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WHAT SHOULD WE LEARN FROM TAX CREDITS?

Looking back and looking forward

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Introduction

In October 1999, tax credits were first paid to parents who worked but had low family incomes. On 5th April 2025, the last tax credit payments were made, bringing to an end a policy that had a major impact on the UK social security system and on efforts to combat child poverty. While tax credits have spent a long time dying – gradually being replaced by Universal Credit (UC) over more than a decade – their final demise marks a moment when it is worth reflecting on what we learned from the tax credit era. The present government's commitment to review and improve UC makes these experiences all the more salient in 2025, as does its commitment to develop a strategy to bring child poverty down, backed by a task force, reporting this year.

While the initial Working Families Tax Credit was paid only to working families with children, the remit of tax credits expanded in 2003 to include both payments to working people without children and the child element of out-of-work benefits. Tax credits had commonalities both with their predecessor, Family Credit, and with their successor, UC. But they should be remembered as an ambitious expansion of support for people on low incomes, that sought to underpin a more comprehensive anti-poverty strategy. In many ways UC is their natural successor, although political and economic change have to some extent exaggerated their differences.

There is a tendency to remember certain negative aspects of tax credits - including administrative anomalies, high and rising costs and selected negative impacts on work incentives. Yet they also enjoyed some fairly spectacular successes, notably the central contribution to by far the biggest fall in child poverty on record, and to a dramatic turnaround in lone parent employment rates. Some of their initial deficiencies were largely remedied.

This paper starts by giving an abbreviated history of tax credits, notes some of their key achievements and then discusses some of the challenges that they faced – in common with UC. A central message is that an anti-poverty mechanism covering people in and out of work is not at all easy to design well, and will always face an underlying dilemma of balancing adequacy for the poorest, reasonable incentives to work and constraints on public spending. The paper ends with a modest proposal for reforming UC entitlements, but this is not the only possible way forward. The important thing for future governments is to be clear about priorities, accepting that not all objectives can be fully achieved, but above all ensuring that claimants feel supported by the system, rather than having to battle against it.

An abbreviated history

It is worth reminding ourselves of the main features of the tax credit story – but skip this section if you already know them.

Tax credits were brought to Britain by the New Labour government of the late 1990s, modelled loosely on the American Earned Income Tax Credit which topped up wages for low-earning families.

The first version of UK tax credits, introduced by Gordon Brown in 1999, was the Working Families Tax Credit. This replaced the previous "Family Credit" with a more generous payment to low-income working families, which also included a new element subsidising childcare costs.

In 2003, "new tax credits" created a more comprehensive means-tested system covering all low income working families with and without children, and also incorporating the child element of out of work benefits. Specifically, it comprised:

- The Working Tax Credit (WTC) paid to both parents and non-parents working a minimum number of hours but on low incomes.
- The Child Tax Credit (CTC) comprising two elements – a larger one for each child and a smaller one at a flat rate for each family with children. The credit was available for both working and non-working families.
- A tapering of these three elements with rising income. WTC was (initially) reduced by 39p for each pound of earnings above £6,420 a year; when it ran out, the child element of CTC was reduced at the same rate, until only the family element remained. At that point, tapering was paused so that families with below £50,000 in gross earnings kept the full family element. This made about 90% of families with children eligible for at least some tax credits.

Tax credit entitlements were based on income assessment over a complete financial year. Awards were initially assessed based on income in the previous year, and later adjusted based on actual income in the year paid, so claimants could get additional payments if their pay had fallen since the previous year, or be required to pay money back where earnings had risen.

This structure of tax credits remained in place for the following 22 years, but since 2013 they have been gradually replaced by UC, starting with new cases; more recently, the remaining existing cases have been "migrated" onto UC. (In the final six months before April 2025, the remaining 440,000 were migrated; six million had received tax credits at their peak.[1])

Within this overall structure, some of the most significant changes made over time were:

- In the rates at which entitlements were uprated:
  - The child element of CTC rose at least in line with earnings until 2011, and thereafter by inflation or less, including a freeze from 2015 to 2019.
  - WTC was mainly increased by inflation, but was also frozen from 2015 to 2019.
  - The family element of CTC was never uprated, remaining at £10.45 a week for over 20 years, while the child element rose from £28 to £66. Thus this more targeted child element grew from less than three times to over six times the family element.

