food stamps minus

FIGURE 6

Weekly Benefits and Earnings, accounting for Food Stamps, with and without the EITC, for a Couple with Two Children, 1996



[11]The impact of state

OASDI contributions and (for earnings beyond roughly $330 per week) federal tax liability. This is take-home pay under the assumption that taxes withheld match obligations exactly; as already indicated, for most workers, over-withholding will pull this line downward. Food stamps provide a positive addition to ‘income’ of $92 per week for families with zero earnings. The upper line that also begins at the $92 food stamp guarantee adds the EITC to the picture. The gap between the ‘net income’ and ‘current cash flow’ lines is the amount of the EITC, taken from Figure 5.

The clear incentive structure associated with the EITC is modified by the interaction with food stamps (Figure 7).[12] While the combination of the food stamps income disregard and the EITC subsidy makes tax rates negative for low income levels, once earnings reach $171 (the weekly earnings level for maximum EITC payment), the marginal tax rates for the system as a whole increase substantially. At the forthcoming minimum wage of $5.15 per hour, this is 33 hours of work — within striking range of full-time.

It is clear that, while the EITC does reduce the marginal deduction rate for low levels of earnings, the consequence is to raise it at higher levels (Scholz, 1996; Eissa and Leibman, 1996). Also, there is little evidence or reason to suppose that the EITC operates as much of an immediate financial incentive to persons receiving assistance and contemplating moving to work or for persons already working who might be attempting to increase hours (Whitehouse, 1996). When the EITC is ignored, marginal deduction rates for the system can still compound to as high as 46 per cent. When the EITC is added, marginal rates for some participants reach 68 per cent. While incentives have been improved for a subset of workers, the cost has been a substantial increase in the deduction rates applied to earners in the region in which the EITC falls. A report distributed in 1995 by the Office of Tax Analysis of the US Department of the Treasury indicates that marginal tax rates applied to workers earning at a level equal to one-half the national median income level are now at the highest level observed over the past 50 years (Lerman, 1995).

FIGURE 7

US Marginal Deduction Rate for Food Stamps Recipients, with and without the EITC, for a Couple with Two Children, 1996

[12]Figure 7 plots the marginal deduction rate with and without the EITC. This is 1 minus the slope of the ‘net income’ and ‘current cash flow’ lines in Figure 6.

Title: fig 7
Creator: FreeHand 7.0
CreationDate: 12/11/97 2:43 pm

To appreciate the full effect of the American system on financial returns to work, it is important to add Aid to Families with Dependent Children and housing subsidies. Prior to the passage of the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) of 1996, two-parent families were, in most states, eligible for cash assistance under AFDC only if the 'principal earner' of the household was involuntarily working less than 100 hours per month. PRWORA substituted 'Temporary Assistance for Needy Families' (TANF) for AFDC and expanded state discretion in providing assistance in such cases. Application of the so-called '100 Hours' eligibility rule varies across states; most have, at least for the time being, retained it. The example given in Figures 8 and 9 is based on AFDC benefit levels as provided in Wisconsin, a relatively generous state.[13] In 1996, the basic AFDC benefit in Wisconsin for a family of four was \$617 a month; a family of three received \$517. Across all 50 states and the District of Columbia, the median benefit for a family of four was \$469 in January 1996.[14]

---

[13]Nine states, including California, Massachusetts and New York, paid more. Wisconsin has a small state earned income tax credit; the effects of including this in the comparative analysis are reported in Walker and Wiseman (1997).

