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Resolution Foundation

REPORT

Universal Credit

A policy under review

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Contents

Executive Summary

Universal Credit (UC) represents the most significant transformation of our welfare system, merging six separate out-of- and in-work benefits into one. While the principles of simplification and making work pay are widely supported, questions remain about UC's ability to deliver on these original intentions. Some of the initial policy choices made about UC, coupled with subsequent revisions over the last few years, have led to concerns that the incentives to get into work and then progress are being blunted.

Up to 10 million families are likely to be affected by Universal Credit and regardless of the outcome of the election, the policy looks set to continue in some form, given broad support for its principles. There is, therefore, a strong case for making the most of the current window of opportunity before the policy is fully rolled out to reassess it against its original ambitions.

To this end, the Resolution Foundation has brought together an expert panel of labour market economists, welfare specialists, employment practitioners and other experts to review the current design of Universal Credit and its likely impacts and propose changes that would make the policy more likely to support people to get into and progress in work. The cumulative impact of changes proposed by the panel on the number of people moving into and on in work will be estimated. This paper sets out the scope of the panel's review.

The panel will focus on Universal Credit as it affects the working-age, non-disabled population and will principally address three aspects of the system:

» The scope of benefits that are integrated as part of UC compared to those that have been excluded and how these choices affect work incentives. This will focus predominantly on the exclusion of Council Tax Support and passported benefits such as free school meals and the inclusion of housing and childcare support.

» The financial incentives to enter and progress in work created by UC's allowances and taper rate. The panel will also consider how these structures interact with tax policy.

» The design and likely success of in-work conditionality for both employees and the self-employed, given the untested nature of the approach. The panel will also consider the potential to use in-work conditionality to support people to earn higher wages rather than simply increase their hours.

Policy choices in each of these three areas will seek to reflect our current understanding of how different groups respond to incentives, which groups respond most, and the nature of the incentives that drive behaviour change.

In addition, policy choices will be set against the backdrop of a number of changing conditions with which UC will have to contend. Of central importance are the underlying trends in the labour market, with the persistence of low pay, the polarisation of jobs and the rise in self-employment all presenting challenges for the design of Universal Credit. Added to this are two wider issues that will have to be taken into consideration in the policy choices that can be made: first, the likelihood of ongoing austerity in the next Parliament that will limit the scope for addressing the generosity of Universal Credit; and second, the nature of the recovery, with strong employment growth but a slower than expected return to real wage growth likely to increase spending on Universal Credit.

Section 1

Introduction

Universal Credit (UC) – the government's most significant welfare reform – has been the subject of considerable controversy over the last 12 months. Delays and implementation difficulties have raised questions about the extent to which Universal Credit will be in place as planned by 2017. A review by the National Audit Office in 2013 raised doubts about the feasibility of a transformation on the scale of Universal Credit and the government now considers the project to be in a 'reset' phase.[1]

However, support for the broad principles of Universal Credit remains strong across all parties and for good reason. Simplifying six benefits with different eligibility and withdrawal criteria into one benefit with a single withdrawal rate that is more easily understood makes sense. Anything that makes it easier for low paid people to calculate whether or not they are likely to be better off by working more would be a positive change. Ending the distinction between out-of and in-work benefits that traps some people in worklessness is also hard to refute, as is the creation of more positive incentives to progress in work. Supporting people to earn more provides important protection for household living standards. As such, it appears there is considerable support for the underlying goals of Universal Credit across the political spectrum.

The likelihood that the roll out of Universal Credit will continue in some form post-election creates a strong case for broadening the current focus of debate to reconsider the potential impact of Universal Credit. Significant changes have been made to the policy since it was first announced in 2010 and from the original proposal put forward by the Centre for Social Justice a year earlier. Some of these have been improvements such as the increase in childcare support from 70 to 85 per cent. However, public spending constraints have largely reduced the support available in numerous ways, as they have also done within the existing tax credit system. Furthermore, some early policy choices are also likely to impact on UC's ability to deliver on its intended outcomes, for example the exclusion of council tax support and the lack of a separate work allowance for second earners.

Assessing whether UC will now deliver the simpler system that was envisaged and support more people into work hinges on four important issues. The first is the extent to which the incentives created by UC reflect the reality of how people make decisions about whether and how much to work and the extent to which the incentives are sharp enough to prompt behaviour change over and above what today's benefits and tax credit system achieves.

The second, and related issue, is whether UC adequately takes account of the nature of the labour market and the ongoing polarisation of jobs. This includes long term structural issues such as the prevalence of a large, low paid labour market, as well as the more cyclical issues related to the ongoing weakness of real wage growth.

Third, UC is reliant on an entirely untested approach to in-work conditionality for which there is currently no established infrastructure or approach and a lack of awareness among employers of the nature of the requirements that their employees will face. Pilots are underway that will inform the development of in-work conditionality but a lot of the success of UC for those who are already in work is reliant on the development of a brand new system of sanctions for a group that have not previously been subject to any such requirements.

[1] Cabinet Office (2014) *Major Projects Authority Annual Report 2013-2014*

Finally, significant changes have already been made to UC since its original conception as a result of public spending constraints. A further round of welfare spending cuts is expected in the next parliament regardless of who wins the election. If these result in an even less generous system they will potentially further dilute the expected impact of UC.

Given the scale and cost of change that Universal Credit entails, it is essential that UC delivers sufficient improvement compared to the current system to warrant such an undertaking. Otherwise, a more modest set of changes to address some of the most pressing issues with the existing system may be more advisable. Of course, every welfare system creates winners and losers. Within finite resources, choices have to be made about how much support to offer different types of households; how much support to offer those out of work while not eroding the incentive to move into work; and how to balance supporting people into work with incentives to progress and work longer hours. The question for UC is whether the current choices sufficiently target the groups who are most likely to respond and in ways that are compatible with the labour market options they face.

To assess these questions, the Resolution Foundation has brought together an expert panel of labour market economists, welfare specialists, practitioners and other experts to review the current design of Universal Credit and its likely impacts and propose changes that would make the policy more likely to deliver on its stated objectives. The cumulative impact of changes proposed by the panel on the number of people moving into and on in work will also be estimated. This paper sets out the scope of the panel's review.

The panel will focus on Universal Credit as it affects the working-age, non-disabled population, recognising that other groups such as carers are equally important but largely beyond the scope of the panel's deliberations. The panel will focus particularly on the incentives to move into and progress in work rather than on the adequacy of out of work benefits and the out of work sanctions regime, while recognising that these are critical from a poverty perspective. There are important aspects to how Universal Credit will be paid that also lie largely beyond the panel's scope, notably the shift from weekly to monthly payments; the shift in paying housing benefit from landlords to tenants; and the division of payments within the household.

The next section describes Universal Credit, its design and how that differs from the current system of benefits and tax credits. Section three considers the impacts of Universal Credit based on the current policy choices, drawing on the government's 2012 impact assessment as a starting point. Sections four, five and six discuss the three aspects of Universal Credit that will form the basis for the expert panel's review:

» The scope of benefits that are integrated as part of UC compared to those that have been excluded and how these choices affect work incentives;

» The financial incentives to enter and progress in work created by the structure of the allowances in UC and the taper rate;

» The role of the proposed in-work conditionality regime for both employees and the self-employed.

Section 2

The design of Universal Credit

What is Universal Credit?

Universal Credit is a means-tested benefit that will replace six forms of out-of and in-work support for working-age households which together cost almost £70 billion in 2013-14– around 10 per cent of all government spending:[2][3]

» working tax credit
» child tax credit
» housing benefit
» income support
» income-based Jobseeker's Allowance
» income-related Employment and Support Allowance

The proposal for the UC system was first made by the Centre for Social Justice, although a single out-of-work benefit for working age people had previously been proposed.[4][5] The existing array of means-tested benefits was characterised, the Centre for Social Justice argued, by low financial work incentives; complexity, poor understanding and bureaucracy – which further discouraged take-up and work; as well as penalties on couples and saving. Its proposals built on the wider literature devoted to simplifying the tax and benefit system and work incentives, most comprehensively captured (later) in the Mirrlees Review.[6]

Through the integration and redesign of existing benefits, UC is intended to: [7]

» Improve work incentives through higher work allowances and lower withdrawal rates;
» Smooth the transition into and out of work;
» Reduce in-work poverty;
» Simplify the benefit system, making it easier to understand and to administer;
» Reduce fraud and error.

[2] Department for Work and Pensions, (2014) Benefit expenditure and caseload tables

[3] HMT (2013) *Public Expenditure Statistical Analyses 2014*

[4] Brien, S et al. (2009) *Dynamic benefits: towards welfare that works*, The Centre for Social Justice

[5] Sainsbury, R and Stanley, K (2007) *One for All: Active welfare and the single working-age benefit*, IPPR.

[6] Institute for Fiscal Studies (2010) *Mirrless Review*

[7] DWP (2010) *Universal Credit: Welfare that works*

The Coalition government introduced proposals for UC in 2010, and pilots began in April 2013. In theory, existing benefits will be closed to new claimants in 2016, and all except recipients of Employment and Support Allowance will have transferred to UC by the end of 2017. Table 1 shows in basic terms how Universal Credit differs from the current system.

Table 1: The basic design of Universal Credit

Current System	**Universal Credit**
Income Support	Elements to build basic entitlement
Income-based JSA	
Income-related ESA	Work Allowance to disregard initial earnings
Child Tax Credit	
Housing Benefit	Single taper rate of 65%
Working Tax Credit	

The current system consists of a number of out-of-work benefits to provide a basic level of income replacement, mainly Jobseekers Allowance, Income Support and Employment and Support Allowance. The Tax Credit system sits on top of these and is tapered away as earnings rise. It provides support with basic income for families with children through Child Tax Credit and further support for the low paid who comply with certain hours rules through Working Tax Credit.

At present out-of work benefits are withdrawn at a 100 per cent marginal rate beyond a small earnings disregard. Working Tax Credit is then paid to parents working at least 16 hours a week (and a total of 24 hours for a couple with children) creating a significant jump in income at that point but little or no incentive to work less than this.[8] Child Tax Credit is awarded based on the number of dependent children in the household. Both Working Tax Credit and Child Tax Credit are tapered away at 41 pence in every pound of gross earnings above an annual threshold of £6,420. Taking into account basic rate income tax and national insurance payments, the overall taper rate is equivalent to 73 per cent.

