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Resolution Foundation
REPORT

Credit where it's due?
Assessing the benefits and risks of Universal Credit

Interim report of the Resolution Foundation expert panel review of UC

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Executive Summary

The government's plans for Universal Credit (UC) were first set out in November 2010, and its concept has received broad cross-party support. But the process of implementation has been dogged by a series of delays – the OBR now anticipates that it will not be fully rolled out until at least 2020, potentially 3 years later than originally planned – causing some to question whether the policy will ever be delivered.

The Resolution Foundation review – launched in 2014 – takes as its starting point the assessment that UC retains the scope to deliver significant benefits, but that its design requires careful reappraisal to ensure that it still meets the aims originally set out. The review brings together a highly regarded panel of experts to assess the design of UC and determine whether it will meet its key goals of simplifying the benefits system and providing stronger incentives to enter and progress in work. A final report will be published, with policy recommendations after the election.

This interim report sets out the challenges facing UC as identified by the review, and the areas most in need of attention. We present new analysis of the impact that UC will have on incomes and incentives to work, point towards potential risks and improvements, and draw out the key questions that will be addressed in the final report.

Universal Credit has the potential to improve outcomes and experiences for many…

Setting aside concerns about implementation, UC has the potential to significantly improve the administration of in- and out-of-work support. By integrating six benefits into one, the new system should reduce the compliance burden and complexity faced by recipients and boost take-up. This would be a very significant prize.

The transition into employment should be smoothed, with the introduction of work allowances meaning that benefit recipients will be able to retain the same level of support even as they start earning (up to a specified limit), which will boost their incomes. The new system will also protect those who fall out of work more seamlessly and be better at dealing with month-to-month variation in circumstances. A monthly assessment, underpinned with a real time earnings feed from HMRC, will reduce the risk of under-and over-payments.

Taken together, these reforms have the potential to improve recipients' interactions with the benefits system and, crucially, boost incentives to work. The DWP has estimated that 250,000 extra people will enter work under UC; 60,000 arriving as a direct result of the integration and enhanced simplicity associated with the new system, a further 145,000 due to improved financial incentives, and 50,000 from greater conditionality requirements.

But question marks remain over whether all these gains will be delivered…

However, some of UC's purported benefits are unlikely to materialise under its current design. For example, while the integration of six benefits into one represents a welcome simplification, the exclusion of other key forms of support – most notably Council Tax Support – means that recipients must still complete multiple applications in many instances.

Similarly, while making the option of undertaking some work more attractive, UC does little to help progression in work. That is, the new system is unlikely to provide much incentive for recipients to work or earn more, not least because the taper that applies to the withdrawal of UC has been increased since the policy was first designed.

While the most punitive withdrawal rates that exist under the current system are removed under UC – mainly where people would currently have tax credit entitlement and housing support withdrawn together as their earnings rise – it is still the case that more people will face a higher rate than in the current system (though these increases tend to be quite small). Those paying income tax and National Insurance (NI) will have a taper rate of 76 per cent, compared with 73 per cent in the current system. Second earners who don't earn enough to pay income tax and NI will face a taper rate of 65 per cent instead of 41 per cent.

Moreover, interactions with the tax system, support with childcare costs and benefits that are outside of UC (such as Council Tax Support and Free-School meals), mean that the single taper – which is frequently advanced as being one of the key simplifying advantages of UC – does not in reality apply for many recipients. Calculating the net benefit that accrues to a household when one of its members earns more will remain a complex task for many.

And the proposed system creates new risks…

In addition to not necessarily delivering some of the benefits claimed for UC, the current design introduces new risks for the Exchequer. These are associated with potential, but as yet unknowable, behavioural responses to UC's prioritisation of reducing worklessness in families over encouraging increases in hours and pay. The interaction of work allowances and the taper within UC mean that families keep more of their benefit entitlement at low hours of work. But they also lose more as their earnings rise or as a second earner enters work.

Three groups of recipients are particularly affected:

» Workers without dependent children, largely younger singles, who currently have very little engagement with the in-work benefit system.

Members of this group do not currently qualify for working tax credit if they are aged under 25 or work less than 30 hours a week. By extending significant new entitlement to this group at lower hours of work, UC might incentivise the out-of-work to enter employment at less than full-time hours and/or encourage those already in-work to reduce their hours. The group's lack of interaction with the current system makes it hard to predict how they may behave – but someone earning the minimum wage (£6.50 an hour) could work eight hours fewer each week and end up just £18 a week worse off. Short-hours working among the young could also affect future wages because earning or working less early on in a career can have serious knock on-effects on long term labour market potential.

» Single parents with housing costs who find their work allowance quickly disappears.