[1] House of Commons Library, December 2021, Managed migration: completing Universal Credit Rollout, https://researchbriefings.files.parliament.uk/documents/CBP-9984/CBP-9984.pdf

- In the rules reducing entitlements when income rose from one year to the next, which caused problematic overpayments, were relaxed but later tightened again. Earnings were allowed to rise a certain amount from the previous year (on which the initial payment was assessed) without reducing the final entitlement. This “disregard” was originally set at £2,500, but raised to £25,000 in 2006 to minimise overpayments. It was progressively reduced from 2011. From 2016 onwards it was £2,500, and in addition, falls in income up to £2,500 were disregarded, reducing the initial help families got if their earnings diminished.

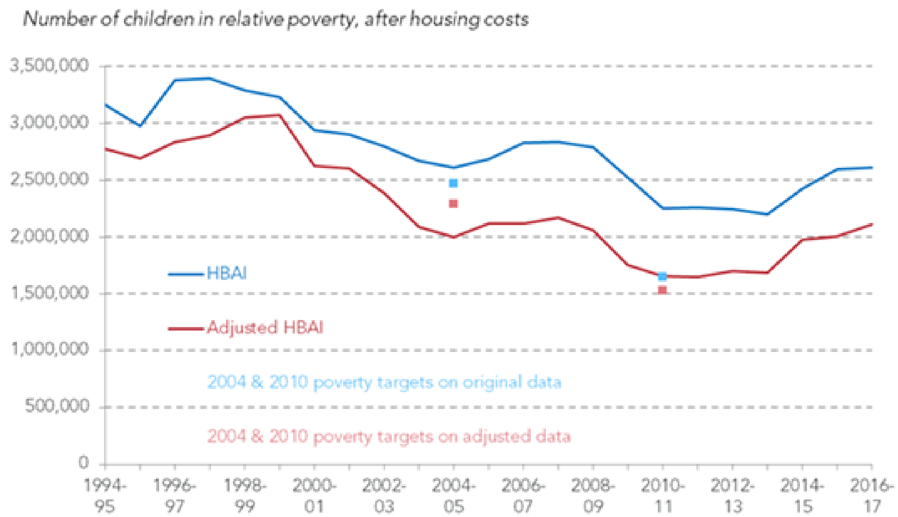
- In the rules governing the family element of CTC. The initial wide entitlement to the family element by most of the population was greatly narrowed as time went on. From 2012, it was tapered away as soon as other tax credits ran out; for families with children all born after 2017, the family element and its UC equivalent were abolished entirely.

- In the tapering of entitlements with rising income. At first sight, this barely changed (other than for the family element – see previous point): the original taper rate of 39% of pre-tax income increased to 41% in 2011/12, but George Osborne’s attempt to raise it to 48% in 2015 was seen off by a backbench Tory revolt. However, a hidden means by which reduction with income became more severe was the failure in most years to adjust the income threshold above which income was tapered (the WTC disregard) to reflect increases in prices and earnings. This threshold only rose on two occasions between 2003 and 2020. In April 2003, it represented 23 hours’ work on the National Minimum Wage; by April 2024, this had fallen to just 13 hours[2].

- Other restrictions applied to both tax credits and UC from the 2010s include the benefit cap limiting total benefits and tax credits paid to out of work families and the two-child limit, applied to the child element of CTC for children born after 2017.

Two key achievements of tax credits

In the 2000s, a key government priority was to deliver on the pledge to reduce child poverty: the target was to halve it by 2010 and eliminate it by 2020. In the event, the 2010 target was missed – but not by as much as originally thought. On the official figures, child poverty fell by about a third, but later analysis by the Resolution Foundation, shown in this chart, suggested it had fallen by very nearly half as planned. (The adjustment was based on evidence that people had under-reported income from benefits and tax credits in the main income survey.)