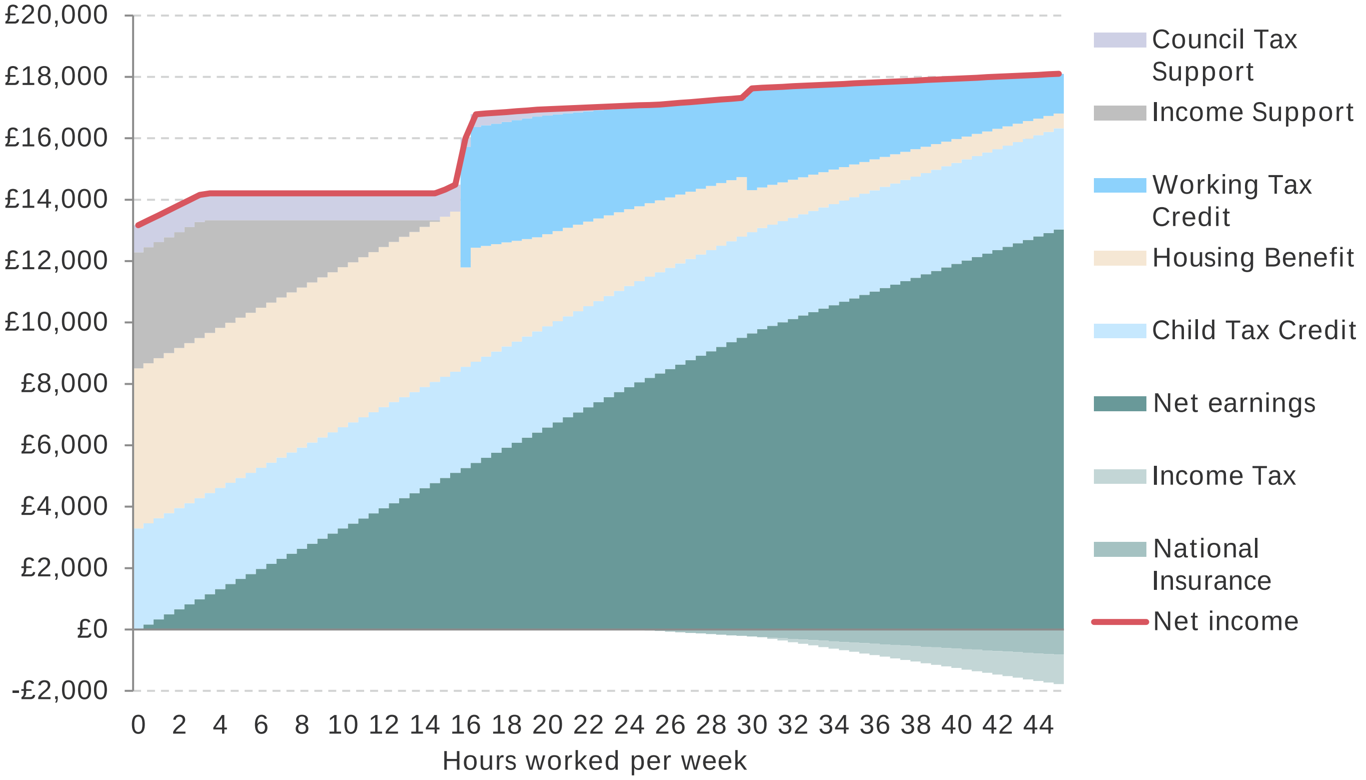
The current system is further complicated as additional elements of support such as housing and council tax are also withdrawn through a taper but from different income thresholds, at different rates and taking into account income from tax credits. The effect of these complexities on an individual's income and benefit award is shown in Figure 1 where the combined withdrawal of housing benefit, council tax benefit and tax credits means that the lone parent in question keeps no more than 17 pence of every extra pound earned, and only 9p once she has worked at least 16 hours. A further element is awarded once 30 hours are worked.

[8] Singles or couples without children working 30 hours or more a week also qualify for working tax credit, but the income limit at which entitlement ends is relatively low at £13,100 and £18,000 respectively

Figure 1:

Current system – Annual net income by component of benefits, taxes and earnings at different weekly hours worked: Lone parent earning the minimum wage with one child, aged 4

Annual net income



Source: Resolution Foundation's tax and benefit model, 2014-15

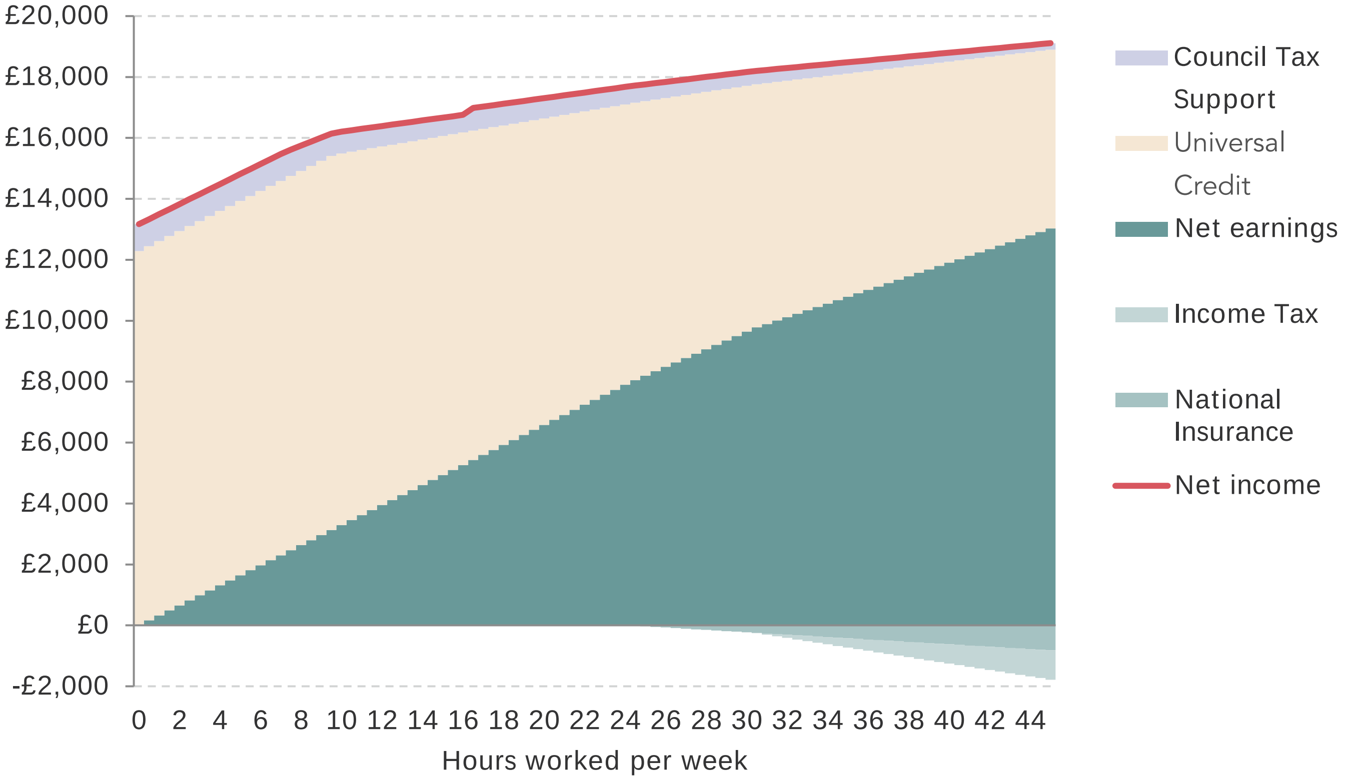
The current system can often be difficult to navigate and leave people unsure whether they are better off moving into work or working more. The design of UC (Figure 2) will be simpler, and built around three key components. Households have a basic out of work entitlement which is based on their household type and a range of other characteristics (see Table 2). On top of this basic entitlement, households have a work allowance which allows them to keep their earnings up to a certain threshold which is also determined by their household type (see Table 2), after which their Universal Credit award starts to be withdrawn as a single benefit on a 65 per cent taper rate. This means that for every additional pound earned, the household keeps 35 pence if they do not pay income tax and National Insurance or 24 pence if they do (76 per cent taper rate). This is significantly less than better off households outside Universal Credit who keep 59 pence of every additional pound they earn after tax and National Insurance.

Table 2: Basic entitlements and work allowances under Universal Credi per year

(£, to nearest £50)	Entitlement (before housing element)	Work allowance (higher figure is if no housing costs)	Net income where UC hits zero (if no housing costs etc.)
Single adult	3,800	1,350	7,150
Couple, no children	5,900	1,350	10,450
Lone parent, 1 child	7,050	3,150 or 8,800	19,700
Lone parent, 2 children	9,800	3,150 or 8,800	23,900
Couple with 1 child	9,200	2,650 or 6,450	20,600
Couple with 2 children	11,950	2,650 or 6,450	24,850

Figure 2:
Universal Credit – Annual net income by component of benefits, taxes and earnings at different weekly hours worked: Lone parent earning the minimum wage with one child, aged 4

Annual net income



Source: Resolution Foundation's tax and benefit model, 2014-15

UC also includes a childcare element for families where all parents work, similar to that in working tax credit but without the current requirement to work at least 16 hours, which from 2016 will cover up to 85 per cent of a family's childcare costs. However, Council Tax Support was not included in UC and has instead been devolved to the local level, creating further complexity and affecting work incentives as each local authority can run its own scheme with differing eligibility rules and different tapers.[9] The additional council tax support taper can mean that households keep seven pence less than the 35p per pound intended under UC, as shown in Figure 2. This will be discussed further in Section 4.

The breakdown by income component shown in Figure 1 highlights the complexity caused by having a number of benefits with differing entitlement rules and Figure 2 shows the simplicity that Universal Credit is intended to bring. There are a range of other significant differences in the design of Universal Credit compared to the current system of benefits and tax credits that significantly shape the impact of Universal Credit:

» The Universal Credit taper is applied to net rather than gross earnings as in tax credits, and this has several important consequences. First, tapers on net earnings prevent marginal deduction rates from becoming too high as can be the case in the current system. Around 100,000 households face MDRs of between 90 and 100 per cent under tax credits. Second, a net earnings taper is relatively less favourable to those who pay less tax, for example second earners, compared to those for whom the gap between gross and net earnings is larger. Third, net earnings tapers mean that any tax cuts that are introduced, for example increasing the personal tax allowance, are not fully passed on to UC recipients as they would be under tax credits.

» The introduction of a work allowance significantly improves the incentive to enter work because individuals keep all of their earnings until the work allowance is exhausted. The single household level work allowance significantly influences the winners and losers under UC compared to tax credits by creating different incentives for part-time and full-time work compared to the current system and for first compared to second earners. The current earnings disregard in tax credits applies for only one year and provides only a level of transitional support for a change in circumstances (such as an increase in household earnings).

» The housing element of UC is tapered away at a lower rate than Housing Benefit is under the current rules. This means that, in parts of the country where rents are high, households remain within UC on higher incomes than under the current system, and therefore continue to be subject to high marginal deduction rates for longer, compared to paying only income tax or National Insurance, reducing their incentive to work.

» The current system of tax credits includes a set of hours rules based on household type which dictate how many hours have to be worked in order to qualify for support (see Table 3). These hours prevent tax credit recipients from receiving support if they only work a small number of hours. In order to simplify the system and smooth incentives to progress in work, Universal Credit no longer includes hours rules. In their place, it has introduced in-work conditionality requirements which entail households being subject to some form of government intervention if they earn less than the equivalent of full time minimum wage earnings. These requirements were not part of the original conception of Universal Credit put forward by the Centre for Social Justice, nor were they part of the original government proposal published in 2010.