[14]The incentive structure under AFDC is difficult to depict in diagrams like Figures 3 and 4 since the 100-hour rule makes benefit loss a function of hourly wage as well as of earnings. In principle, all benefits are lost when earnings reach the amount associated with $12\times100/52 = 23$ hours of work per week. Moreover, under AFDC (and, in most states, also under TANF), earnings were only disregarded for the first four months of employment. The example is based on annual accounting and takes a four-person household in which the principal wage-earner begins employment on 1 January. The average weekly gain from AFDC is plotted up to the point that the 100-hour rule leads to loss of benefit. To fix this point in terms of earnings, the principal earner is assumed to earn \$8.00 per hour,

FIGURE 8

Weekly Benefits and Earnings accounting for Food Stamps, AFDC, Section 8 Housing Subsidies and Earnings, with and without the EITC, for a Couple with Two Children, 1996

Title: fig 8
Creator: FreeHand 7.0
CreationDate: 12/11/97 2:44 pm

Rented housing subsidies are far less common in the US than in the UK. In 1995, only about one-fifth of all recipients of AFDC were living in federally subsidised housing.[15] Nevertheless, since receipt of housing benefit is common in the UK, it is appropriate in this comparison to take account of what is called a ‘Section 8’ rent subsidy. This provides the difference between 30 per cent of a family’s income (after a small disregard) and what the US Department of Housing and Urban Development judges to be ‘fair market rent’ in the area in which the recipient resides.[16]

Figures 8 and 9 show the result of adding AFDC and Section 8 housing subsidies to the schedules depicted in Figures 6 and 7. The guarantee is now greater, but the marginal deduction rate is higher as well. With or without the EITC, the deduction rate moves beyond 100 per cent as the 100-hour threshold is crossed. Since the position of this threshold depends on the wage rate, it will occur at different levels of earnings for different workers, but such a threshold exists for

---

an amount that would just bring the family to the poverty line were he (or, in some instances, she) to work full-time, all year.

[15]This estimate was calculated from the 1995 Federal Quality Control Sample of AFDC cases.

[16]The fair market rent effective in Milwaukee (Wisconsin’s largest city) in 1996 for a two-bedroom apartment — $564 per month — is used.

FIGURE 9

US Marginal Deduction Rate for Food Stamps, AFDC and Section 8 Housing Subsidies Recipients, with and without the EITC, for a Couple with Two Children, 1996

Title: fig 9
Creator: FreeHand 7.0
CreationDate: 12/11/97 2:45 pm

all two-parent families. The lone-parent case, not illustrated here, lacks the 100-hour break but, in general, exhibits the same high marginal deduction rates.

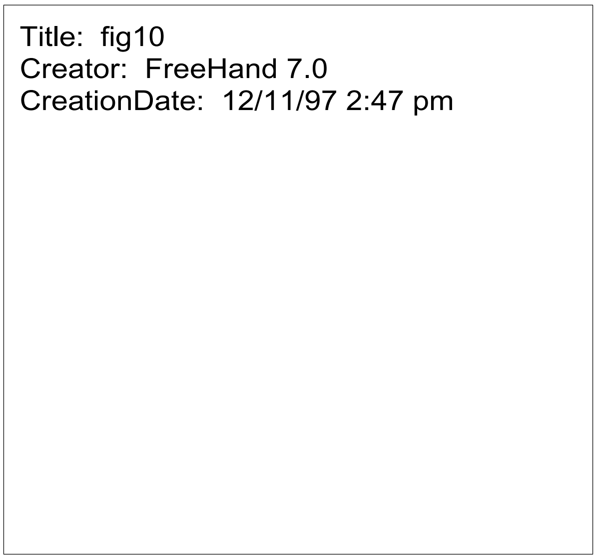
3. Comparison with the UK

The final step in investigating the American EITC and related assistance programmes is to compare the US and UK cases directly. To do this, income and benefits are converted to a common scale based on the median weekly earnings of men working full-time.[17] Figure 10 combines Figure 3 (the UK income–earnings diagram), modified to take account of income support for people working less than 16 hours per week, with Figure 8 (the US income–earnings diagram); Figure 11 does the same for Figures 4 and 9.