Source: Resolution Foundation[3]

[2] Note that someone working 13 hours would not actually have been eligible for WTC, whose hours threshold is at least 16, but if for example a lone parent worked 23 hours on the NMW, they would have had 41% of 10 hours’ pay deducted from their WTC in 2024, but no deduction in 2003.
[3] Adjusted figures are based on underreporting of take up of benefits and tax credits in Family Resources Survey. https://www.resolutionfoundation.org/comment/a-history-lesson-wouldnt-hurt-at-least-when-it-comes-to-child-poverty/

Not all, but much of the decade of falling child poverty shown in this chart can be attributed to tax credits. Successive budgets allocated billions of pounds to raising the incomes of lower-income families through the CTC – the first benefit to be targeted at all children in low income families, not just those in-work or out-of-work. This was complemented by rising employment rates and therefore an increase in family income from work, which was certainly influenced to some extent by the fact that tax credits made people better off in work than previously, giving an additional incentive to work.

It is easy to take this progress for granted, given that it had been promised and the targets were not quite reached. Yet such a large reduction in child poverty over a sustained period is remarkable in both historic and economic terms. Figures going back to 1961 show that relative child poverty (the percentage of children living in households with less than 60% median income) has in most periods been remarkably flat, never moving in one direction for more than two years in a row except in the 1980s and early 1990s when it more than doubled, and in the late 90s and 2000s, when it nearly halved. Furthermore, the economic benefit for those families brought out of relative poverty comes on top of the general rise in living standards in that period. Median income rose by nearly a quarter between 1998 and 2008, meaning that the line against which poverty is measured also rose. To make such progress against a rising threshold should be considered the gold standard of poverty reduction.

The other, linked achievement was to improve employment rates, especially among lone parents. In the 1990s, following two decades of growth in lone parenthood, the majority of lone parents were not working. By 2010, this had reversed, with nearly six in ten in jobs. As this graph shows, after pause in the early 2010s, the rate continued to rise later in that decade, to above two thirds, and has remained close to this level. We should be more aware of this historic trend (also in generally rising employment rates) before wringing our hands about the after-effects of the pandemic on labour market participation.

Tax credits were only one factor influencing more lone parents to work, but an important one. It was the first measure to give the vital help with childcare that a lone parent relies on to take a job. It gave a strong incentive at least to work part-time (if not always to work beyond a certain number of hours – see below). Another influence, starting in the later Labour period, was increasing conditionality on lone parents to work as their children got older. This requirement felt more reasonable in the context of continuing to receive Child Tax Credit than if working had risked making lone parents worse off as a result of losing out of work benefits. It's easy to forget this long-term change in expectations of lone parents, with the paradigm of using a combination of work and help from the state to escape poverty being much more commonly achieved today than before the advent of tax credits. Universal Credit's continuation of paying for the larger part of childcare costs is an example of how this ethos has been sustained.

The safety net/work incentive/public budget trilemma

As Labour's term in office came to an end in 2010, two underlying criticisms were levelled at the tax credit system. The first was that its costs had soared to nearly £30 billion, and it was still not on track to reduce child poverty as much as had been promised. This drew into question whether there was an over-reliance on state transfers, rather than on increasing family earnings, as the means of lifting children out of poverty. The second critique was that work incentives could be very poor, with people sometimes having effective marginal tax rates above 90%.

To some extent these two points are related – if pay were high enough to make in-work benefits unnecessary, working families would not be drawing large amounts from the state and would not suffer the penalty of losing it if they worked longer hours or got promotions. But better work incentives can also be expensive. Where the state does need to support a working family to avoid child poverty, the more slowly it withdraws this support as earnings rise, the higher the potential cost to the public purse.

Any chancellor seeking to address family poverty through a system of means-tested transfers must thus make difficult decisions about where to set baseline or safety-net incomes and how to withdraw support with rising earnings. The trilemma is that (i) if you set the safety net too low, those relying on it will remain in hardship; (ii) if you withdraw money too quickly with rising earnings, work incentives will worsen; and (iii) if you have a generous baseline and a relatively slow withdrawal rate, the system will become very expensive (as well as extending means-testing, and thus still-high effective marginal tax rates, further up the income distribution).

Gordon Brown’s strategy emphasised the increase in baseline entitlements through CTC rates. As described above, the rising cost of doing so was partially contained by hidden increases in withdrawal schedules, but still made most beneficiaries much better off. Under Universal Credit and the winding down of tax credits, the generosity of the system has been significantly reduced, both through uprating restrictions (including a four-year freeze) and other rules restricting benefits. The key priority has been to contain the cost of the system.