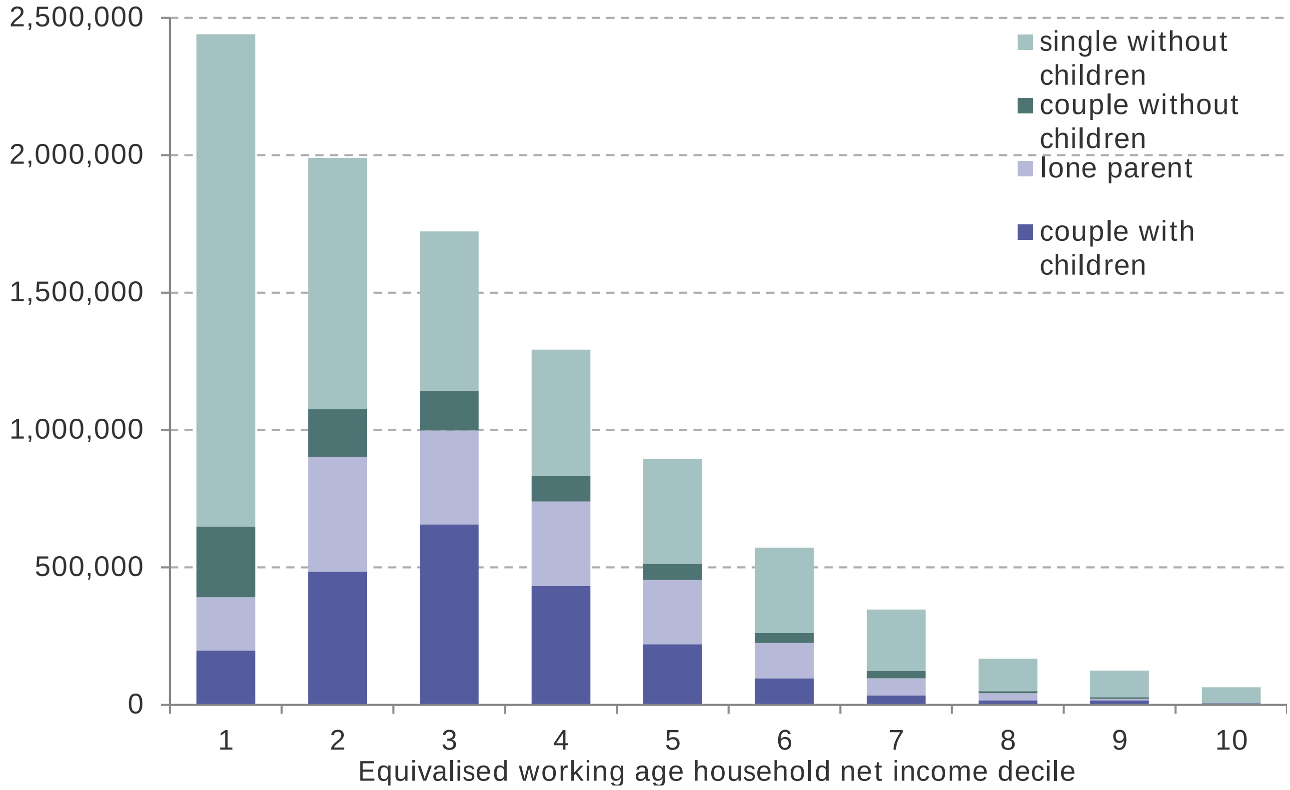
[9] Figure 3 makes a simplified assumption that Council Tax Support will be withdrawn at a 20% rate on net income after other benefits are withdrawn

Table 3: Hours rules under tax credits

Circumstance	Hours a week
Age 25 to 59	At least 30 hours
Age 60 or over	At least 16 hours
Disabled	At least 16 hours
Single with 1 or more children	At least 16 hours
Couple with 1 or more children	At least 24 hours (with 1 working at least 16 if both work)

Figure 3:
Distribution of families entitled to Universal Credit

Number of families



Source: Resolution Foundation analysis using IPPR tax benefit model

Who is eligible for Universal Credit?

Our analysis suggests that 40 per cent of UK working age families will be eligible for UC. While Northern Ireland has its own powers in this area, it has signed up for UC alongside England, Scotland and Wales.[10] The Scottish Nationalist Party has, however, said that it would halt the role out of the current UC policy if Scotland were to become independent in order to develop its own approach.

Households eligible for UC are predominantly in the bottom half of the income distribution but stretch all the way to the highest decile as shown in Figure 3. The majority of households with the lowest incomes eligible for UC are single people or couples without children. Families with children are less likely to be at the very bottom of the distribution – in part due to the additional support a household receives where children are present. Families in the top 20 per cent of incomes fall under UC largely because of their entitlement to housing support in high rent areas and to some extent disability or caring responsibilities. At any given point in time, half of all children will be living in families eligible for UC, and even more will fall under UC once churn over the life time is taken into account.[11]

Existing means-tested benefits also impact on a large proportion of families, but with UC any one policy change can – because it combines six previous schemes – affect many more people. Households receiving UC will have their incomes, work incentives, finances and even perceptions in part determined by policy choices. Many, if not all, aspects of UC's design are therefore of great importance both to individual families and to the economy as a whole. In the medium term cash benefits are unlikely in themselves to be a significant and sustained driver of household income growth.[12] This makes it even more important to ensure that the introduction of UC helps rather than hinders low and middle income families in finding work and increasing their earnings.

[10] Browne, J. and Roantree, B. (2013) *Universal Credit in Northern Ireland: what will its impact be, and what are the challenges?*, IFS

[11] Roantree, B and Shaw J (2014) *The Case for Taking a Life-Cycle Perspective: Inequality, Redistribution, and Tax and Benefit Reforms*, IFS

[12] Brewer, M and Wren-Lewis, L (2012) *Why did Britain's households get richer? Decomposing UK household income growth between 1968 and 2008–09*, Institute for Social & Economic Research

Section 3

The potential impact of UC

Any welfare system faces a trade-off in its design between three key factors, coined the 'Iron Triangle': redistribution of income from those with higher incomes to lower incomes; returns from work compared to the support available out of work and the overall cost and reach of the welfare system.[13] For those in work, the rate at which government either taxes increased income or withdraws benefit income as earnings increase will affect the incentive to work or earn more. Whatever level these are set at will have a cost implication as it will affect the size of the entitled population. UC cannot fully resolve these tensions and its original, more generous conception sought to balance these conflicting priorities in a particular way. The latest version of UC, however, makes somewhat different trade-offs.

i The Centre for Social Justice's proposals versus implementation – select comparisons

Dynamic Benefits, 2009

- Two simplified benefits for out-of-work and in-work
- Includes Council Tax Benefit and Disability Living Allowance[1]
- Benefits paid by DWP and withdrawn by PAYE system
- Withdraws 55% of post-tax earnings
- Maximum earnings disregard[2] for:
    - singles over 25 of £5,750
    - lone parent with 2 children of £9,550
    - couple with 2 children of £6,150
- Earnings disregards reduced relative to housing and council tax element
- Monetary value of passported benefits tapered away
- Second earners to engage with welfare-to-work programme to be eligible for couple level disregard
- Conditionality only applies to those receiving out-of-work benefits

[1] Disability Living Allowance is being replaced for people of working age by Personal Independence Payment

[2] Values shown are from Brien, S et al (2009) Dynamic Benefits, CSJ and uprated by CPI to 2014/5

Universal Credit 2014-15

- One simplified benefit
- Excludes Council Tax Support and Disability Living Allowance
- Benefits paid and withdrawn by DWP
- Withdraws 65% of post-tax earnings
- Maximum earnings disregard (now Work Allowance) for:
    - singles over 25 of £1,330
    - lone parent with two children of £8,800
    - couple with two children of £6,450
- Uniformly lower earnings disregards for households with housing element
- No confirmed policy on passported benefits
- Claimant commitment necessary for those out-of-work or earning less than £11,515 (35 hours at minimum wage)
- In-work conditionality for those earning less than the equivalent of full-time National Minimum Wage5

[13] Blundell, R (2002) *Welfare-to-work: Which policies work and why?*, UCL & IFS

This section looks at how the trade-offs being made under Universal Credit change the profile of winners and losers compared to the current system of benefits and tax credits. The evidence presented here is based on the government's impact assessment published in December 2012 as an indication of the scale and type of impacts expected. However, this assessment is now out of date. While it includes many of the changes made to UC since its original conception in 2009 (see box on previous page) it does not include the impact of freezing work allowances from 2014 to 2017 rather than uprating them in line with CPI. For these reasons our project will conduct an assessment of the impacts of the scheme taking account of the changes to uprating and how the overall generosity of the welfare system itself has changed since 2010. Existing impacts are set out here to give an indication of the different patterns of winners and loser compared to the current system.

Overall impact on income

Overall, the introduction of UC is expected to be broadly progressive and create more winners than losers. Of the 8 million households expected to be in receipt of UC, 3.1 million are estimated to gain, while 2.8 million will lose.[14] The remainder would see no change to their entitlement.

Behind the overall figures, changes for different family types vary significantly, with all groups seeing some gains and some losses. For example, among couple families who rent and have children, more see an increase in entitlement than a fall. Single person households and households where the main householder is under 25 are least likely to experience a change in entitlement. Lone parent families are more likely to lose than gain.