Members of this group may have little incentive to work beyond their work allowance – which runs out when working nine hours a week at the national minimum wage – especially when the cost of childcare is taken into account. This is much lower than the current 16 hours that they are required to work in order to receive working tax credit. Because single parents tend to be relatively responsive to financial incentives, it's possible that there will be a change in hours worked. Not only would this increase reliance on UC but it would also reduce the incomes of these parents.

» Second earners in couples who face increased effective tax rates.

Second earners already face a relatively poor incentive to work. In the current system they lose 41 per cent of their earnings through withdrawal of tax credits, increasing to 73 per cent once tax and NI are paid. This outcome is set to worsen under UC, however. They will find that 65 per cent of their earnings will be lost through the UC taper, increasing to 76 per cent when tax and NI are paid, making already poor incentives even worse. Some second earners would only keep around one-third of their first £10,000 of earnings each year.

These risks have been accentuated by repeated cuts to the generosity of UC work allowances. They have been frozen since their introduction in April 2013, and will now not be increased until 2018. These cuts go beyond those being made in the current benefit system and significantly reduce some of the gains for working families that UC would have otherwise created.

It is too early to say if these risks could be mitigated by the proposed system of in-work conditionality …

To counter these potential behavioural responses, UC will introduce a new system of 'in-work conditionality' whereby recipients would face sanctions if not taking the steps considered necessary to boost their earnings. However, this is an untried and untested system and will apply in varying – and potentially confusing – ways, depending on the circumstances of the recipient. While some system of support for people in work at low hours and low pay might be highly desirable to improve their chances of progression, it cannot be relied upon to mitigate the above risks.

There is very little evidence nationally, or internationally, to inform this new in-work system; the current system of out-of-work conditionality has taken years of development to become effective. The current system uses hours rules and pound for pound withdrawal of benefits to prevent people working short hours, individualised conditionality will be much harder to deliver.

Finally, employers, many of whom are not really engaged with UC at this time, would need much greater involvement to ensure sufficient opportunities exist for their employees to increase hours or earnings.

Getting the most out of UC will require short and medium term reform…

It is clear that UC has the potential to bring a number of improvements compared to the current benefit system, most notable of which is the integration of six benefits into a single system. The work allowance should provide a positive incentive to enter work, particularly for those who wish to do so at low hours but cannot in the current system. However, UC will do little for progression, and in many cases it will slightly blunt existing incentives to work or earn more.

Some of these issues could be tackled with changes to the design of UC. But it is also clear that the ability of UC to achieve the government's aims is being affected by repeated cuts to its budget. The findings set out in this report form part of the evidence feeding into our review of UC. The final report will set out the recommendations of the expert panel, which includes labour market economists, welfare specialists and employment practitioners. It will address the concerns set out in this report and provide a package of reforms to not only preserve, but improve the impact of UC.

Box 1: A summary of the impacts, benefits and risks of Universal Credit as it is currently designed

The introduction of UC will produce a **complex mix of winners and losers** – some inevitable (as with any such reform without significant extra funding), others the result of deliberate policy choices associated with the structure of the new system.

The **clearest advantages** flow from:

» the **integration of multiple benefits;**

» the **simplification of recipients' interactions** with the system; and

» the **provision of regular, reliable payments**.

These should **smooth the transition into work** and by themselves increase the number of people in employment. No longer having to claim for multiple benefits should **increase take up of the support families are entitled to**, potentially providing an important boost to income for low-income families.

In addition, **work allowances will provide a clear and improved financial incentive to enter work.** They will allow people to keep all of their benefits as they first start working and should encourage more people into employment. These are significant gains.

But, cuts in the generosity of UC, particularly to the work allowances, are set to persist in the next parliament and **blunt these improved financial incentives to start work.**

For some households UC will still be difficult to use: providing the system with information about childcare costs and self-employed income could be tricky, and this could undermine some of the benefits of the simplified integrated system.

The **inclusion of housing benefit, withdrawn under one taper rate** within UC **reduces the very highest withdrawal rates** that people face in the current system, with the additional gain of providing a clearer indication of the return to working or earning more.

But in practice there often won't be a single smooth taper. The system will continue to produce variable withdrawal rates for recipients through interactions with the tax system, support with childcare costs and other benefits such as council tax support and free-school meals.

UC is purported to improve work incentives, but its **primary focus is on reducing worklessness within households.** It does **little to encourage increases in hours or earnings,** beyond what the current system provides. Indeed, many will face slightly blunter incentives to work or earn more.

Uncertain outcomes and reactions to the introduction of UC among specific groups create a **potential risk to the exchequer.** In particular:

» **Workers without children** and **single parents with housing costs** may have greater incentive to **work fewer hours**, with the taper cushioning a drop in earnings

» **Second earners** face having already poor incentives made still weaker under UC, creating an increased **risk that they choose not to work at all**.