[17]In April 1996, median earnings for full-time male employees on adult rates in the UK were £334.90. The closest comparable data available for the US are median weekly earnings for all men 16 and older for the second quarter of 1996, \$554.60. The UK data are from the 1996 New Earnings Survey. The American figure is from *Employment and Earnings*, vol. 43, no. 7, July 1996, p. 151. Note that at the then current exchange rate (\$1.52/£), the American earnings level is £365, or approximately 9 per cent higher than the UK figure. At current (August 1997) exchange rates (\$1.67/£), the two figures are virtually identical. For reasons of comparability, the British data have been recalculated on the basis of increments of £6 (rather than the £1 used in Figures 3 and 4) to correspond with the \$10 increments used in all the US analysis. All other assumptions are retained.

FIGURE 10

Comparison of Earnings and Incomes in the UK and US after Payment of Taxes and Benefits, for a Couple with Two Children, 1996[a]



[a]See Figure 3 and text for assumptions.

It is apparent that the US system, when operated in the context of a relatively generous state, serves to achieve higher incomes than the British system for those with earnings above 25 per cent of median earnings but is less successful at raising the incomes of those with the lowest initial earnings. The underlying reason is that Britain offers a more generous system — jobseeker's allowance and previously income support — for those who are effectively without work, but that the US system offers more to those in low-paid employment.[18] The consequence in terms of potential disincentives is that deduction rates in Britain are highest at the bottom of the earnings range while those in the US peak at the 100-hour threshold and again at around two-thirds of median earnings. Indeed, US deduction rates are higher than those in Britain as earnings approach the median.

FIGURE 11

UK and US Comparison of Marginal Deduction Rate for All Benefits including the EITC, for a Couple with Two Children, 1996[a]

---

[18]Differences in the tax system are also important. For the model family, the US federal income tax of 15 per cent starts at 60 per cent of median earnings, whereas in Britain the tax rate commences at 20 per cent, with a threshold at about 30 per cent of median earnings.

Title: fig11
Creator: FreeHand 7.0
CreationDate: 12/11/97 2:48 pm

[a]See Figure 3 and text for assumptions.

Finally, it must not be forgotten that this like-with-like comparison masks two important considerations. First, only the federal food stamps and EITC programmes are available everywhere in the US. In several states, two-adult families are eligible for AFDC/TANF only under very restrictive conditions (including a six-month time limit) and obtaining a Section 8 housing subsidy may require a two-year wait. Therefore, in practice, the American system achieves significantly lower incomes than suggested by Figure 10, although, as a consequence, marginal deduction rates are generally noticeably lower than in Britain (see Walker and Wiseman (1997) for further details). Second, and to reiterate, Americans with low earnings do not receive any immediate benefit from EITC in the short term, relying instead on food stamps for supplementary income.

4. The Emerging Critique of EITC

While the EITC programme enjoys substantial and continuing political support, it is also widely criticised. Critics make four points, all of which are relevant to the UK discussion.

The programme is too expensive. Between 1986 and 1996, federal spending on the Earned Income Tax Credit increased from $1.7 billion to $18 billion; as Table 1 indicates, this rivals total federal outlays on Aid to Families with Dependent Children. In the words of tax expert George Yin of the University of Virginia, ‘a transfer programme of this magnitude ... shouldn’t be hidden in our tax code’ (Yin, 1996, p. 78).

The programme is subject to excessive fraud. An Internal Revenue Service (IRS) study of tax compliance released early in 1997 reported that taxpayers claimed $4.4 billion more in EITC refunds for 1994 than they were eligible to receive (*Tax Notes*, 1997). In response, the IRS recommended various actions and changes in EITC law intended to combat erroneous and fraudulent claims. The two principal compliance issues involve assuring that the work that is reported to justify receipt of the subsidy has actually occurred and verifying that children reported as a basis for claiming the credit are indeed in the household (Steuerle, 1997, p. 1414).