Comparing tax credits and UC in terms of work incentives is not straightforward. In doing so, it is vital to distinguish the incentive to move into work and the incentive to progress in work or take on more hours. Tax credits were always quite good at providing a decent financial incentive to move into work, provided you worked enough hours to qualify for WTC: 16 hours for someone with a disability or responsibility for a child (and from 2012 also 24 hours combined for couple parents), and 30 for others. This threshold made it barely worthwhile to work more hours, since then out-of-work benefits would be reduced pound for pound against earnings above a very small disregard. UC improved this by continuing to pay the out of-work benefit with tapered rather than 100% withdrawal, above a more generous disregard for those with children or disabilities (but no disregard for others). However, those with the lowest earnings remain subject to work conditionality, to reduce their dependence on the state where this is possible.

Looking at in-work withdrawal rates, the emphasis on the possibility of having over 90p in the pound withdrawn (including through taxation) under tax credits, reduced under UC, was somewhat misleading. The very highest rates affected relatively few people. More commonly, income tax payers on the tax credit taper paid around 70%, slightly lower than their equivalents (initially) in UC. For second earners’ incomes up to the tax threshold, withdrawal was far less under tax credits than in UC (41p, compared to 65p initially and 55p in UC today). At present, four in ten UC recipients pay more than the 55p headline rate, mainly through income tax and withdrawal of council tax support.[4]

So while both the tax credit system and UC have promised to “make work pay”, and both have helped make it financially more advantageous to work than not to, each in its own way creates many situations where someone increasing their income through longer hours or a pay rise will lose most of the increase through a reduction in state support.

Such a situation is hard to avoid in an economy where earnings are not always high enough to cover family costs. Looked at the other way around, we can say that someone suffering a reduction in earnings is protected by the system so that the majority of what they lose is made up by the state, to soften the impact on their living standards.

To some extent, better minimum wages should reduce these dilemmas. The near-doubling of the National Minimum Wage in the ten years to April 2025 (from £6.50 to £12.21 an hour) should make this easier. This is bound to improve the number of people able to make ends meet with less help from the state, releasing money that can be used to maintain better support for those who need it. It does not however do this comprehensively, since much in-work poverty is a result not of inadequate hourly pay rates but of low or intermittent hours.

[4] Becky Milne and Ashwin Kumar (2024), “ Work incentives in the tax and benefit system”

In looking for the right balance between adequacy, incentives and affordability, any system needs to take some tough choices, of which perhaps the most important is at what point and how fast to taper working benefits.

The ideal may be a relatively fast taper once income reaches some decent acceptable level. This may mean accepting that some people will choose to work fewer hours than they would otherwise, to avoid the taper, although others able to raise their earnings substantially, such as via promotion, to a level where they no longer require UC for a decent living standard.

These choices arise whether working benefits are contingent on a minimum amount of hours, as under tax credits, or conditional on seeking to raise one's earnings at least to a given level as under UC. Some options for UC are suggested in the concluding discussion below.

Is progressive universalism dead?

An important objective of the tax credits system introduced in 2003 was to be inclusive – with 90% of parents eligible for CTC in some form. This was intended to create a system regarded very differently from out-of-work benefits, where recipients are often stigmatised. CTC was originally an exemplar of the "progressive universalism" principle suggested by Gordon Brown, which could be summarised as "something for everyone but more for the poorest".

As described above, this principle was undermined from the start by not uprating the more "universal" family element of CTC, by its eventual demise and by an erosion of the value of the income threshold above which tax credits were reduced. And with even the previously fully universal Child Benefit withdrawn from those on high incomes from 2013, the whole approach to working-age benefits has become more targeted, justified by the need to direct scarce public funds to those with the greatest need.

Nevertheless, there are ways in which payments are presented that can potentially help build support for them by avoiding the "ghettoisation" of benefits restricted to those out of work. Initially, rebranding in-work and some out-of-work benefits as "tax credits" aimed to suggest a process, paying less tax, that would seem less like a "handout" and emphasise that it was allowing working people to keep more of what they earn. This was to a large extent a cosmetic feature: child tax credits, for example, came as a monthly cheque based on family income, and many claimants were not taxpayers. Similarly, bringing in- and out-of-work payments together in Universal Credit may to some extent have softened stigma, but the name does not prevent the public from recognising it as in part an out-of-work benefit.