Assisting low paid recipients to progress in work will rest on a system of **in-work conditionality**, providing an opportunity for support – but we know very little about how effective it may be in dealing with these new risks.

Maximising the potential benefits of the major reform that is UC will mean both **strengthening the positive impact of the work allowance** and a **simplified, better-integrated system**, but also **mitigating the risks** posed by complex information requirements and weak incentives to progress.

Section 1

Introduction

The current focus on Universal Credit (UC) has been with the difficulties surrounding delivery and whether it will ever be properly implemented. With the election approaching, DWP have announced that they will speed up the roll-out of UC to cover more than the current 31,030 simple cases in receipt. But these will still be relatively simple cases, using a system that the department itself has deemed not fit for purpose to expand coverage to all recipients.

A new digital service is being developed to be introduced in 2016, and while significant risks remain about whether it will be delivered on time, it is clear that UC could bring about significant benefits through a more integrated and accurate benefit system and improved incentives to enter work. Perhaps this is why despite challenges with delivery the concept of UC, in at least its basic form and policy intent, continues to have political support across the main Westminster parties.

But the design of UC has changed since its initial conception and not enough attention has been paid to what impact UC will have on its recipients, despite ever increasing cuts to the UC budget in a time of austerity. With financial constraint set to continue into the next parliament it is vital that people understand what UC will mean for both their incomes and opportunities to work and progress when in work – something that UC has promised to improve.

This report provides new analysis to provide an assessment of both the generosity of UC compared to the current system and the work incentives that it creates. We identify key risks to both the public purse and the labour market outcomes of future recipients.

We also assess the impact of the cumulative cuts made to UC since the system was announced in 2018 and their potential long term implications. The last full assessment provided by government was in December 2012, before the announcement of further cuts to the work allowance .[1]

UC could bring some important advantages to the current system, providing an integrated benefit system that makes regular and accurate awards to recipients, and is easy for recipients to provide the right information to could bring significant benefits. It would remove barriers to work such as the fear of losing entitlement when moving in- and out-of-work, or the risk of significant overpayments after a change in circumstances.

What is Universal Credit?

UC represents a radical transformation of our welfare system. It will merge six separate working age benefits into a single benefit which together cost almost £70 billion in 2013-14[2] – around 10 per cent of all government spending:[3]

[1] An early analysis of the impact of UC was also provided in M Brewer, J Browne, J Wenchao, Universal Credit: A preliminary analysis of its impact on incomes and work incentives, Fiscal Studies, Volume 33, Issue 1 pp39-71, March 2012

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

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

- working tax credit;
- child tax credit;
- housing benefit;
- income support;
- income-based Jobseeker's Allowance (JSA); and
- income-related Employment and Support Allowance (ESA).

In principle, UC should shift us from a situation where income-related benefits and tax credits have to be applied for separately on the basis of different eligibility rules and then get withdrawn at different rates and at different levels of income to one in which there is a single application, one set of eligibility criteria, one set of definitions of what counts as income, and a single taper of 65 per cent. In practice however, significant benefits received by low-income families will remain outside of UC, including Council Tax Support, passported benefits such as free school meals, and contributory JSA and ESA .[4]

As well as the integration of what are currently separate benefits, there are two further elements that are central to the design of UC: the introduction of work allowances, and the single taper for earned income.

In the current system income-related out-of-work benefits are withdrawn pound for pound at low hours of work, while working tax credit provides a boost to income beyond a minimum number of hours worked – the 'hours rules'. Together these work to encourage recipients to work longer hours.

UC introduces a work allowance for each household: this is an amount of money that each household can earn without any benefits being withdrawn. The work allowance creates a stronger incentive to move into jobs with low earnings than does the current system, although in some cases it incentivises only relatively short hours of work and creates little incentive to move beyond that. There is no direct replacement in the structure of UC for existing hours rules, instead, a system of in-work conditionality will be introduced to prevent people from working low hours through a mix of support and sanctioning by Jobcentre Plus.

Beyond the work allowance, all components of UC are withdrawn at a single rate of 65 per cent for every additional £1 earned (net-of-tax)[5]. This single, simple system of reducing entitlement as earnings rise eliminates the situation in the current system where some working families face a simultaneous withdrawal of more than one benefit, and should ensure that all recipients are better off in work, and are better off if they choose to earn more. However, in most instances this return to earning more is usually little greater than in the current system and, in a significant number of cases, is worse, particularly for second earners or those with higher earnings.