The size of changes in entitlement also varies, as shown in Figure 4 below. Broadly the gains and losses offset each other, with individual household losses slightly smaller than gains. However, when comparing back to an earlier Impact Assessment from 2011, the amount a household may lose has increased significantly: 79 per cent of those with lower entitlements will now lose more than £40 a month, compared to 53 per cent previously; 25 per cent will lose more than £200 a month, compared to 12 per cent previously.[15]

As a result of these changes in income losses and gains, the estimate for how many families UC will lift out of poverty has also fallen. A 2011 estimate indicated that UC would lift as many as 350,000 children and 500,000 working-age adults out of poverty in 2014.[16] The recent government Child Poverty Strategy shows that the estimate for children has fallen slightly to 300,000 when accounting for subsequent changes to the value of the UC allowances in 2014 and updated modelling assumptions.[17]

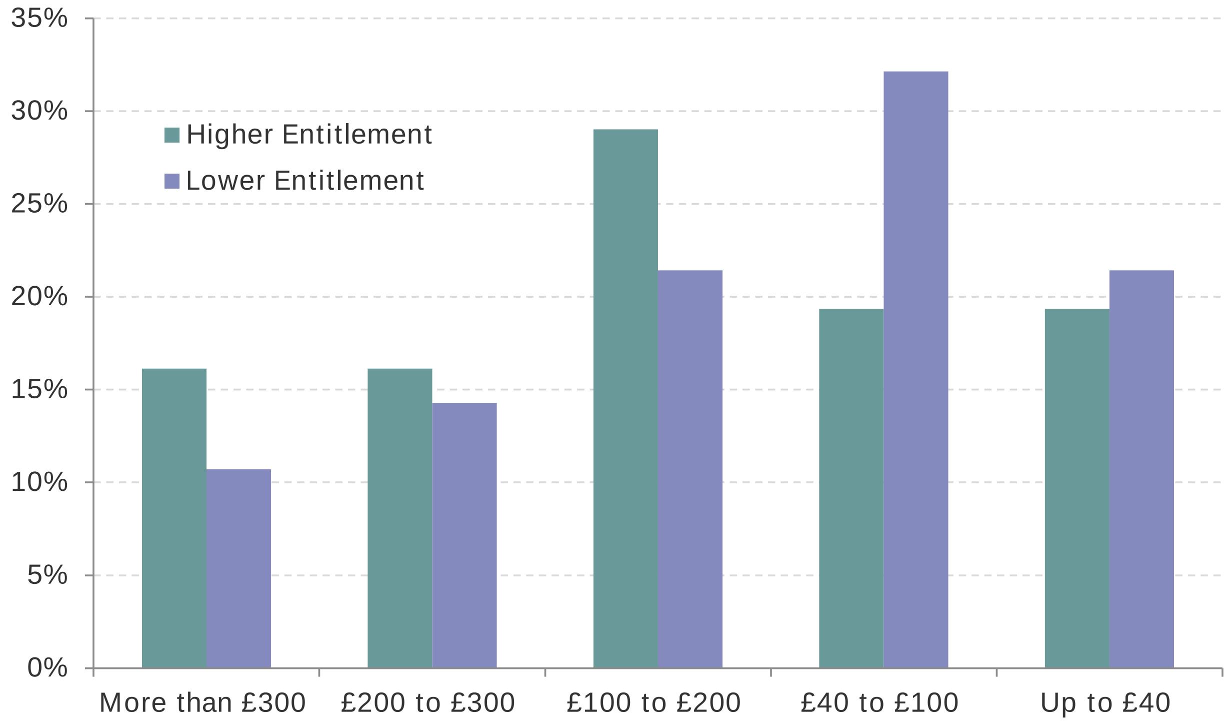
[14] These figures include households who would otherwise have been on the legacy benefits or tax credits which were abolished by the 2012 Welfare Reform Act, and those who become newly entitled as a result of Universal Credit. These estimates account for take-up and so are lower than the Resolution Foundation estimates of the eligible population.

[15] DWP (2011), *Universal Credit Impact Assessment*

[16] ibid

[17] Child Poverty Unit (2014), *Child Poverty Strategy 2014-17*

Figure 4:
Distribution of change in household entitlement comparing the current system with Universal Credit



Source: Universal Credit Impact Assessment, December 2012, DWP

Work incentives

The amalgamation of out-of-work and in-work benefits, introduction of work allowances and a single taper rate are expected to have a substantial impact on work incentives. However, one of the central trade-offs in the design of UC is the extent to which it sharpens work incentives for those moving into work compared to those who are already in work and want to work more hours. Given budget constraints since the policy was first announced, the government has prioritised improving the incentive to enter work to reduce worklessness over the incentive to progress once in employment.[18] Note that the following estimates of the impact of UC on work incentives do not take into account the impact of childcare costs or the potential withdrawal of Council Tax Support. These are explored in Section 4 and can mean much higher marginal rates for many households.

Entering work

In the current system, a minority face losing money by entering work with participation tax rates (PTR) (the financial gain from work as a proportion of total earnings after tax and benefit withdrawal) of over 100 per cent and significant numbers face participation tax rates of over 80 per cent. This is caused by the 100 per cent withdrawal of out-of-work benefits at the point of entering work combined with high rates of benefit withdrawal caused by the housing benefit and tax credit tapers. These extremely high PTRs have been eliminated for first earners and single parents by the introduction of the work allowance and 65 per cent taper rate in UC.

[18] DWP (2012), *Universal Credit Impact Assessment*

Table 4: Change in Participation Tax Rates for benefit recipients who are out-of-work

	Under 60%	60% to 70%	70% to 80%	80% to 90%	90% to 100%	Over 100%
Millions						
First earners						
16 hours						
Current System	2.1	0.6	0.1	0.6	0.4	0.1
Universal Credit	3.7	*	*	*	*	*
37 hours						
Current System	2.6	0.7	0.6	0.1	*	*
Universal Credit	3.4	0.5	*	*	*	*
Second Earners						
16 hours						
Current System	0.6	0.3	0.2	0.1	*	*
Universal Credit	0.7	0.4	*	*	*	*
37 hours						
Current System	0.6	0.3	0.2	0.1	*	*
Universal Credit	0.8	0.4	*	*	*	*

Notes: The table captures households receiving benefits or tax credits either in the current system or under Universal Credit. People are assumed to earn the national minimum wage when entering work. Totals may not sum due to rounding. *denotes estimate rounds to less than 50,000.

Source: Universal Credit Impact Assessment, December 2012, DWP

The incentives are strongest for those entering work on a part-time basis. Virtually no one would face a PTR of more than 70 per cent when entering work part-time on the national minimum wage. As Table 4 shows, first earners who enter work at 16 hours will keep at least 40 per cent of their total earning once their benefits have been withdrawn. In contrast, a small proportion of those who enter at full-time hours will face a higher PTR, keeping between thirty and forty per cent of their earnings. This is because, up to a point, the greater the proportion of net earnings that exceeds the work allowance, the greater the amount of benefit that is withdrawn and, for some, the greater the amount of tax and National Insurance paid.

While first earners and single parents face significantly more positive incentives to enter work, this is less the case for second earners. Households have a single work allowance. If this is exhausted by the first earner, then the second earner faces a 65 per cent taper rate from her (and it is usually women) first hour of work. This is in contrast to the current system where second earners who do not earn enough to pay National Insurance and tax face only a 41 per cent taper rate. Keeping only around half as much of your earnings compared to the current system weakens the incentive to work for second earners. The choice not to introduce a separate second earner work allowance is part of a deliberate attempt to prioritise reducing the number of households with no-one in work, rather than boosting employment overall. The importance of a second earner disregard will be discussed further in Section 5 in assessing changes that could improve work incentives.

Working or earning more

Decisions about entering work are shaped by the participation tax rate the household faces. Choices about whether to progress in work by earning more per hour or working more hours are influenced by the amount of money that is lost in withdrawn taxes and benefits for each additional hour of work – the marginal deduction rate (MDR). As Table 5 below illustrates, for 1.5 million workers the MDR is improved but for 2.1 million earners it will be worse (their Marginal Deduction Rate is increased). However, many of those with an improved (lower) MDR currently face the highest withdrawal rates, losing more than 20p of very extra pound earned, and for some of those whose MDR is made worse the change is small.

Households whose MDRs improve are those who are working part-time hours, a proportion of whom currently lose almost all of each additional pound they earn. In contrast, there are two groups who stand to lose more of each additional pound under Universal Credit: those who already earn enough to pay tax and National Insurance and want to progress; and second earners who do not earn enough to pay tax and National Insurance.

Those who already pay tax and National Insurance will face MDRs of 76 per cent under UC compared to 73 per cent under the current system. While not a significant deterioration for this group, the financial incentives created by Universal Credit will do little to support those already working part-time to increase their hours. This will be down to in-work conditionality – an untested approach. In fact, the removal of hours rules, while preferable from the perspective of smoothing incentives and removing cliff edges, may in fact be more challenging for individuals to understand.

Second earners who do not earn enough to pay National Insurance and income tax will only keep 35 pence of every additional pound they earn under UC compared to 59 pence under tax credits. Once they earn enough to pay tax and National Insurance, they too will face an MDR of 76 per cent. For this reason, a significant number of households facing higher MDRs are couples with children, where the second earner faces lower incentives to enter and progress in work than under the current system. However, without significant additional investment, it is hard to see how to improve these rates substantially.

Table 5: Change in Marginal Deduction Rates for those in employment by family type

	Under 60%	**60% to 70%**	**70% to 80%**	**80% to 90%**	**90% to 100%**	**Increase**	**Decrease**
Millions							
Couple with children							
Current System	0.6	0.1	0.9	0.3	0.1	1.1	0.7
Universal Credit	0.4	0.4	1.1	*	*		
Lone Parent							
Current System	0.2	0.1	0.5	0.2	*	0.5	0.5
Universal Credit	0.2	0.3	0.6	-	-		
Couple no children							
Current System	0.1	*	0.1	*	*	0.1	0.2
Universal Credit	0.1	0.1	0.2	*	-		
Single no children							
Current System	0.3	0.1	0.2	*	*	0.4	0.2
Universal Credit	0.1	0.3	0.2	-	-		

Notes: The table captures households receiving benefits or tax credits either in the current system or under Universal Credit. Totals may not sum due to rounding. *denotes estimate rounds to less than 50,000.

Dynamic impacts

The impacts outlined above consider only a static world where patterns of work and earnings remain the same regardless of the policy scenario. While it is difficult to produce robust estimates of dynamic impacts, the government estimated that overall changes to financial incentives would reduce the number of workless households by up to 300,000. Further improvements of up to 200,000 people in employment are expected from the increased transparency and simplicity of the system and increased population subject to conditionality. [19]

Overall, while the Government has promoted Universal Credit on the basis that it would always make work pay and eliminate high marginal deduction rates, it is clear that beyond the very highest rates, UC does not fundamentally change the problem of high marginal rates at around three quarters of additional earnings facing benefit recipients and to do so would be challenging and expensive (see Section 5 for further detail). In fact, while Universal Credit is undoubtedly simpler to understand than the current system, it is highly dependent on the successful implementation of in-work conditionality to move people on. This is an untested approach whose implementation is likely to be challenging and will add a new layer of complexity to the system (see Section 6).

The remaining three sections of this report will consider the three principle areas that this project is seeking to explore and the extent to which changes in these areas could create more winners from Universal Credit and at what price.

[19] DWP (2012) *Universal Credit Impact Assessment*

Section 4

The scope of Universal Credit

As we saw in Section 2, one of the central rationales for the introduction of Universal Credit is the existence in the current system of benefits with different eligibility and withdrawal thresholds which create major impediments to moving into and progressing in work due to complexity and very high marginal rates. One argument is that UC does not go far enough in streamlining the current system, leaving out benefits that will undermine simplicity, for example contributory JSA and ESA and council tax support. Others argue that there are practical and technical limits to integration. In the case of some benefits, there are also arguments in favour of local administration and flexibility but equally, a risk that benefits provided outside UC may undermine its goals. The withdrawal of non-UC benefits, which may not replicate UC's steady taper, can mean that marginal rates are higher or work allowances smaller than intended.

In this section, we consider four important income-related supports, two which have currently been excluded from the scope of the UC – council tax support and passported benefits – and two which are currently within the scope of UC – the housing element and childcare support.