Various opinion surveys have shown fluctuating trends in support for raising or cutting social security, but the most obvious softening came during the late 2010s and during the pandemic, rather than in response to the introduction of tax credits[5]. Part of this may be because benefit cuts during a period of austerity had made it more obvious that benefits were low relative to need than in the preceding, more generous period.

Yet while bringing together in- and out-of-work benefits may not systematically transform the way each is regarded, there have certainly been occasions where it has made a difference. For example, during the pandemic the £1,000 a year extra given to all UC families was clearly popular. The plan to increase the UC Standard Allowance by 5% in real terms in the present government will restore about a quarter of that boost, although many families receiving disability benefits will be net losers. The present structure of UC can still be used selectively to benefit favoured groups. While general UC levels have fallen in real terms, the early 2020s saw an increase in the Work Allowance (the threshold of disregarded income) and a cut in the income taper, both of which benefit working but not out-of-work families.

[5] See for example "The fall of anti-welfare attitudes", LSE blog, 2023 https://blogs.lse.ac.uk/politicsandpolicy/the-fall-of-anti-welfare-attitudes/

Overall, while the system is now clearly not designed to reach people on middle incomes, there remains the potential for people on a wide range of incomes to see it as something that could affect them, if their incomes fall – to some extent recreating the spirit of social insurance. This sense of being protected against adversity could potentially be strengthened by a reform to contributory benefits, on which the government is now consulting. This would give a substantially higher payment to people with sufficient contributions in the first months of unemployment than those supported only by means tested benefits, by a substantial amount: in the initial proposal, the insurance benefit would be over 50% higher than the means-tested one. This is in fact unprecedented in the UK, where in recent decades the payments have been identical, and prior to that only slightly different.

Having more substantial protection against falling on hard times should in principle be attractive to a wide swathe of the population, given how many face unstable lives. It is worth noting that 40% of people in the middle fifth of the income distribution this year will be in a lower quintile next year.

Creating a supportive system

Many issues around both tax credits and UC have centred around aspects of delivery. It has been challenging to create a seamless system that gets money to families when they need it, and from which recipients feel supported, rather than claimants having to battle to cope with a system that they do not feel is on their side (not least those currently threatened by cuts in disability benefits). Some of these issues have related to features common to any system of income benefits, such as what kinds of work conditions are required and how these are enforced. There has been a tendency towards a tightening of these conditions and greater use of sanctions in recent years, which has been a specific policy choice.

Other issues have been related to the assessment and timing of payments. The most problematic aspect of the tax credit regime was the way in which the assessment system led to overpayments which then had to be repaid, often causing major difficulties for families who had little financial leeway and found it hard to understand the complex system, causing difficulties when repayments were demanded. The Government's response to this was to make the system much more forgiving of income fluctuations, which did not eliminate but greatly reduced the overpayments.

With UC, the biggest issue has been the five-week wait for initial payments, based on it being paid a month in arrears. While this theoretically mirrors the way wages are paid, in practice it has led to significant hardship and debt among UC claimants. The government's response has been a small reduction in the wait (originally up to six weeks) and in the maximum monthly repayments of debts accrued while waiting – which however prolongs the period over which these are deducted. This has not solved the underlying problem that at the very moment that the government steps in to help a low income family, it often creates a debt which reduces the net value of that help over an often lengthy period. This problem would be easy to resolve if the government decided to be more generous with its support.

There are also a range of ways in which UC interacts with other benefits that could be improved. For example, the ways in which UC entitlement gives access to other "passported" benefits could be reviewed to reduce the extent of "cliff edges" where benefits disappear suddenly once income reaches a certain level[6]. A particularly stark example of this is with the Scottish Child Payment, a large additional payment available to UC recipients, which would not have to disappear in full once income exceeded the UC threshold if entitlement became part of the main UK means-test.