A unified benefit, the single taper, and the work allowance are intended to make it more likely that people move into work. The government has clearly prioritised creating incentives for families to have at least one person doing some work over other outcomes such as enabling people to earn their way to a higher standard of living. The structures are supposed to ease the transition in- and out-of-work for those who cycle between employment and unemployment, ensure that recipients are always better off if they choose to work more and mean that recipients are better able to understand the incentives they face. Taken together, the government anticipates that the introduction of UC will drive 250,000 more people into work – 145,000 due to improved financial

[4] Entitlement to contributory benefits are dependent on the recipient's National Insurance (NI) contributory record and do not take into account income, as do income-related benefits eligibility to which does not include NI contributions.

[5] Combined with income tax and National insurance there is an overall withdrawal rate of 76.2 per cent: £1 of gross earnings becomes 68p after 32p of income tax (20 per cent) and NI (12 per cent) is deducted. 65 per cent of the 68p (44.2p) is then withdrawn from the UC award leaving the worker better off by 23.8p of the £1 they earned. We refer to the combined taper of 76.2 per cent as 76 per cent throughout the report.

incentives, 60,000 because UC is simpler and better integrated, and 50,000 due to greater conditionality requirements .[6]

Some of the benefits that UC is intended to create are undoubtedly improvements on the current system of in- and out-of-work benefits, but there are other areas where the benefits are largely rhetorical and will not be experienced by most people. UC will do little, if anything, to encourage progression for those already in work and will actually make incentives worse for some, particularly for those earning enough to pay income tax and NI or second earners. The single unified taper rate UC is meant to introduce is not a reality for many once other forms of support are considered – such as help with childcare costs and council tax support – and differs again once someone earns enough to pay income tax and NI.

It is our view that policy design choices for UC need to be balanced against the risks that protecting these purported benefits could create detriment elsewhere, such as through imposing complicated rules or information gathering for recipients to comply with. Furthermore, there are areas where the benefits of UC are likely to be eroded over time as the ongoing consolidation of the public finances takes more funding out of UC, reducing the generosity of the system but also the sharpness of the incentives to work. There is a real danger that the post-austerity version of UC is very different – with different patterns of winners and losers and incentives to work – to the version initially announced.

In addition, there are areas where the current design creates additional spending over and above today's tax credit system and areas where UC creates new risks that could potentially lead to further spending and also limit the ability of families to earn their way to a higher standard of living. These new risks are related to the incentives UC creates for individuals to work fewer hours than they would currently do so in the tax credit system. Reduced earnings would lead to an increase in government spend, with the UC award increasing at a lower level of earnings. While it is notoriously difficult to accurately anticipate how individuals will respond to a new set of incentives, there is a clear risk that this will provide more pressure on government spending than is anticipated, and at a time of significant fiscal constraint.

This report focuses on the benefits and risks created by the current design of UC compared to the current system, including policy changes taking effect to 2018. The delay in roll out creates an opportunity to change some of the policy decisions underpinning UC to ensure that it can achieve its goal of moving more people into work and supporting those already in work to progress.

» The next chapter of this report describes the winners and losers from the transition to UC and looks at how that pattern changes as a result of announced spending cuts to 2018.

» Chapter 3 assesses the strengths of UC, and looks at the ways in which these advantages might be threatened and how they could be enhanced.

» Chapter 4 focuses on the issues created by the new structure of work allowances and the single taper, identifying where groups will have new or increased entitlement and where there is a risk of spending rising further through (perhaps undesirable) behaviour change among recipients.

» Chapter 5 concludes, highlighting those areas that need to be addressed to ensure that UC genuinely improves work incentives.

[6] NAO, "Universal Credit: progress update" November 2014

Section 2

The winners and losers from Universal Credit

By February 2015, only 31,030 people were receiving UC in restricted parts of the country, all of whom were simple cases.[7] Once fully rolled out, however, over 8 million families[8] will be eligible. This includes almost half of families with dependent children at any one point in time. With the exception of just over half a million recipients,[9] the government expect roll out to be complete by the end of 2019, although the OBR already anticipate additional delays with this extended timetable.[10]

The government estimates that over a ten year period from the end of 2013 UC will have made total savings to government of £8.2bn: £9.5bn from reduced benefit spend (driven by reducing overpayments compared to the tax credit system) and an offsetting £1.2bn from the cost of delivery. Total benefits to wider society are estimated at £19.0 billion: £1.6 billion of gains to households from increased employment and £17.5 billion from redistributing income to lower-income families,[11] though it should be noted that such reform is not necessary to increase generosity to low-income families.

In determining who gains and loses under UC it is worth establishing some broad typologies that reflect family and working status. Of the overall number of eligible families, we initially separate out the 3.5 million families in which one or more adult has a disability or caring responsibilities. The characteristics of these 3.5 million families vary greatly: around a third have dependent children, 30 per cent have at least one adult in work and 60 per cent are single adult families. Significantly, splitting the population in this way highlights that other than singles without children and single parents with very young children the vast majority of workless families contain an adult with a disability or caring responsibilities. This is an important consideration when a key aim of Universal Credit is to reduce the number of workless households.