The effects on labour supply may be perverse. Since the EITC raises marginal tax rates for more workers than get marginal tax reductions, on balance the EITC may lower work effort. The actual consequence of the policy for labour supply is complicated by timing of the reward. Again to quote Yin, 'EITC benefits may be perceived as an income tax refund, a product of the tax preparer's ingenuity, or simply a windfall, and not a reward for work effort. This mutes any significant influence the programme might have on work levels' (Yin, 1996, p. 78).

The good news arrives so late that the message is lost. As is clear from the figures presented above, the disjuncture between earning and receiving the EITC means that the tax reduction fails both as a reward for work and as a contribution to family liquidity during the difficult welfare-to-work transition. A number of experiments have been proposed in the US to use third parties — welfare agencies, state revenue offices or community organisations — to deliver the benefit as the claim is accrued and to integrate the EITC with other components of the transfer system (Wiseman, 1995). Some (Steuerle, 1997) encourage third-party participation as a method of reducing fraud and improving EITC administration; others see it as an essential element in an integrated tax and benefit system. One reluctant endorsement comes this way:

> Sad to say, what is needed to effectively administer a programme like the EITC is a caseworker: a person who can explain rules and choices to potential beneficiaries, use discretion in difficult cases, and monitor the flow of public funds ... If EITC funds were folded into the welfare funding pot, efforts to reform welfare into a system for firmly leading recipients to work would be easier.
>
> (Yin, 1996, p. 79)

To date, the IRS has resisted attempts to experiment with such integration.

To summarise, there is no longer a consensus that the EITC is a sensible addition to America's anti-poverty programmes (*Economist*, 1995). The scale and rapid growth of the programme and its susceptibility to fraud, combined with its failure to offer demonstrable incentives or to offer low-wage-earners extra income in the short term, have caused people to begin to look for alternatives. Few reputable commentators advocate full abolition, but people are increasingly suggesting the need to separate support for low wages from support for children (Steuerle, 1997) and to use some of the EITC funds to finance the work requirements of TANF (Yin, 1996); there is, as yet, no equivalent of child benefit in the US (but see above).

As to the direct comparison with family credit, the EITC imposes a lower marginal deduction rate because the average benefit to families is less and the credit is withdrawn over a comparable income range. Nevertheless, nominal withdrawal rates approach 70 per cent when account is taken of food stamps and rise to over 100 per cent when allowance is made for AFDC.

IV. POSSIBLE BRITISH VARIANTS

While the US experience provides no strong case for adopting an EITC in Britain, the political momentum behind such a scheme may yet prove to be unstoppable. After all, the Taylor Committee — if the Budget speech is to be taken literally — is charged to consider the *advantages*, not the *disadvantages*, of an EITC. What would such a scheme look like?

There are a number of obstacles to introducing a US-style EITC into Britain:

- the annual accounting employed by the Inland Revenue, the need to pay benefit more frequently and the absence of a food stamps programme or its equivalent;
- the individual assessment for tax but the requirement for household (benefit unit) assessment for needs-based payments;
- the precedent of paying money directly to the mother, thus targeting benefit towards children even if it is her partner who is employed;
- the problem of embroiling the Inland Revenue in the assessment of need — investigating, for example, whether or not a couple is cohabiting.

The last problem may be the most serious. The Inland Revenue's concept of the 'ability to pay', for example, is more rough and ready than the needs-based formulations inherent in social security. Because of the divergent objectives, time scales, systems and expertise of the Inland Revenue and of the Benefits Agency, a full merger of tax and social security is probably as undesirable as it is unworkable. Indeed, such differences cannot be ignored even when considering a more limited scheme to replace family credit. For so long as the principal objective of wage supplementation is to compensate for wages that are inadequate to sustain families' needs, rather than simply and solely to enhance work incentives, there is a strong case for leaving the details of family assessment in the hands of the Department of Social Security, or perhaps a specialist agency, rather than passing responsibility to the Inland Revenue or employers.