Council Tax Support

In the government's initial 2010 UC consultation document, *21st Century Welfare*, and in previous work by the Centre for Social Justice and by the Institute for Fiscal Studies, Council Tax Benefit (CTB) was listed as one of the means-tested benefits that could be included within UC or similar systems.

However, a few months later in the Spending Review of October 2010, it was announced that CTB would be localised from 2013-14 and its budget cut by 10 per cent. A further UC consultation in November 2010 confirmed that CTB would not form part of UC.

The exclusion of Council Tax Benefit, in England renamed Council Tax Support (CTS), risks undermining the goals of UC.[20] First, public understanding is hampered by having multiple forms of CTS across the country rather than a single, well-defined system, and the expense of means-testing separately in each area is not insignificant. Furthermore, the separation between CTS and UC makes it more difficult to understand how an increase in earnings will affect disposable income. After the 65 per cent UC taper is applied to post-tax income, around 20 per cent of the remainder may then be withdrawn through CTS.

These successive deductions mean very high marginal rates where the two benefits overlap, similar to the current system of tax credits and benefits. The UC taper followed by the default 20 per cent CTS taper gives a combined taper of 72 per cent. When income tax and employee National Insurance are also included, this means a marginal rate of 81 per cent.[21] In the few local authorities with the highest CTS taper rate of 30 per cent, this figure is just over 83 per cent.[22] It is possible to avoid UC and CTS being tapered cumulatively, by withdrawing CTS entirely before

[20] Brewer, et al (2012) *Universal Credit: a preliminary analysis of its impact on incomes and work incentives*, IFS

[21] Pennycook M., and Hurrell A. (2013) *No Clear Benefit: The financial impact of Council Tax Benefit reform on low income households*, Resolution Foundation

[22] DCLG, 2012, *Localising support for council tax: Taking work incentives into account*

the UC taper begins.[23] But with CTS delivered at the local level and UC delivered nationally both options are likely to create complicated delivery issues. Similar, if not more severe, problems exist today when CTS interacts with the current system of benefits and tax credits. The Public Accounts Committee found that for up to 225,000 people, the replacement of CTB has meant a weakening of work incentives, and marginal rates of up to 97 per cent.[24]

The adequacy of the basic entitlements under both tax credits and UC have been eroded by cuts to welfare spending. In the case of CTS, protection for pensioners means that the 10 per cent cut is in fact a cut of almost 20 per cent on average for those of working-age, and up to 33 per cent in those areas with the highest proportion of pensioners.[25] Three quarters of councils in England now require all households to pay at least some council tax, regardless of income.[26]

Scotland and Wales have also been devolved responsibility for payment of council tax benefit renaming their systems as Council Tax Reduction and Council Tax Reduction Scheme respectively. Both countries have opted to maintain the level of support with council tax that was provided under council tax benefit, funding the difference from elsewhere in their budgets, but the potential delivery problems created by providing these schemes at a local level still apply.

A possible solution to these issues would be to incorporate Council Tax Support into UC, as initially proposed. The IFS concluded that "it is difficult to think of reasons why full integration of council tax support into UC is inferior to what is now being implemented."[27] Rather than long-term design considerations, the reasons may have included a desire to make savings in the short-term, and to devolve the subsequent decisions to Local Authorities.[28] In any case, the Local Government Finance Act 2012 requires there to be a review of CTS in 2015 at the latest, which must include "recommendations as to whether such schemes should be brought within UC".[29]

This project will look further at how a merger might work and what the taper rate and work allowances would look like if CTS were brought within UC and how this would affect work incentives, household incomes and public spending. In considering a merger, there are a range of competing arguments that we will consider. The government has argued that the new CTS system gives councils greater flexibility and incentives to help get residents into work. It may, therefore, be sensible to retain some element of localisation, such as setting the basic generosity of CTS in each area but tapering the benefit as part of the single taper.

The benefits of localisation need to be set against the cost of local administration. However, this is further complicated by the fact that CTS would remain as a separate system for pensioners, who are not covered by UC. Most non-pensioner households eligible for CTS would also be eligible for UC – making their interaction very important. But around half of CTS expenditure is directed at pensioner households. Although, this is not an insurmountable problem as a housing element is expected to be added to Pension Credit once UC is fully rolled out.

[23] DCLG, 2012, *Localising support for council tax: Taking work incentives into account*

[24] Committee of Public Accounts (2014) Council Tax Support 48th report of session *Work doesn't pay for some people after Council Tax policy change*

[25] http://www.ifs.org.uk/comms/comm123.pdf

[26] Bushe, Kenway and Aldridge (2014) *How have low-income families been affected by changes in council tax support?*

[27] op cit, Adam S and Browne J

[28] op cit, Committee of Public Accounts

[29] Local Government Finance Act 2012, c.17, s.9

Free School Meals and other passported benefits

Passported benefits are those which use other means-tested benefits to determine eligibility. A prime example is Free School Meals, which are provided based on receipt of Income Support, income-based JSA or ESA, or Child Tax Credit (but not Working Tax Credit) – all of which will be replaced by UC. There are a large number of such benefits, including free prescriptions, Healthy Start vouchers, legal aid, cash grants for travel and school clothing, and leisure discounts.[30]

The problem presented by passported benefits is that any 'cliff-edge' for determining eligibility, such as losing Free School Meals at a particular income, risks undermining the simplicity and transparency of UC and, ultimately, work incentives. The single taper rate of 65 per cent, designed to make work pay, may be undone by a series of sudden benefit-in-kind withdrawals. The withdrawal of these benefits can be very significant for low income households. For example, a £1 increase in income could mean the loss of Free School Meals worth around £370 per year per child.[31] Furthermore, as highly visible benefits in many cases, families may be particularly sensitive to the loss of these benefits compared to other, less well understood forms of support.

The government has not yet announced what the criteria for Free School Meals will be under UC. A report by the Social Security Advisory Committee concluded that the shift to UC offers the opportunity for a rethink of the complex and un-coordinated 'myriad' of passported benefits.[32] The government similarly believes that there may be possibilities in the longer term to use better delivery mechanisms to provide passported benefits whilst supporting work incentives.[33] However, there are trade-offs with any proposal.

In the case of Free School Meals, one option would be to give Free School Meals to all households on UC. This would eliminate cliff edges within UC but would be costly and would leave a cliff-edge at the transition out of UC.[34] Another option would be to make these benefits-in-kind truly universal, as has been done with meals for children in their first three years of primary school, but this is clearly even more costly and has a high deadweight cost attached to it. An alternative way to avoid sudden drops in entitlement would be to provide partial credits (e.g. covering a diminishing proportion of school meal costs), or replace benefits-in-kind with cash. Such drops could also be minimised by ensuring that different benefits – or the same benefits for subsequent children in a family – are withdrawn at different income levels preventing a single large cliff-edge effect.

There are no easy solutions, but these benefits cannot be overlooked in discussions of UC's design and effects because they represent a significant contribution to the income of poorer households. This project will develop an approach to addressing passported benefits, with the potential to distinguish between different benefits. Those that have higher take-up or are more frequently used may need to be dealt with in a different way from those that are used only infrequently or by a small group of people.

Housing

Housing Benefit now costs around £25 billion a year and makes up over a third of the benefit spending that will be replaced by UC.[35] Given its importance, the design of the UC housing element deserves considerable scrutiny. There are some issues related to housing support that are particular to the design of UC and others that arise because of the level of support on offer under UC which is a continuation of current policy.

[30] Social Security Advisory Committee (2012) *Universal Credit: the impact on passported benefits*

[31] The Children's Society, Fair and Square: Free school meals for all children in poverty

[32] ibid.

[33] ibid.

[34] Citizens Advice Bureau (2014) *Pop goes the payslip: making Universal Credit work for families*

[35] DWP (2014) Benefit expenditure and caseload tables

In UC, families who receive the housing element will generally receive a lower work allowance, in some part offsetting their higher entitlement relative to families without housing costs. A lower work allowance means that families with housing support will be earning enough to have their benefits withdrawn by the taper much sooner. The work allowance for a couple with children is £536 a month (equivalent to 19 hours a week at the minimum wage) but if they have housing costs this falls to £222 (equivalent to 8 hours a week at the minimum wage). This lower work allowance has a direct impact on the incentive to enter work.

At the same time, the lower overall taper rate of 65 per cent in UC which will apply to support with housing costs will weaken incentives to progress for some because families will face MDRs of 76 per cent for longer than under the current system. This is because, in areas where rent is expensive, families remain within UC at higher levels of income because they continue to receive some support with their housing costs. For example, in Inner East London, a couple with two children would need to have net earnings of almost £50,000 before their Universal Credit was fully tapered away, twice the level needed by a couple with no support for housing costs as shown in Table 6.

Table 6: Universal Credit entitlement for couples with 2 children and different housing costs

(£, to nearest £50)	Entitlement (before housing element)	Housing element	Work allowance	Net earnings where UC hits zero*
No housing costs	11,950		6,450	24,850
With housing costs				
Broad market area				
Inner East London	11,950	18,250	2,650	49,150
Guildford	11,950	13,800	2,650	42,300
Plymouth	11,950	7,250	2,650	32,250
Dundee	11,950	6,600	2,650	31,250
Sheffield	11,950	6,000	2,650	30,300

Source: Resolution Foundation analysis

Notes: Housing element is based on maximum local housing allowance in given area from gov.uk, July 2014

Households with mortgages, on the other hand, face the opposite problem under UC. They will not be eligible for Support for Mortgage Interest if they undertake any work at all.[36] SMI is principally targeted at home owners who become unemployed and offers them help with their mortgage interest payments for up to two years. However, it is currently also available to those working fewer than 16 hours. Under UC, this will change and SMI will only be available to those receiving out of work benefits. The absence of the 16 hour rule under UC and the focus on smoothing and simplifying incentives makes it difficult to target support on particular groups within working households. However, with interest rates set to rise over the same period as UC is introduced and with clear evidence that more households will face difficulties in meeting mortgage payments, removing SMI from those working a small number of hours or moving in and out of work does not seem sensible and could create a significant barrier to working.[37]

[36] Housing costs are calculated using the average mortgage rate published by the Bank of England and the value of the loan up to a set capital limit – DWP (2012) Explanatory Memorandum for the Social Security Advisory Committee

[37] Whittaker, M and Blacklock, K (2014) *Hangover Cure: Dealing with the household debt overhang as interest rates rise*, Resolution Foundation

While the three issues discussed above are particular to UC itself, the central issue with housing support under UC relates more to the fact that it is largely a continuation of the current system. This means that there are real concerns over the extent to which UC will provide adequate support for housing costs. Cuts to Local Housing Allowance and the decision to uprate LHA by 1 per cent for the next two years and then by CPI rather than in line with rents is likely to mean that in high cost parts of the country, the amount of housing support available under UC will not be adequate to afford housing. The possibilities for tenants to deal with this issue by finding cheaper accommodation or moving to a cheaper area can be very limited and housing support may start to affect labour mobility for those on UC, especially their ability to move to take up jobs in more expensive parts of the country.[38]

More fundamentally, it has been suggested that housing benefit should be kept out of UC. The Expert Working Group on Welfare set up to advise the Scottish government on the options if Scotland becomes independent, recommended a system similar to UC but favoured the flexibility that localised housing benefit offers.[39] Others have argued that the local administration of housing support, even if the level of the benefit was nationally determined, can be important because housing benefit officers play a wider role in managing the local market, working with landlords and supporting tenancies for those on Housing Benefit. Much in the same way as CTS, there are also elements of housing benefit that will remain outside UC, notably support for pensioners and for those in supported accommodation. Keeping housing benefit local could maintain a unified system.[40] There is certainly an argument that CTS and housing should be dealt with consistently, at the same level, either centrally or at a more local level.

