

# Did working families' tax credit work? The impact of in-work support on labour supply in Great Britain

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## Abstract

In-work benefits are promoted as a way to make low-income families better off without introducing adverse work incentives. In 1999, the structure of in-work benefits in the UK changed, and their generosity almost doubled, through the introduction of Working Families' Tax Credit (WFTC). With micro-data from before and after its introduction, a structural model of labour supply and programme participation estimates that, by 2002, WFTC had increased labour supply of lone mothers by around 5.1 percentage points, slightly reduced labour supply of mothers in couples by 0.6 percentage points, and increased the labour supply of fathers in couples by 0.8 percentage points, compared with the programme that preceded it. Other tax and benefit reforms contemporaneous with WFTC acted to reduce the labour supply of parents, though. Without any form of in-work benefit in the UK, labour force participation by lone mothers would be around 45 percent, rather than the 55 per cent we now observe. Participating in family credit, the UK's in-work programme before October 1999, conferred a utility loss as well as a utility gain from the extra income, but this utility cost of participation was lower in the final year of WFTC than under previous programmes for lone mothers, and no different for individuals in couples: this in itself induced more lone mothers to work.

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## 1. Introduction

This paper provides an evaluation of the impact of Working Families' Tax Credit (WFTC) on the labour market behaviour of families with children in Great Britain. It makes use of data from all of WFTC's 42 month history, from October 1999 to March 2003.<sup>1</sup>

The key features of this paper are that it recognises and quantifies the role that programme participation (or "take-up") plays in determining the effective incentives arising from a given tax and benefit system. In addition, using micro-data from before and after a major reform to the structure and form of in-work benefits in the UK in 1999, we can analyse the impact such reforms have on both programme participation and labour supply. We do this using a structural model of labour supply and programme participation, which has two main benefits: first, it allows us to disentangle the impact of changes in in-work benefits from the other, substantial, changes to taxes and benefits affecting families with children taking place at the same time as WFTC was introduced; second, it also allows us to control for the fact that the individuals entitled to participate in income-related programmes like WFTC form a self-selecting group.

Non-participation in a transfer programme is typically rationalised through some implicit utility costs of participating. Both our data and our model are uninformative about the reasons why entitled individuals do not participate, but frequently cited arguments include lack of information, hassle costs, and claimant "stigma". Regardless of its cause, non-participation in income transfer programmes, whether work-contingent or not, is important for a number of reasons. First, it indicates how well a transfer programme is reaching its intended population, assuming that the intended population is "everyone who is entitled to it".<sup>2</sup> This is often the way the debate is framed in the UK, because the main political justification for using income-related transfers is that they allow greater increase in incomes for the less well-off for a given amount of government spending compared to non-income-related benefits like Child Benefit, which have almost full participation rates. Second, transfer programmes only affect labour supply decisions if people actually participate in the programme: estimating labour supply responses to programmes assuming full participation will over-state their actual impact on labour supply.

The WFTC programme was not the first form of in-work support in Britain: in-work benefits for families with children have existed in the UK since 1971, and WFTC replaced a programme known as Family Credit (FC).<sup>3</sup> The two key differences between WFTC and FC were its increased generosity, and the fact that WFTC was a payable tax credit administered by the Inland Revenue, rather than a traditional income-related cash benefit, administered by the Benefits Agency. Its introduction in October 1999 provides an excellent example to investigate programme participation in transfer programmes, and to build a more accurate picture of the labour supply preferences of families with children. WFTC was a national, entitlement-based,

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<sup>1</sup> In April 2003, support for families with children was reformed again when Child Tax Credit and Working Tax Credit were introduced, and WFTC, amongst other things, abolished. These new credits were more generous than the programmes they replaced, and more closely integrated with the annual income tax system. This paper does not attempt, though, to examine the impact of these reforms.

<sup>2</sup> Although governments may deliberately allow for utility costs of participating as an additional targeting mechanism; see, for example, Yaniv (1997) and Besley and Coate (1992).

<sup>3</sup> See Blundell and Hoynes (in press) for details of in-work credits in the UK, Hotz and Scholz (2003) for a history of the Earned Income Tax Credit in the US, and Gradus (2001) for recent developments in continental Europe.

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