While strong financial incentives to work matter enormously for families with a disability or caring responsibilities – the work allowance and integration of benefits are likely to be of particular benefit to this group as they may be more likely to move in and out of work or start working at a low number of hours – they generally also face other significant barriers to work which require a different range of interventions and support, such as workplace support and better transportation. It is vital that these barriers are addressed alongside financial incentives for this group, but because this aspect largely sits outside the scope of UC they are not addressed by this review.

Aside from those with disabilities and caring responsibilities, there are a further 4.7 million families who are eligible for UC. Fewer than 100,000 of these are couples with children who are not in work – as most workless couples with children have at least one adult with a disability or caring responsibilities - and we exclude these from the more detailed analysis below because they

[7] DWP Universal Credit – Monthly experimental official statistics to February 2015, February 2015

[8] Families are defined as the 'benefit unit'. That is an adult and their spouse (where they have one) plus any dependent children they are living with.

[9] Cases with tax credits or ESA only

[10] Office for Budget Responsibility, Economic and Fiscal Outlook December 2014, December 2014

[11] NAO, Universal Credit: progress update, November 2014

are such a small group[12]. The remainder break down as follows:

» Working single parents: 0.8 million
» Working couples with children: 1.3 million
» Working families with no children: 1.1 million
» Workless single parents: 0.4 million
» Workless families without children: 1.1 million

The full breakdown of the eligible UC population[13] is shown in Figure 1.

[12] There are a further 200,000 workless couples with children in families where an adult has a disability or caring responsibilities.

[13] Our analysis assumes that all people who are entitled to UC or tax credits and benefits in the current system will receive those entitlements based on the characteristics reported in the Family Resources Survey 2012-13. Modelling is conducted on a static basis – it does not account for any potential behavioural responses due to the introduction of UC – and compares a 2014-15 in which UC is fully implemented to the current system