1. A Full Earned Income Tax Credit

Unfortunately, what may be the neatest strategy, which involves employers providing a tax rebate based upon certification provided by the DSS, clears only three of the four obstacles.[19] Such a scheme would entail the Benefits Agency calculating entitlement to a credit which would be offset against National Insurance contributions and/or income tax: some claimants would simply pay less in tax or contributions but most would receive a positive credit with the weekly wage packet or monthly salary slip. The scheme would be analogous to statutory maternity pay in the way that employers deduct the payment from their monthly remittance to the Inland Revenue, although they would play no role in calculating the amount of tax credit.

How much importance is attached to the unresolved problem of the intra-familial transfer from handbag to wallet inherent in this scheme depends on the weight given to targeting the benefit on children. If this is considered to be paramount, as reluctantly it was in 1985 long before the appointment of a Minister for Women, family credit may need to be retained (though see below). But there could be other difficulties too. One is take-up. Even though the benefit is received through the pay packet as a tax credit — itself a positive change, clearly signalling the true value of working — the fact that the benefit is assessed by the Benefits Agency may confer stigma, eroding the sense of self-sufficiency. If so, one strategy might be to create a separate agency, perhaps badged as a special section of the Inland Revenue but staffed with specialists in needs assessment. But this still does not obviate the need for people both to recognise the value of a tax credit and to apply for it.

Another complication is the short-term nature of some employment. About a third of people who move off unemployment-related benefits re-claim within six months, while 44 per cent of family credit recipients change jobs within six to eight months of a claim (Bryson and Marsh, 1996). Currently, claimants retain their family credit as they move from employer to employer for the duration of the six-month eligibility period (after which, of course, they have to make another claim). While this system could be retained under a tax credit system by adding the credit code to employees' P45s, the more integrated the tax and benefit systems, the more difficult this would prove to be.[20]

---

[19]Meadows (1997) lists three other options. In one, the Inland Revenue assesses information on taxable income and family circumstances and informs employers of the appropriate tax code (schedule) to apply for eligible employees; in the second, responsibility for collecting family and household information from all employees is given to employers who would pass it along to the Inland Revenue; while, in the third, employers only collect this information from people with earnings that fall in a qualifying zone and then calculate the credit payable on the basis of a manual or computer program.

[20]An employment credit could be conceptualised as a social security benefit paid through the tax system. In this case, it would not matter if, at year-end, credit payments did not tally with the tax position because of variations in earnings that were ignored in the calculation of the employment credit. However, if the credit were treated as a tax

A final, perhaps insuperable, problem is created by the concentration of low-paid jobs among small employers. Given that only 38 per cent of the labour force have dependent children and just 3 per cent receive family credit, most employers should have no difficulty paying positive credits from the tax deducted from wages paid to their labour forces. Nevertheless, some small employers, paying low wages, will require supplementation from the Inland Revenue. While mechanisms already exist for the Inland Revenue to make rebates, these are quite cumbersome and delays could have a fatal impact on employers' cash flows.[21] Similar, though inevitably more complex, problems would arise for the self-employed. Substantially to eradicate the problem would probably entail the Inland Revenue, or the assessment agency, directly mailing credits to recipients but it is not altogether clear how this would improve on family credit.

2. A Partial Earned Income Tax Credit

However, if there is a principled commitment to introducing an earnings tax credit, despite the practical difficulties and evidence of limited success in the US, there may be value in considering dividing the cost of wage subsidisation between the tax and benefit systems and separating family support from support of wages.

Such a scheme might have three elements: an out-of-work benefit, probably similar to jobseeker's allowance but with no dependency additions; a parental responsibility benefit, combining the dependency elements from jobseeker's allowance and family credit and paid on an income-tested basis irrespective of the work status of either parent;[22] and a family employment credit paid to *one* earner in low-income families. The pragmatic attraction of such a proposal is that the amount of earnings credit would be much reduced, with the probability that virtually all employers would be able to add the credit to wage packets without needing a rebate from the Inland Revenue. Although the credit would be comparatively small, the financial incentive would be clear and it would be realised on the pay cheque: a net wage inflated by a tax credit compared with an individualised out-of-work benefit. The prominent recognition given to government's contribution to meeting the costs of parenting — which would generally be paid to mothers — is a further attraction of the scheme.