There have also been proposals put forward to divert housing benefit into new housing supply at the discretion of Local Authorities. While this argument is persuasive in theory, the low level of Housing Benefit makes it difficult to see how it can simultaneously meet the rental affordability requirements on current tenants, while also supporting much needed house building that will take years to have a material impact on prices.[41]

There are many issues to consider in the context of how housing costs are supported within Universal Credit. As both the highest cost element within UC and the single largest cost within household budgets, it is critical that this element of UC works to adequately support work incentives. This will be the focus of our project's work on housing support. The wider issues related to housing affordability are important but beyond the scope of this project. This includes the balance between supply-side and demand-side subsidies: whether local authorities should have the ability to spend housing benefit instead on housing supply, and whether demand-side, earmarked benefits drive up rents.

Childcare

Along with benefit withdrawal and personal taxation, the cost of childcare is a significant barrier to many parents working. UC will extend childcare support to all those in work, including those working fewer than 16 hours a week, covering childcare costs at an enhanced rate of 85 per cent from 2016 compared to 70 percent under the current system. This means-tested support system will sit alongside the free childcare entitlements that now exist for three, four, and the most disadvantaged 40 per cent of two year olds. Families not in UC will be entitled to 'Tax-Free Childcare' – a separate system of demand-side support.

[38] What little existed – the £15 per week excess – was planned to be scrapped in 2009 and came into effect in 2011.

[39] Expert Working Group on Welfare (2014) *Re-thinking welfare: fair, personal & simple*. They also suggested that the contributory forms of JSA and ESA might be integrated with other benefits too.

[40] Shelter (2012) *Policy Briefing: Universal Credit and housing*

[41] Hull, A and Cooke, G (2012) *Together at home*, IPPR

Despite additional investment, the impact of childcare on work incentives remains dramatic. Even with 85 per cent of costs covered, a minimum wage earner with two young children in childcare would still keep only 15 pence for each extra hour worked. As a result, there have already been calls for further increases in support within UC.[42] However, with 85 per cent of costs already covered it is unclear what impact further demand-side government support would have on childcare prices, or how well support provided through Universal Credit is helping the underlying issue of high childcare costs. Evidence from Australia suggests that subsidising childcare through support directly to parents can simply inflate prices.[43] The 85 per cent support will also lead to, as yet unclear, trade-offs in UC as the additional spending to fund the increase from the current 70 per cent of support is to be funded from elsewhere in the UC budget.[44]

Furthermore, the introduction of Tax-Free Childcare has created a second demand-side funding system for those parents who are not eligible for Universal Credit. This raises questions about how at the boundary the two systems will interact but also whether a single demand-side system might be a more efficient use of public money. The IFS has suggested that a single system of childcare accounts could be put in place with different levels of government support depending on the income of the parents – 85 per cent for less well off parents and 20 per cent for better off parents.[45] Beyond this, there is a broader question about the overall direction of travel of childcare support and whether additional investment would be more efficient if it were channelled through the supply rather than the demand-side.

The optimal design for the childcare system and significant questions such as the balance between services such as childcare and income transfers to support families with children is beyond the scope of this project. However, given the importance of childcare to work incentives (among other outcomes) this project must consider the influence of childcare costs on the incentives UC creates and the way those incentives translate into behaviour change for families with children.

[42] Citizens Advice (2014) *Pop Goes the Payslip: Making Universal Credit Work for Families*

[43] Cooke, G. and Henehan, K. (2012) *Double-Dutch: The case against deregulation and demand-led funding in childcare, IPPR*

[44] HMT (2014) Budget 2014

[45] Brewer, M., Cattan, S, Crawford, C. (2014) *State support for early education and care in England*, IFS Green Budget 2014

Section 5

Financial incentives

The previous chapter looked at the scope of UC – the benefits that fall under the system's single taper. Together with the work allowances, the taper rate shapes the pattern of work incentives the new system will create, boosting the incentive to move into work but not significantly changing the limited incentives to move on. This section discusses the extent to which the financial incentives created by these basic structures will be adequate now and over time to deliver the movement into and within work that the government expects.

The work allowance

The work allowance is one of the central features of Universal Credit and a significant improvement on the current system from the perspective of those moving into part-time work. While there is a single 65 per cent rate for tapering away benefits, this only begins once the 'work allowance' (formerly the 'earnings disregard') has been used up.

However, the work allowances have been subject to a series of cuts which will erode their ability to improve work incentives over time, reducing, by 2018, the extent to which people would benefit from UC. The first step in the erosion of the work allowances was the decision to only increase working age benefits – including UC – in line with CPI inflation rather than earnings. Next, in 2012 the government announced that working-age benefits would rise by only 1 per cent each year for three years – lower than the expected rate of CPI inflation. Finally, in the 2013 Autumn Statement, it was announced that the work allowances would instead be frozen for three years – an additional cut of £600 million.[46]

By the time UC does arrive, its generosity will be less in real terms and in relation to earnings than was expected just a few years ago, calling into question its positive contribution to improving work incentives. As a first step to assessing the adequacy of the work allowances, this project will consider how these cumulative cuts will, by 2018, change the pattern of winners and losers from UC reported in Section 3.

Second earners

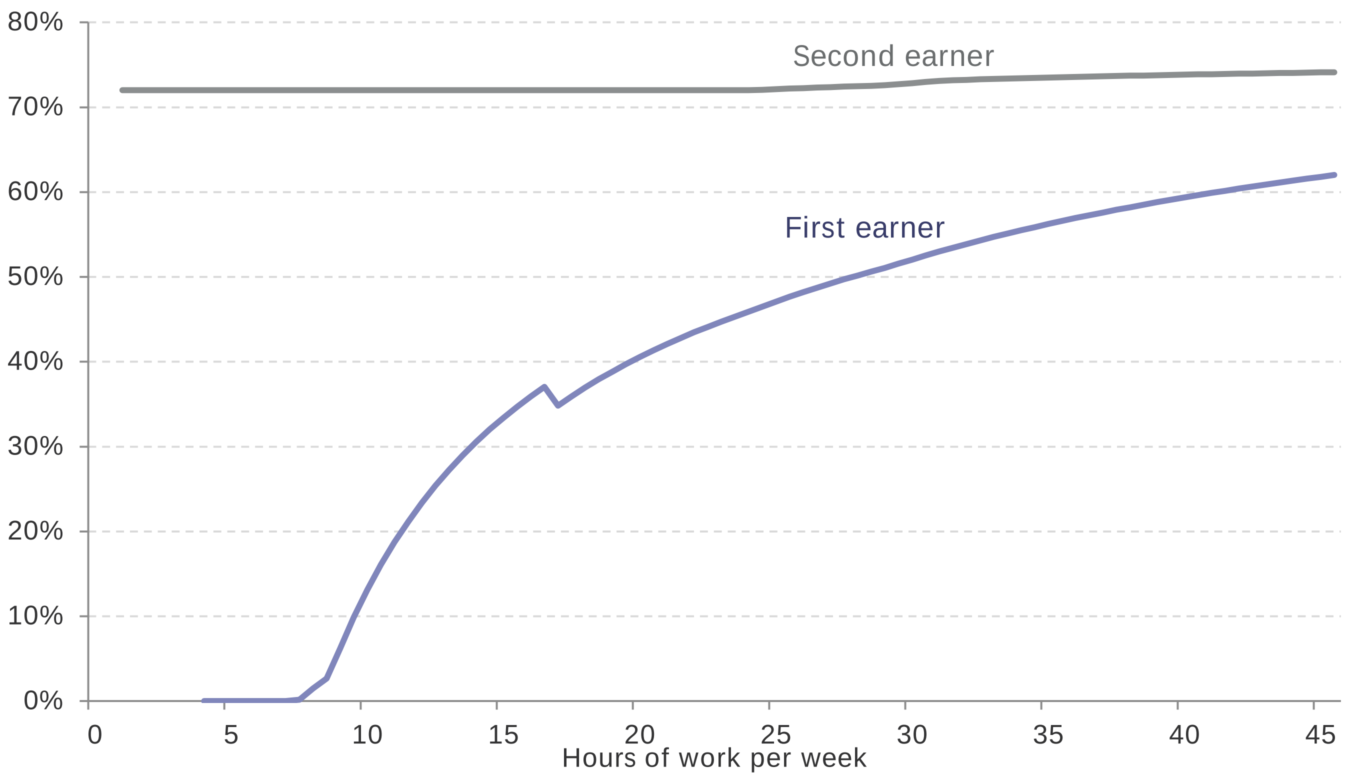
As noted in Section 2, households in Universal Credit only have a single work allowance. While this improves the incentive to work for the first earner compared to the current system, many second earners are subject to the 65 per cent withdrawal rate as soon as they move into work. Even though the stated aim of UC is to encourage more people into work, the government itself has said that some second earners may reduce their hours or leave work entirely.[47]

[46] Kelly, G (2013) 'Stealth cuts are making universal credit toxic to the working poor,' *The Guardian*

[47] DWP (2010) *Universal Credit: welfare that works*

Figure 5:
Participation tax rates in Universal Credit

Couple with 2 children, both earning minimum wage with rental costs



Notes: the second earner PTR is calculated where the first earner' hours of work are fixed at 37.5 hours a week

Figure 5 gives an example of a couple with two children. The first earner can begin earning without losing any UC, and when moving into work keeps most of their pay. But incentives are weaker for second earners – who are overwhelmingly women.[48] In this example of a first earner on an income of around £12,000, the second parent would lose almost three quarters of their first £10,000 of earnings to the UC taper, Council Tax Support and taxation. These figures do not take account of the planned transferable tax allowance for married couples, which would further reduce work incentives for second earners by reducing their personal tax allowance.

Second earners are now a significant part of the path to higher incomes for working households[49] and children in dual earner families are considerably less likely to be in poverty than those relying on a single breadwinner.[50] The problem of poor incentives for second earners is not a new one. It is present in the current system of tax credits, although to a lesser extent. The tax credit system incentivises people to enter work by providing extra support through working tax credit once a certain number of hours are worked. A couple with children must work 24 hours between them with one person working at least 16 hours, but it is not necessary for both to work. The incentive for the second earner to move into work under tax credits is, therefore, not that strong but if a second earner does choose to work, she keeps 59 per cent of her first £10,000 of earnings compared to only 35 per cent under UC because of the higher net earnings taper.