Figure 1:
Family type and work status of Universal Credit families

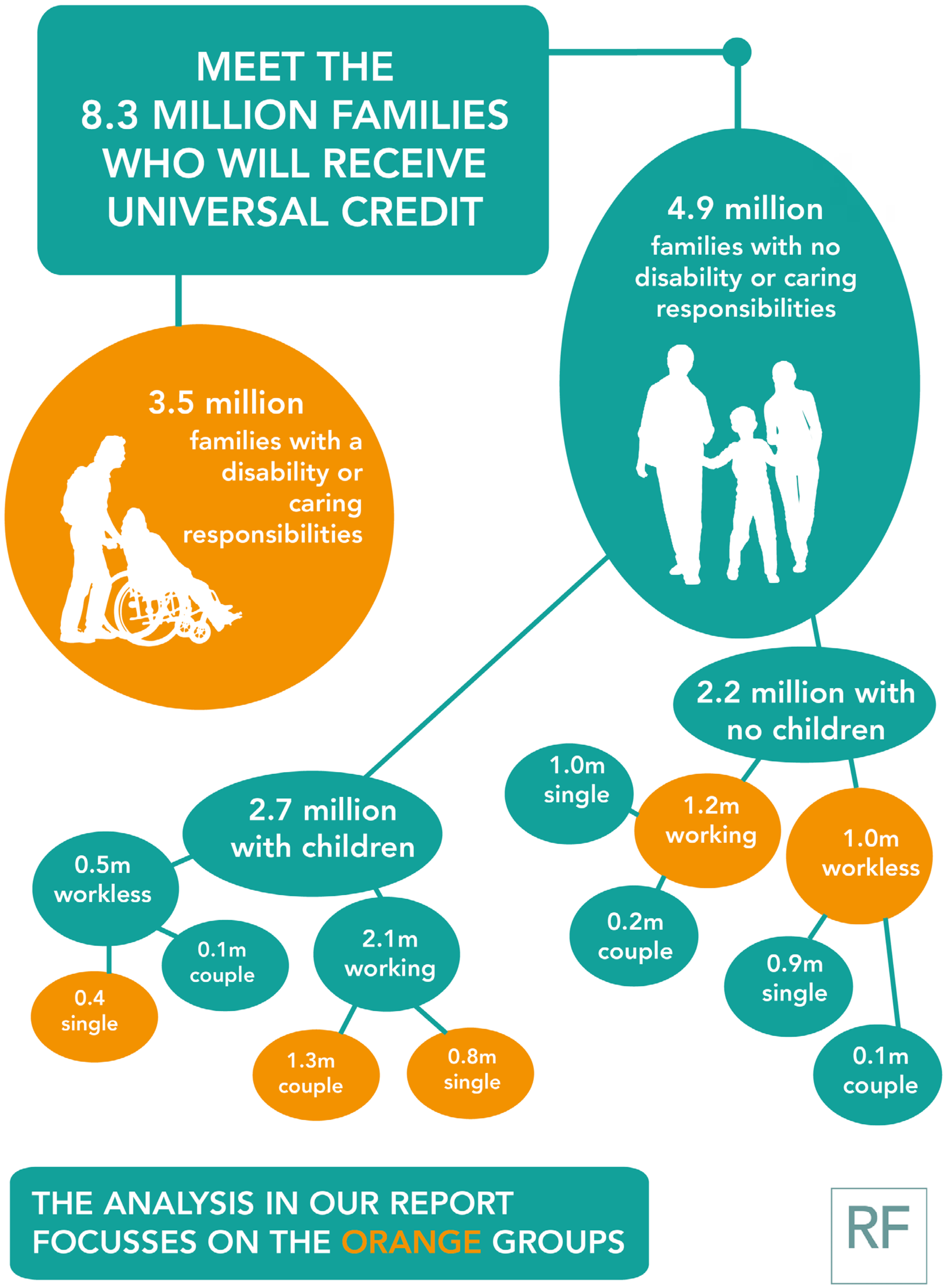
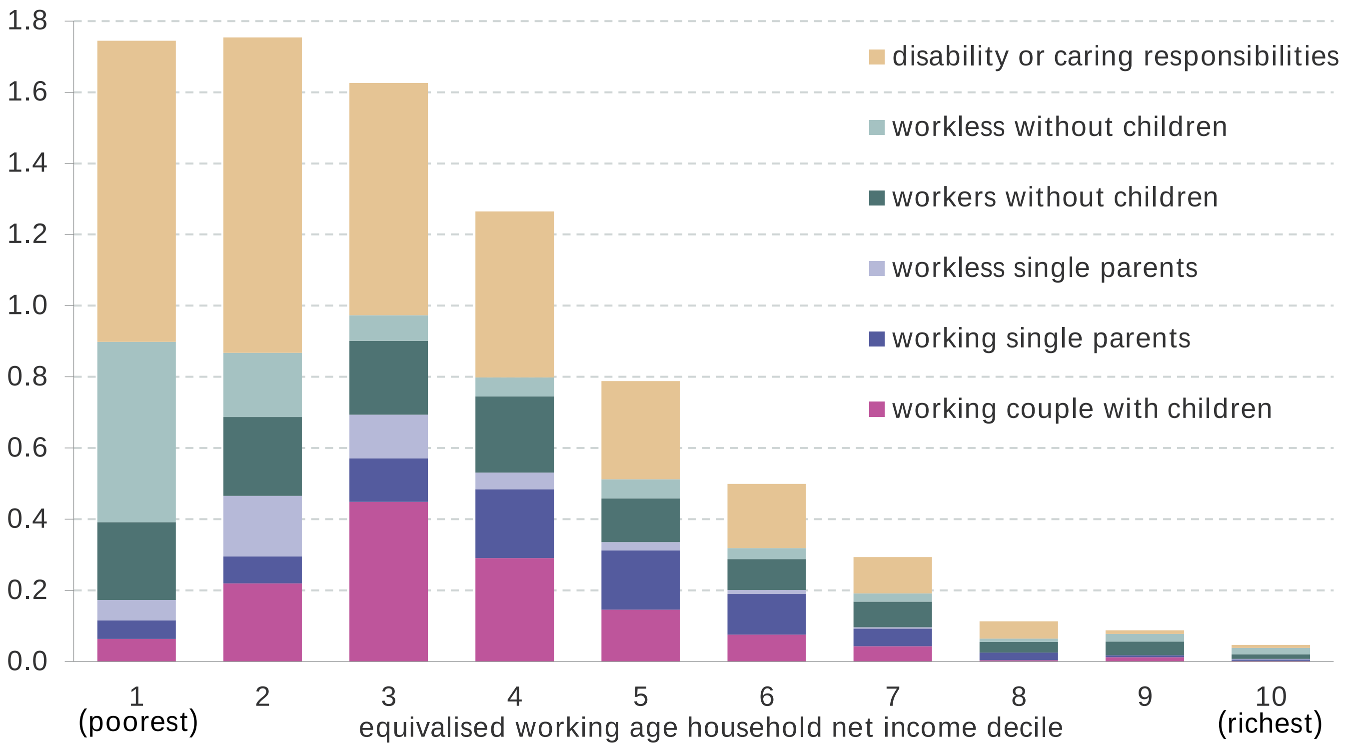


Figure 2 shows how these 8 million different families are distributed across the income distribution. Families where all adults are out of work are concentrated in the bottom decile, particularly those with no children or that contain disabled people or people with caring responsibilities. Families with children are more likely to be in deciles three to five. UC entitlement extends up to the richest 10 per cent of families in Britain, driven by entitlement to the housing and disability elements of UC.