Most of the limitations of the strategy arise from complex administration. To minimise this, joint assessment would be required for couples, but the logic of the scheme would demand separate giros to be paid to the main breadwinner and partner. Moreover, it would be appropriate to let couples choose to whom each benefit is paid. A further problem is the disjuncture between the out-of-work

refund or negative tax, employment credit would need to be assessed with each change of employer (or, indeed, each change in wage rate) or be subject to an end-of-year reconciliation.

[21]To speed this process, rebates would need to be subject to audit after payment by the Inland Revenue.

[22]One could envisage the same system operating for lone parents and child benefit being retained in its current form (i.e. assumed to be in payment when fixing scale rates for income-tested benefits).

benefit and employment credit, even though the parental responsibility benefit crosses the employment divide. This raises the spectre of the principal wage-earner having to claim the credit on starting work and his or her partner being reassessed through a different mechanism. If, however, the earnings credit were individualised,[23] with all dependency additions absorbed into the parental responsibility benefit, then the only information needed by the employer to implement the scheme would be confirmation that the employee had family responsibilities and that no credit was being claimed by his or her partner. Fraud-resistant certification by the Benefits Agency or a combined employment and benefits agency would be required.

V. REFLECTIONS

The low-wage sector in Britain, as in the US, has expanded so much that some form of wage supplementation is inevitable. Without it, families in work could not make ends meet or might not be prepared to work. The libertarian solution of lowering benefits would simply create mass destitution. To alleviate the problem by means of a high minimum wage would require wages to be pinned at such a level that the benefits would almost certainly be far outweighed by increased unemployment.

The existing system of family credit has strengths but also weaknesses. However, the US Earned Income Tax Credit is similarly flawed and offers few advantages. Yes, the US system does seem to leave working families with higher net incomes than in Britain but this is primarily because of lower income taxes and higher tax thresholds, not because of the EITC. Benefit withdrawal in the US creates high effective tax rates that, for a family of four, are even higher than in Britain with wages above 60 per cent of the median. Where effective tax rates are lower in the US than in Britain, this is partly because the American system delivers less family support, leaving people with the lowest incomes worse off than in Britain.

So what is to be done? A full EITC scores by reducing the apparent churning and by promoting independence from benefit. It might also be possible to spend more on supplementing wages: even a Labour Chancellor might find it easier to announce tax cuts than increases in benefits. But finding a realistic mode of implementation is not easy. An EITC would do little to tackle the poverty trap or, more especially, to bridge the very real gulf between the worlds of unemployment and work that characterises the current system. Also, it would only support the aims of Labour’s New Deal welfare-to-work policies in a benign, passive way by ensuring that people were better off in employment.

---

[23]The term ‘individualised’ denotes only that payment is made to one individual in the household. Assessment of entitlement remains on a household basis.

Perhaps the only future for an EITC is as a partial scheme, linked to the amalgamation of in-work and out-of-work benefits, which removes wage subsidisation from the sphere of social security by means of an individualised tax credit. A tripartite system — comprising the tax credit and out-of-work and parental responsibility benefits — might have something to commend it. Certainly, New Deal policies can only yield maximum dividends if they are supported by a benefit system that more adequately bridges the employment divide and reflects the flexibility inherent in the modern labour market. Indeed, providing a benefit system that systematically rewards steps into work, however tentative circumstances may force them to be, empowers both unemployed people and their employment advisers. But all of this could be achieved by making the individualised tax credit an individualised benefit instead. Heads it will be, tails it will not.

REFERENCES

Ashworth, K. and Walker, R. (1993), 'How Family Credit works', *Benefits*, vol. 7, pp. 27–8.