[48] *Gaining from Growth: the final report of the Commission on Living Standards* (October 2012) Resolution Foundation

[49] ibid.

[50] JRF (2013) *Tackling in-work poverty by supporting dual-earning families*

Adding a second earner work allowance to Universal Credit would ensure that UC went with the grain of the long-term rise of second earners rather than reinforcing an outdated 'male breadwinner' model and would compensate second earners for the net earnings taper. The evidence about which groups respond most to financial incentives also shows that mothers with school age children are generally more responsive.[51] There seems a strong case, therefore, for a second earner work allowance, in line with the work incentive goals of UC.

A similar allowance has previously been proposed by the IFS[52] and IPPR[53] under the Working Tax Credit system. The allowance could only be used by a second earner and would not be transferable to the first earner. For example, a second earner hoping to enter work at 20 hours a week earning £7 an hour, alongside a partner earning £20,000 a year, would keep only a third (35 per cent) of her pay under current UC proposals. With an annual second earner work allowance of £1,920, she would keep more than half (52 per cent) of her earnings.[54]

There are trade-offs that must be considered when thinking about a second earner allowance. By increasing the point at which UC starts to be tapered away for a second earner, the level of earnings at which the family move off UC entirely would also increase. This means that not only would families be subject to the taper for longer, reducing the marginal incentive to work, families on slightly higher incomes would be brought into Universal Credit. The allowance would also mean that extra money is paid to families where both members of the couple are already in work.

This project will seek to calculate how many second earners might move into work or increase their earnings if such an allowance were introduced, how large it should be, as well as the distributional effects. It may also explore the case for targeting the allowance on particular types of families, for example those with young children where the barriers to work are higher.

Setting the taper rate

UC's single 65 per cent taper rate will reduce the highest marginal rates that exist under certain current benefits but, for some, rates will actually increase. When combined with basic rate tax and National Insurance, tax paying employees in UC households would face overall marginal rates of 76 per cent – keeping less than a quarter of any extra earnings. This is not a new issue. The combined taper rate of tax credits with income tax and National Insurance is 73 per cent.

Figure 6 looks at an example of effective marginal rates for a single earner couple with two children. Marginal rates rise to 65 per cent after the work allowance is used up, and rise again to 76 percent as National Insurance and then income tax kick in, before falling dramatically when a couple earns enough to have all of their UC withdrawn and only be subject to tax and National Insurance.

The Centre for Social Justice's initial work argued for a 55 per cent taper, based on modelling of employment responses.[55] Some groups have proposed that the government's chosen 65 per cent rate should over time be lowered to 55 per cent, increasing the incentive to earn more. The trade-offs are: the substantial cost (estimated at £3.3 billion in this case);[56] the fact that a slower withdrawal would mean more families would be eligible for UC and therefore face higher marginal rates; and that the highest earning families already on UC (and those just above) would gain most.

[51] P Johnson (July 2012) *Fairer by design: efficient tax reform for those on low to middle incomes*

[52] Brewer, M et al. (2008) *Means-testing and tax rates on earnings*, IFS

[53] Cooke, G and Lawton, K (2008) *Working out of poverty*, IPPR

[54] *Gaining from Growth: the final report of the Commission on Living Standards* (October 2012) Resolution Foundation

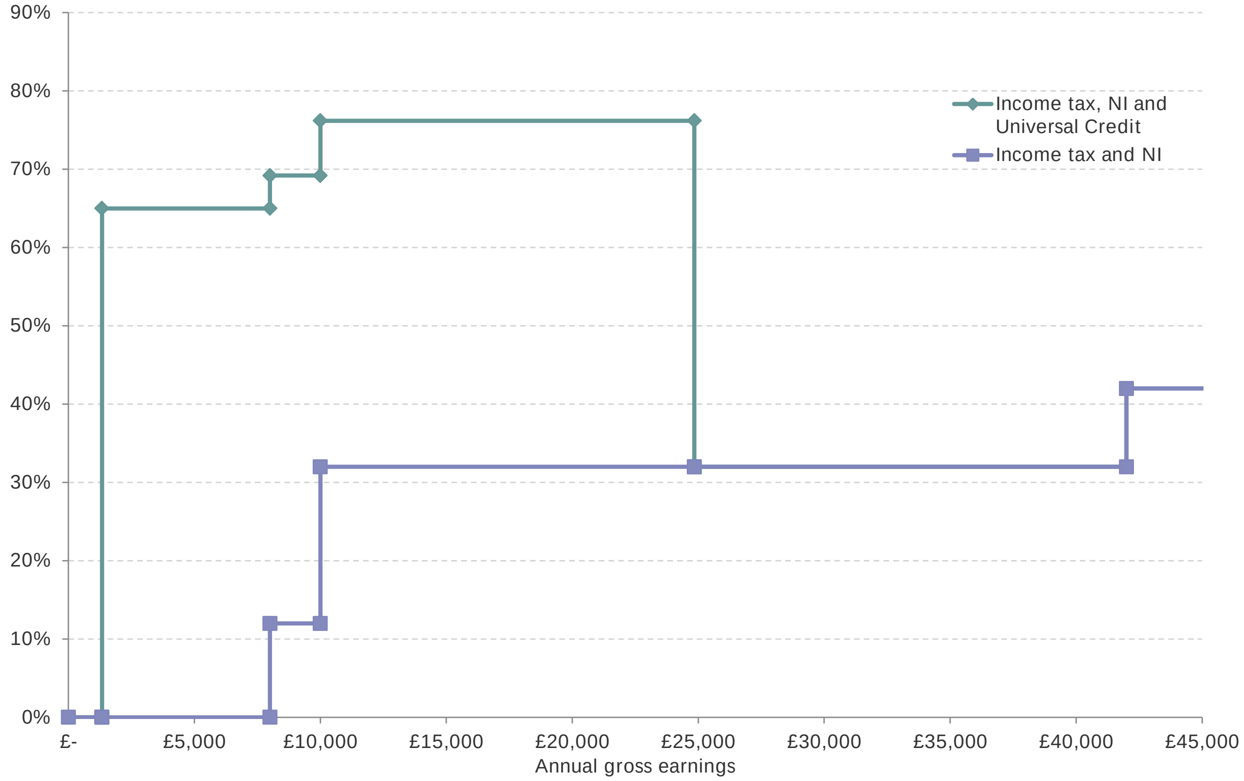
[55] Taken much further, there comes a point where it would be better to replace a low taper rate with a truly universal benefit that would be withdrawn instead through the tax system.

[56] *Gaining from Growth: the final report of the Commission on Living Standards* (October 2012) Resolution Foundation

The Citizens Advice Bureau on the other hand, has argued that increasing the taper to 70 per cent would be a fair trade-off for increasing the generosity of other elements of UC.[57] This highlights an important potential trade-off. Small changes to parts of UC which affect most families, such as the taper, could have little or no substantial impact on work outcomes. Making larger changes to specific elements of UC (such as the childcare element) could have a more significant impact on work outcomes but for a smaller group of people.

Figure 6:
Effective marginal tax rates under Universal Credit for a couple with two children

Marginal deduction rate from tax, national insurance and benefit withdrawal



Notes: Excludes any interaction with Council Tax Support

This project will consider these trade-offs in looking at whether the taper rate is currently set at the optimal level in terms of reducing the numbers facing high marginal rates and maximising labour market impact. Central to this will be a review of what is currently known about how different types of household respond to incentives, who responds most and, therefore, who should be targeted.

Interaction with tax policy

In the tax credit system a cut to income tax or National Insurance is directly passed onto earners as their tax credit award is calculated on their gross earnings – that is before tax and national insurance are paid. However, the level of UC depends on a family's *post-tax* earnings. The net earnings taper avoids some of the highest MDRs seen in the tax credit system. However, it means

[57] Citizens Advice (2014) *Pop Goes the Payslip: Making Universal Credit Work for Families*

that households on UC who start paying National Insurance and tax after their work allowance is exhausted only benefit from 35 per cent of any tax cut because 65 per cent is tapered away. The IFS has shown that more than 40 per cent of families on some of the lowest incomes receiving a tax cut would see their gain reduced through UC or Council Tax Support.[58]

This aspect of Universal Credit has become particularly relevant because the Coalition Government has focused its support for low to middle income families on reducing the tax burden on the low paid by raising the personal tax allowance, while reducing the amount of support available through tax credits. While the personal income tax threshold will be £10,500 by April 2015, some have suggested that it should continue to rise to take all minimum wage workers out of tax. Others have suggested that a rise in the National Insurance threshold would be a better way of targeting the lowest paid, as many low paid people have already been taken out of income tax. In both cases, low and middle income households on UC would receive only a fraction of any intended gain from cuts in income tax or National Insurance.[59]

One solution that would ensure low and middle income households benefit from cuts to tax and National Insurance would be to increase the work allowances to offset the withdrawal of the tax cut.[60] Raising the personal tax allowance by £1,000, for example, could be accompanied by a £200 increase in work allowances. This would ensure that taxpayers in UC households (at least those with a single earner) gain equally to those in higher income households not entitled to UC. Although, such an increase would also provide additional income to first earners in UC not earning enough to pay income tax but exceeding their work allowance.

This project will consider how offsetting increases in the work allowance or other approaches can ensure that households on UC are able to benefit to the full extent from tax cuts that are intended, at least rhetorically, to benefit them.

[58] Op cit.

[59] Hood, A, et al, (2014) *Policies to help the low paid, part of IFS Green Budget 2014*

[60] Hirsch, D (2013), *Will future tax cuts reach struggling working households?*, Resolution Foundation

Section 6

Interventions to boost earnings

UC's work allowance can provide strong incentives to begin working part-time, up to 20 to 26 hours on the minimum wage and it is amongst such low earners that some of the gains from UC are concentrated.[61] [62] But above the allowance, marginal deduction rates remain high, with families losing two thirds or more of each extra £1 of earnings. This does not represent a significant improvement in work incentives compared to the current system and for significant numbers is, in fact, worse. UC will also remove the particularly large incentive in the current system to work at least 16 hours per week (24 hours for couples with children) in order to be eligible for Working Tax Credit, and the smaller step change for working 30 hours or more.

UC includes no hours rules and offers no bonuses for full-time work (though one does exist within Council Tax Support, and has been suggested for UC).[63] So, while UC makes it worthwhile for people to enter work at a smaller number of hours, it removes the current strong disincentive to work fewer than 16 hours. Without some way of forcing people to increase their hours or earnings and reduce their reliance on UC, it is possible that many people on UC will remain in 'mini jobs' at higher cost to the state. To tackle this issue, UC will for the first time extend conditionality to claimants who are already in work. This new area of welfare policy presents significant challenges because it is without precedent but it could also create important opportunities to boost pay progression.