Figure 2:
Families with entitlement to Universal Credit by group and equivalised working age household net income decile, 2014-15

Millions of families entitled to Universal Credit



Source: Resolution Foundation analysis using the IPPR tax-benefit model

By and large, the basic entitlements in UC replicate the level of support that households receive in the current system (see Annex A for further detail), albeit recognising that the generosity of both systems has been subject to significant cuts since 2010. As a result, the amount of money that will eventually be channelled through UC will be broadly similar to that in the benefits and tax credits it replaces with one notable exception which is the decision to be less generous towards under 25s through the basic allowances in UC, mainly affecting out-of-work single parents.

The government estimated in December 2012 that once fully rolled out there would be an additional £2.3billion of benefit spend (approximately 3 per cent of the current spend on equivalent working-age benefits) in 2022, a fall from £5 billion when the same figure was estimated in 2011,[14] reflecting subsequent cuts to the generosity of UC, and a figure we would expect to fall

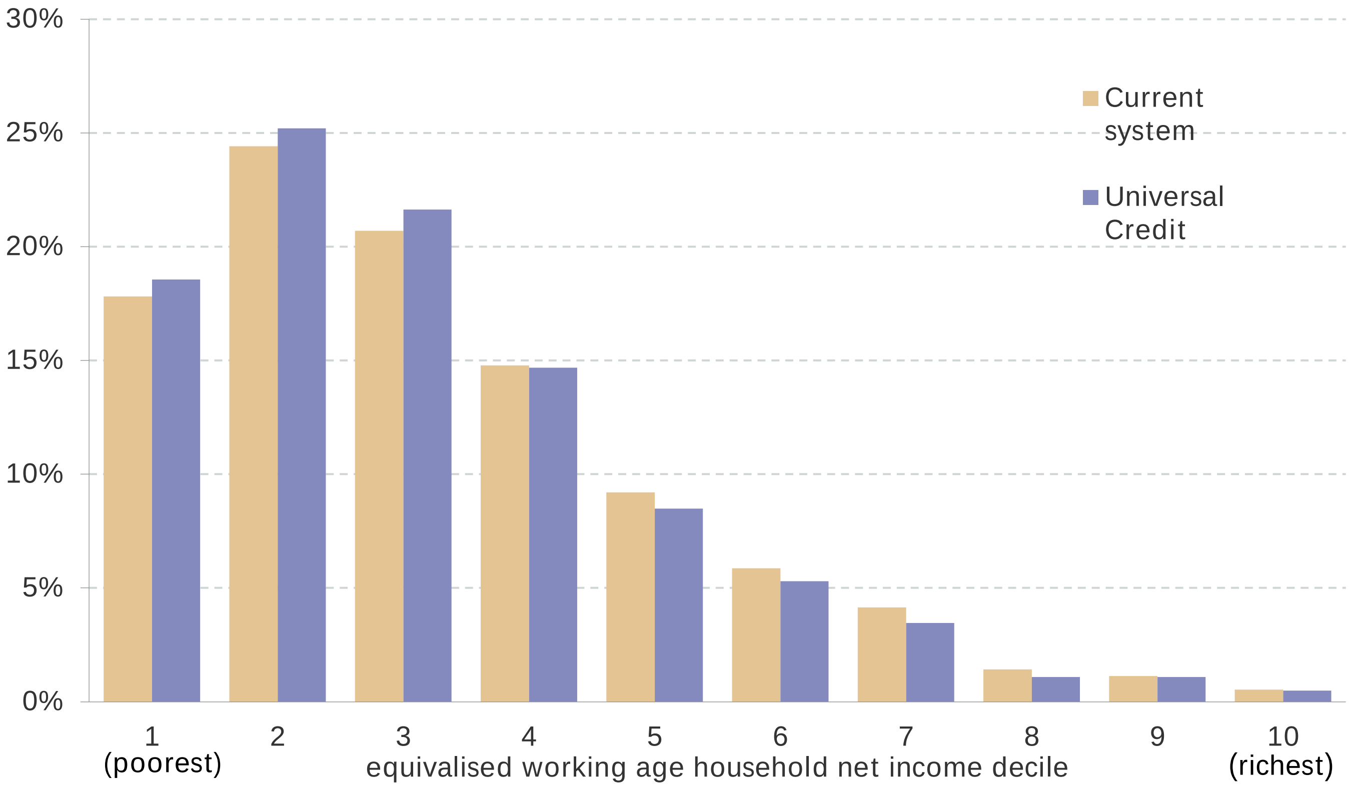
[14] NAO, Universal Credit: early progress, September 2013

further still by a further £800m when additional cuts are taken into account[15]. Increased spend in these estimates is partly driven by increases in take-up of benefits where currently people may claim one of several benefits they are entitled to and in Universal Credit they only have to claim once to be entitled to all of them. Increasing take-up amongst lower income families could have a significant impact on their overall incomes.