Bryson, A. (1997), 'Lone mother's earnings', paper presented at the 'Private Lives and Public Responses' Seminar, University of Bath, 5–6 June.

— and Marsh, A. (1996), *Leaving Family Credit*, Department of Social Security, Research Report no. 48, London: HMSO.

Committee on Ways and Means (1996), *1996 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means*, Washington DC: US House of Representatives Committee on Ways and Means.

Department of Health and Social Security (1985), *Reform of Social Security*, Cmnd 9517, London: HMSO.

Department of Social Security (1996), *Tax Benefit Model Tables*, London: Department of Social Security, Analytic Services Division.

— (1997), *The Government's Expenditure Plans, 1997–98 to 1999–2000: Social Security Departmental Report*, Cm 3613, London: Stationery Office.

Dilnot, A. and Giles, C. (eds) (1996), *Options for 1997: The Green Budget*, Commentary no. 56, London: Institute for Fiscal Studies.

Duncan, A. and Giles, C. (1996), 'Labour supply and incentives and recent Family Credit reforms', *Economic Journal*, vol. 106, pp. 142–55.

Eardley, T., Bradshaw, J., Ditch, J., Gough, I. and Whiteford, P. (1996), *Social Assistance in the OECD Countries*, Department of Social Security, Research Report nos 46 and 47, London: HMSO.

Economist (1995), 'A slap in the face for the working poor', *Economist*, vol. 336, no. 7922, pp. 47–9.

Eissa, N. and Leibman, J. (1996), 'Labor supply response to the Earned Income Tax Credit', *Quarterly Journal of Economics*, vol. 11, no. 1, pp. 605–37.

Finlayson, L. and Marsh, A. (1997), *Lone Parents on the Margins of Work*, paper presented at the 'Private Lives and Public Responses' Seminar, University of Bath, 5–6 June.

Gosling, A., Machin, S. and Meghir, C. (1994), 'What has happened to men's wages since the mid-1960s?', *Fiscal Studies*, vol. 17, no. 4, pp. 31–48.

Kempson, E. (1996), *Life on a Low Income*, York: York Publishing Services.

Lerman, A. (1995), *Average and Marginal Federal Income, Social Security, and Medicare Tax Rates for Four-Person Families at the Same Relative Position in the Income Distribution, 1955–1995*, Washington DC: US Department of the Treasury, Office of Tax Analysis.

Meadows, P. (1997), *The Integration of Taxes and Benefits for Working Families with Children*, York: York Publishing Service, forthcoming.

Scholz, J. (1996), 'In-work benefits in the United States: the Earned Income Tax Credit', *Economic Journal*, vol. 106, pp. 156–69.

Shaw, A., Walker, R., Ashworth, K., Jenkins, S. and Middleton, S. (1996), *Moving off Income Support: Barriers and Bridges*, Department of Social Security, Research Report no. 53, London: HMSO.

Steuerle, G. (1997), 'Cheating and the Earned Income Tax Credit', *Tax Notes*, 9 June, pp. 1413–14.

Tax Notes (1997), 'Treasury wants more IRS resources spent on EITC administration', *Tax Notes*, 28 April, p. 484.

Walker, R. (1994), 'Springing the poverty trap?', *New Economics*, vol. 1, Autumn, pp. 163–7.

— with Ashworth, K. (1994), *Poverty Dynamics: Issues and Examples*, Aldershot: Avebury.

— and Wiseman, M. (1997), 'An earned income tax credit for Britain: possibilities and alternatives', Loughborough University, Centre for Research in Social Policy, Working Paper no. 3035.

Whitehouse, E. (1996), 'Designing and implementing in-work benefits', *Economic Journal*, vol. 106, pp. 130–41.

Wiseman, M. (1995), 'Welfare work incentives in real time', manuscript.

Yin, G. (1996), 'Should today's fastest growing federal assistance program be roped in?', *The American Enterprise*, July/August, pp. 78–9.