

# Activation or redistribution? The mystery of tax credits

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*The latest row over welfare cuts has focussed attention on the merits and limitations of the tax credits system which Gordon Brown put in place almost twenty years ago. [Peter Sloman](#) examines why tax credits are so controversial and how the debate has been obscured for so long.*



George Osborne's proposal to cut £4 billion from tax credits has provoked the first major political row of the 2015 Parliament. The Chancellor has [sought to justify](#) his proposed cuts by pointing to the rapid growth in spending on tax credits – from £1.1 billion in 1999-2000 to £30 billion today. [Declan Gaffney](#), among others, has pointed out that the true rate of growth is closer to three-fold than thirty-fold and has insisted that

*there is no mystery about the rise in tax credit expenditure: it was driven by overt distributional choices by Labour governments (the main factor) coupled with falls in real wages since 2007/8.*

The problem for supporters of tax credits is that their growth *is* a mystery as far as much of the voting public is concerned. Gordon Brown's tax credit system, introduced in 1999 and assiduously expanded in successive budgets, was the most ambitious attempt to redistribute income towards the poor undertaken by any British government in the last forty years. By the time New Labour left office in 2010 it accounted for 1.9% of GDP – almost as much as the government spends on Defence – and was the second-largest item in the social security budget after the state pension. Yet it did not feature prominently in any of New Labour's three winning election campaigns, and in so far as Tony Blair and Gordon Brown did talk about the policy before 1997, they cast it in a very different light to what eventually materialised.

The original purpose of tax credits was to reduce unemployment among middle-aged men by making low-paid service-sector jobs more attractive to would-be family breadwinners. Ed Balls was particularly concerned by the way in which technological change had created a mismatch between the economic expectations of unskilled working-class men and the job opportunities available to them. Moreover, the all-or-nothing nature of unemployment benefit meant that part-time service-sector jobs were often not worth taking. The long-term solution was to improve 'human capital' through education and training, but Balls [warned](#) that 'upskilling the labour force will take years rather than months.' In the interim, it would make sense to 'subsidise unskilled employment in the private sector, closing the gap between male wage aspirations... and what the market will pay'.

Balls' proposal was a controversial one in Labour quarters, especially in view of the trade unions' longstanding suspicion that wage subsidies would simply encourage low pay. In 1994 the Commission on Social Justice, set up by John Smith to rethink Labour's social policy, [suggested](#) merging Income Support and Family Credit to ease the transition into work but stressed that 'our goal is to ensure that people can earn enough to meet their needs without relying on means-tested benefits'. Tony Blair and Gordon Brown also went out of their way to [emphasise](#) the moral and social value of paid work and downplay the role which benefits could play in achieving social justice. During the 1997 campaign, for instance, Blair told [The Observer](#) that he saw welfare-to-work policies as the best means of reducing poverty.

Discussions of welfare-to-work policy during the early years of New Labour focussed mainly on the New Deal for Young People, financed by a 'windfall tax' on the privatized utilities, which combined intensive support for the young unemployed with the threat of sanctions for those who refused offers of work or training. In contrast, the party's plans for changing the benefit system received relatively little attention. The [1997 Labour manifesto](#), for instance, said only that

*We will... examine the interaction of the tax and benefits systems so that they can be streamlined and modernised, so as to fulfil our objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening community and family life.*

It was predictable, then, that when Gordon Brown announced his plans for Working Families Tax Credit in his [1998 budget speech](#) he presented it as a springboard into work. The clear implication was that tax credits would be a form of activation policy with dynamic effects: smoothing the transition from unemployment into work and then providing incentives for workers to increase their hours and take better-paid jobs.

There is [evidence](#) to suggest that tax credits contributed to the fall in unemployment which took place in the late 1990s and early 2000s – though no doubt the buoyant world economy was also a factor. Many of the individuals who moved into low-paid work, however, struggled to move up and out of it. Although the introduction of the National Minimum Wage in 1999 helped low-paid workers keep up with strong median wage growth between 1997 and 2003, real wages appear to have stagnated thereafter, even before the 2008 financial crash. There are a number of possible explanations for this, but two points are worth highlighting: it is difficult to raise productivity in the service sector, and it takes time for improvements in education and training to feed through into the economic structure.

One of the consequences of this stagnation was that changes in earned income did relatively little to help the Labour government meet its target of halving child poverty by 2010 and eliminating it by 2020. Richard Dickens has [calculated](#) that although rising employment and wage levels helped reduce aggregate poverty, they had practically no effect on relative child poverty (defined as the proportion of children living in households with less than 60% of median income). Instead, almost all of the progress which the government made towards that target by 2010 can be accounted for by the increased generosity of tax credits and other social benefits.

In other words, what was initially presented as a dynamic form of activation that would help people into jobs ended up becoming a permanent system of redistribution to the low paid. Perhaps that was the intention all along. John Kay has [pointed out](#) that Gordon Brown's Treasury was heavily influenced by what he calls 'redistributive market liberalism', which suggests that government should leave production to the private sector but intervene to correct market failures and use the tax and benefits system to reduce disparities in income. It is hardly surprising that such doctrine should be so attractive to a government in search of a 'third way'. What was more remarkable was the extent to which Brown sought to redistribute by stealth. This may have reflected tensions within government – Tony Blair conceded in his memoirs that he was 'not a fan of tax credits' – but it also stemmed from an underlying fear of the electorate. Perhaps the most telling vignette in *The Times*' [recent special report](#) on Labour's defeat is the story of Gordon Brown asking his aides why they joined the Labour Party. 'To help the bottom 25 per cent', said Stewart Wood. 'Yes', replied Brown, 'but we mustn't say that or we will never win.'

Labour's ability to make political capital out of tax credits was hampered by endemic administrative problems, documented in detail in [The Blunders of Our Governments](#). Although tax credits were [one of Brown's pet policies](#), it was less risky for the government to take credit for the fall in child poverty than to draw attention to how this had been achieved. Only when the Brown government was forced into a defensive posture by a resurgent Conservative Party did tax credits begin to feature prominently in Labour's campaigning, with [a hard-hitting broadcast](#) in the final week of the 2010 election highlighting the Conservatives' plans to cut the scheme. Ed Miliband and Ed Balls tried to drive home the [same argument](#) during the 2015 campaign.

Now the question of political legitimacy cuts the other way, as David Cameron stands accused of [reneging on his pledge](#) not to cut child tax credits during the election campaign. Many of the government's present difficulties could have been avoided if George Osborne had followed Gordon Brown's precedent and whittled the system down incrementally before folding it into Universal Credit. But that would [significantly reduce](#) the budget savings in the present Parliament – forcing the Chancellor to raise taxes, find cuts elsewhere, or extend his deficit-reduction timetable still further – and deprive the Conservatives of a set-piece confrontation with Labour over the merits of

work and welfare. Perhaps it is the desire to expose Labour as benefit junkies that is the real attraction.

It looks increasingly like the Prime Minister and Chancellor have blundered, and will be forced into some sort of U-turn to win over the Lords and their own backbenchers. But if this row has achieved anything, it has at least opened up a debate which has been avoided for too long. Whether tax credits survive or fall, all parties will now have to engage with the question of how best to reduce in-work poverty in 21<sup>st</sup>-century Britain.

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### **About the Author**

**Peter Sloman** is a University Lecturer in British Politics at the University of Cambridge and is currently working on the history of tax-benefit integration. He tweets as [@pjsloman](#)



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