In-work conditionality for employees

UC will introduce an earnings 'conditionality threshold' equivalent to a 35-hour week on the national minimum wage. At present this is around £221 a week (or £11,500 a year) for over 21s. Claimants without care commitments will be expected to meet this target through higher wages or hours, and conditionality will be on an individual rather than a household basis. Our estimate is that one million people may be subject to this in-work conditionality.[64]

The government has commissioned a number of trials to develop the evidence base on how conditionality for those in work can be effective.[65] The current conditionality regime applies only to those who are not in work and the existing Job Centre Plus infrastructure has little experience of supporting those already in work to progress. There are many risks involved in introducing this new approach. An ineffective regime may see some workers' earnings slide down, with reductions in hours or earnings cushioned by UC spending. On the other hand, providing additional advice and services to such large numbers of people would be a significant challenge to public resources and require careful thinking about the appropriate infrastructure to reach those in work.

In-work conditionality must also account for the state of the labour market to ensure that any requirement to increase hours or pay is reasonable. Employers will also have a central role, although

[61] Based on work allowances for a lone parent or couple with children if earning the minimum wage

[62] DWP (2012) *Universal Credit Impact Assessment*

[63] http://touchstoneblog.org.uk/2014/06/can-universal-credit-be-made-to-work-in-reducing-poverty/

[64] Pennycook, M. and Whittaker, M. (2012) *Conditions Uncertain: Assessing the implications of Universal Credit in-work conditionality*, Resolution Foundation

[65] https://www.gov.uk/government/news/universal-credit-roll-out-from-october-2013

anecdotal evidence suggest they have little awareness of in-work conditionality requirements and see a limited business case in offering opportunities for progression.[66] For some groups, in particular single parents, working additional hours may require changing job altogether.[67]

The OECD have stated that the UK may need to restrict entitlement to UC for those working less than full-time hours as few other countries with similarly generous means-tested systems allow part-time workers to keep benefits to such an extent. They suggest that part-time workers could have their UC entitlement time-limited, while people on UC earning above the minimum wage but working less than full-time hours could also be encouraged to increase their hours.[68]

Alongside these challenges, there is also a clear opportunity to use in-work conditionality in a more positive way to identify and help those for whom low pay is not temporary. On a longer term basis, encouraging greater pay progression will be central to managing welfare spending by reducing claims on Universal Credit. Of all low paid workers in 2002, for example, only 18 per cent had 'escaped' low pay ten years later.[69] Women, those working part-time and those in elementary occupations were more likely to get stuck on low pay. Changing jobs and occupation and staying in employment were important in facilitating pay progression for those who started on low pay.

While encouraging people into full-time minimum wage work through conditionality may be important in the short term, this should not be at the expense of the retraining and education that might be needed to avoid permanent low pay. UC could provide opportunities and incentives to support low paid workers to progress and move onto a more positive earnings trajectory rather than simply extending their hours on low pay, although evidence of how to support pay progression is equally limited. In assessing the balance between these conflicting objectives, the project will consider how the UC regime could link to broader areas of adult skills, further education, in-job training and retraining to boost low pay.[70]

Treatment of the self-employed

Similar but stricter conditionality will also exist for the self-employed, who now make up nearly 15 per cent of the workforce, and whose earnings are typically lower than those of employees. Recent analyses indicate that the significant growth in self-employment over the last decade, up by 750,000 from 3.8 million in 2008, is partly the result of structural changes to the labour market due to an ageing population and an increase in the percentage of working women.[71] This suggests that any conditionality regime for the self-employed will be dealing with a growing group of workers and needs to be sensitive to their needs.[72]

UC will introduce several new rules for the self-employed. One is a Gateway Interview to assess whether applicants meet the UC standards of gainful self-employment and therefore do not need to be seeking other work. Another is a move to self-reporting of monthly earnings (to match the 'real time information' UC will use for employees), rather than an annual assessment and reconciliation.[73] There are concerns that frequent reporting and inconsistent accounting

[66] Hurrell, A. (2013) *Starting out or getting stuck? An analysis of who gets trapped in low paid work - and who escapes*, Resolution Foundation

[67] Blundell, R, Brewer, M and Francesconi, M (2008) 'Job changes and hours changes: understanding the path of labour supply adjustment, *Journal of Labor Economics*, 26:3

[68] OECD (2014) *Connecting people with jobs*

[69] Hurrell, A. (2013) *Starting out or getting stuck?*. Low pay is defined as below two thirds of the median wage.

[70] Such as in Resolution Foundation, *More than a minimum: The review of the minimum wage* (2014), March 2014

[71] Comparison of quarters March to May 2008 with March to May 2014, Labour Force Survey

[72] D'Arcy, C. and Gardiner, L. (2014) *Just the job – or a working compromise? The changing nature of self-employment in the UK*, Resolution Foundation, May 2014

[73] Sainsbury, R and Corden, A (2013) *Self-employment, tax credits and the move to Universal Credit*, DWP

requirements will create confusion and new administrative burdens.[74][75]

Most significantly, UC will include a 'minimum income floor' for the self-employed. This is an assumed level of earnings that will be used to calculate UC entitlements for those whose earnings are actually below this floor. As with the conditionality threshold for employees, this is likely for most to be equivalent to working 35 hours per week on the relevant National Minimum Wage, although the floor will be set individually following assessments. The floor will not apply during an allowed 12 month start-up period, and so lower earnings will be reflected in higher UC payments during this time. Of those who reported being self-employed in the last year, 11 per cent had been self-employed for less than 12 months.[76] This period is intended to recognise the time it can take to establish and grow an enterprise before turning a reasonable profit.

Government guidance explains that "If you earn less than the minimum income floor in any month, UC will not bridge that gap. This will encourage you to grow your business and make sure it can support you."[77] For example, a self-employed worker earning £1,000 per month – just above the floor – will be treated equally to an employee earning the same. But a self-employed worker earning £500 in any month will, once UC is introduced, receive no more support than if they earned £1,000. One proposed change in how the floor applies is that shortfalls in income below the floor could be carried forward to other months, reflecting the volatile nature of profits.[78]

A wide range of organisations have raised concerns about the minimum income floor, as have government-commissioned interviews with self-employed tax credit claimants.[79] Recent data on self-employment also suggests that this floor will present a challenge to large numbers of the self-employed. In 2011-12, 47 per cent of self-employed workers earned below the proposed minimum income floor, although earnings are not always an accurate measure for the self-employed given dividend payments.[80] The share of self-employment accounted for by people working part-time grew by 22 per cent compared to a 4 per cent increase for employees, indicating a growing number of self-employed who may have low earnings. Furthermore, some have argued that a 12 month period before which the minimum income floor applies is insufficient. Others have suggested that for many sectors of self-employment – e.g. employed hairdressers moving to self-employment while retaining client lists – such a long period is not necessary.

On paper, the minimum income floor has the reasonable aim of ensuring that UC does not subsidise low income and low productivity self-employment, where other employment would be a more efficient long-run option.[81] It may also reduce the scope for fraud and abuse, and boost work incentives for self-employed earners below the floor (as their UC entitlement will be unaffected by increases in income). But despite these arguments, and improvements that the government has already made, there is a strong case for exploration of the probable effects of the current proposals. This project will consider the extent to which the planned treatment of the self-employed, especially the in-work conditionality regime, is fit for purpose given the growing scale of self-employment and the ways in which that workforce differs from low paid employees.

[74] For example, see the letter from the Low Incomes Tax Reform Group, Federation of Small Businesses, Chartered Institute of Taxation, Community Links and others, to Lord Freud, 12 July 2012.

[75] Universal Credit Rescue Committee: Independent Report to the Labour Party at http://www.yourbritain.org.uk/uploads/editor/files/UCRC_final_report.pdf

[76] Comparison of Q2 2013 and Q2 2014, Labour Force Survey

[77] DWP (2014) *Universal Credit and self-employment*

[78] Federation of Small Businesses (2013) *Universal Credit and the self-employed*

[79] Sainsbury, R. and Corden A. (2013) *Self-employment, tax credits and the move to Universal Credit*, DWP

[80] Resolution Foundation analysis using the Family Resources Survey. See also Blundell, R. et al. (2013) "*What can wages and employment tell us about the UK's productivity puzzle?*", IFS Working Paper W13/11, Figure 1.1

[81] DWP (2012) *Universal Credit Impact Assessment*

Section 7

Conclusion

The principles behind UC are welcome. The benefits system should be simpler and do more to help people into work and to increase their earnings once there. The status quo has significant shortcomings, but the design of the system of UC currently being rolled out also has limitations, quite aside from the IT problems and personal finance requirements that have attracted most attention. Public spending cuts have already weakened many of the functions that were originally intended or forced hasty redesigns. More can be done, even with limited resources, to boost household incomes by encouraging work. Arguably, it would be best to implement changes to UC before it is rolled out to a possible 10 million families, and while changes in entitlement are covered by transitional protection.

This paper has drawn on a broad range of previous work by the Resolution Foundation and others, which has emphasised a number of concerns about the policy choices within UC. Some previous work has also proposed solutions, such as a second earner work allowance, while some problems have no obvious solution. Some issues, such as UC's level of childcare support, have, to some extent, already been addressed by the government. The project launched by this paper will explore these problems and solutions in detail and propose costed revisions. Our aim is to look at the impact of a package of changes in combination, as well as in isolation, and model the impacts of this on labour supply, with the goal of making UC deliver better for low and middle income families and the economy.

As this paper has shown, given the decisions already made any change to the structure of UC will create trade-offs between a number of outcomes. Increasing the generosity of UC would create the need for additional spending, which in a fiscally neutral world would likely mean that other groups in the UK are made worse off. Re-allocating resources within the UC budget would create clear trade-offs between different family types; between incentives to move into work against progressing in-work; and between the basic level of income adequacy compared to the work incentives the system creates. Overall, there is a clear tension between maintaining the simplicity and transparency of UC's design and better targeting of incentives and support.

It will be essential to take into account and appropriately balance these, and other, necessary trade-offs that changes to UC will create. But it is equally important to understand the consequences of such trade-offs given the position of the labour market, while being clear about the extent to which changes in incentives are necessary to drive changes in behaviour. The questions raised in this paper provide a guide for this project in developing specific proposals to boost UC's beneficial impact.

A renowned panel of experts will help the Resolution Foundation to address these and other questions.

The panel will consist of:

Professor Mike Brewer, University of Essex

Professor Paul Gregg, University of Bath

Grainia Long, Chief Executive of the Chartered Institute of Housing

Dr Jim McCormick, Scotland adviser to the Social Security Advisory Committee and the Joseph Rowntree Foundation

Ian Mulheirn, Associate Director of Oxford Economics

Emma Stewart MBE, Director of Timewise Foundation

Nick Timmins, public policy expert and historian of the welfare state

Giles Wilkes, economist and former adviser to Vince Cable

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Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

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» *engaging with policy makers and stakeholders to influence decision-making and bring about change.*

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