Both tax credits and UC have provided overall frameworks for helping low income families, within which governments can create more or less supportive rules according to political will. The biggest way that tax credits were made increasingly supportive in the 2000s was through the earnings-plus uprating of CTC, although this was partially offset by under-indexation of some elements.

[6] See Institute for Policy Research, Bath, 2024, "The interaction between Universal Credit and additional means-tested help for working claimants"

Today, while most elements are uprated in line with inflation, some, such as the Local Housing Allowances capping rent support for private sector tenants, continue to be frozen. Remedying these inconsistencies would be a first step for the present government to show that it is on the side of those on the lowest incomes, whom UC is designed to help.

Conclusion: Setting a clear path

The present government has inherited a system of income support for working-age households that starts with a safety net barely worth its name. Benefits have fallen sharply relative to needs. For example, out-of-work benefits now cover well under half what a family with children requires for a minimum acceptable living standard, compared to almost two thirds in 2010. Even if both parents work full time on the National Minimum Wage, the family still falls close to 20% short of the Minimum Income Standard (MIS)[7].

A priority for UC must be to get both in- and out-of-work families closer to meeting their needs. As a minimum requirement of the system, it should be possible for a family with both parents working full time to reach MIS – something that they could do as recently as 2021. Rising minimum wages will make a small contribution to returning to this situation, but a higher baseline UC entitlement will also be necessary.

At the same time, it will be necessary to be realistic both about the ability of the system to take on extra costs and about the extent to which it can be expected to provide for people who are closer to the middle than to the bottom of the income distribution. Over the long term, this creates the case for moving towards a system that explicitly prioritises getting people up to an acceptable living standard, but withdraws support relatively rapidly above that level.

This might suggest the following framework of UC entitlements:

- A safety net entitlement that grows at least with the rising costs felt by low income families, but with a commitment to increasing it in real terms as general growth allows.[8]

- An initial earnings disregard (the Work Allowance) set at similar to its present level.

- For earnings above this, moving towards an initial band with a more modest taper rate than the 55% of post-tax income used at present. Setting it at say 30% would allow claimants to keep half their additional income even when paying tax, speeding up the rate at which living standards rose to an acceptable level with rising earnings.

- For earnings above this point, moving towards a taper rate significantly higher than at present. This would create relatively steep withdrawal rates, but this would be a quid pro quo for making it easier in the first instance to reach a decent income with a low taper. Such a provision would be fiscally necessary in order to have gentler tapers below this point while containing costs. However, it would need to be designed with some care, to avoid excessively high overall withdrawal rates that unreasonably disincentivise additional work. In particular, it is important to avoid making people worse off as a result of taking on additional hours, for example through a high UC taper alongside a separate means test for Council Tax Support. There is a case for integrating this benefit with UC.

- Importantly, in-work conditionality (the requirement that working claimants seek to increase their earnings) would be needed for those whose earnings were fully disregarded or were being tapered slowly. This would represent the expectation that while getting relatively large amounts from the state, claimants should have to make an effort to provide more from themselves, knowing that the relatively shallow taper would reward them financially for doing so.

[7] Davis, A. et al. (2024), A minimum income standard for the United Kingdom in 2024. York: Joseph Rowntree Foundation
[8] See Hirsch, D. (2024) A new living standards escalator? abrdn Financial Fairness Trust

- For those on the steeper taper, there would be a case for a more wide-ranging, lighter touch form of conditionality based on considering future career development. As with the tax credit system hours rules, such a system would accept that some chose to live on modest, but still adequate incomes, still receiving some support from the state. It would not force them to seek marginal increases in earnings of which they would see little due to the steep taper. But neither would it not put a lid on aspiration to reaching higher living standards through significantly higher earnings that took them out of dependence on UC altogether. This lighter-touch conditionality would ask claimants to consider longer-term, skill-enhancing activities that could move them to higher pay grades or better-paying occupations.

The tax credit system set a good foundation for considering these trade-offs, and this is retained by UC. But governments have never been explicit about how they expect adequate living standards to be reached, combining decent pay with sufficient state support to cover family needs. Now would be a good time to be more open about the choices to be made, and more explicit about where priorities have to lie. The present government is committed to improving living standards. Having said a final goodbye to tax credits, it needs to use their successor, UC, to help people move towards at least a minimum acceptable standard of living.

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