However, individual outcomes will vary, generating a complex mix of changes in entitlement will be driven primarily by the different way in which UC is withdrawn as earnings rise compared to the current system. The work allowances, in particular, result in a redistribution of spending towards the lowest deciles who work small numbers of hours, with families in the middle of the distribution losing the most, as shown in Figure 3. This pattern of redistribution partly reflects the government's decision to prioritise eradicating worklessness at the household level over other welfare objectives such as supporting all adults (e.g. second earners) in a household to work, or to earn and work more, which could more significantly increase the standard of living families can earn their way to.

Figure 3:
Distribution of total spend on working age income-related benefits, 2014-15

Percentage of total spending on working-age income-related benefits



Notes: Distribution of spend on working-age income-related benefits as modelled in 2014-15. Current system spend is the sum of, income support, income-related jobseekers allowance, income-related employment support allowance, housing benefit, child tax credit, working tax credit and council tax support. Universal Credit spend is the sum of Universal Credit and Council Tax Support.

Source: Resolution Foundation analysis using the IPPR tax-benefit model

[15] An estimated £800m has been saved from policy changes to UC since March 2013 – OBR, Economic and Fiscal Outlook December 2013, HMT, Autumn Statement 2014: policy costings, December 2014

Winners and losers under UC

The detailed pattern of winners and losers is considerably more complicated than as set out above. This complexity arises from aligning rules on eligibility, the treatment of income and assets and the generosity of the system for people out-of-work, while introducing the work allowance and a single taper for the equivalent of housing benefit and working tax credit support. Some families will not be affected at all, while others may lose entitlement from one change but gain from another: for example, they might gain from the work allowance but be losing out from the generosity of their basic allowance.

The profile of winners and losers is shown in Figure 4 with the bars representing the percentage change in income for each group. Just over half of all families with a change in income have either a loss or a gain of no more than 10 per cent of their net income. Expressed as cash around half of families have a gain or loss of up to £25 a week, but income varies significantly across groups, for example a couple with children on UC would normally have a higher level of income than a single person with no children as they are entitled to support for their children as well as the basic allowances. Overall, couples with children who are in work are generally better off in UC, as are working single parents, though to a lesser extent. Non-working single parents, families without children and those with a disability or caring responsibilities are overall generally worse off with more families losing than gaining. A large group of losers with a disability or caring responsibility are expected to lose no more than 5 per cent of their total income.

Figure 4:

Percentage change in net income by family group as a percentage of all families entitled in the current system or under Universal Credit, 2014-15

Percentage of all families entitled to Universal Credit or the current tax credit system

Source: Resolution Foundation analysis using the IPPR tax-benefit model

There is also a significant group on UC with no change in their entitlement. This is mainly those who are out-of-work for whom the basic allowances in UC largely mirror the current out-of-work benefit system.

Table 1 shows that there are 150,000 out-of-work single parents losing under UC,[16] with 300,000 having no change in their entitlement. The losses are largely driven by the reduced generosity in the basic allowances for under-25s. The picture is similar for families who are out-of-work but do not have dependent children, where 450,000 are losing, but 900,000 see no change in their entitlement.

Transitional Protection will be in place to help families who will lose income when moving from the current system to UC. This will apply to families moved to UC from the current system as part of a managed moves process overseen by DWP, it will not apply to families who would naturally flow onto UC due to a change in circumstances, for example, the birth of a child or losing a job. The amount of protection will cover a loss in income due to the move to UC, but at the point a family switches schemes. It is eroded over time as income rises and lost following a significant change in circumstances, such as a sustained drop in earnings or a partner leaving the household.[17]

Table 1: Change in entitlement by family type and whether entitled to working-age income-related benefits in either the current system or under Universal Credit, 2014-15

1,000s

Family type	Gainers	Losers	No change	Entitled in either system	Not entitled in either system	Total population
working couple with children	900	600	0	1650	3150	4800
working single parents	450	300	*	900	150	1,050
workless single parents	*	150	300	450	*	450
workers without children	750	1,050	150	1,950	9,150	11,100
workless without children	*	450	900	1,350	1,350	2,700
disability or caring responsibilities	1,050	2,550	150	3,900	900	4,800
All	3,450	5,250	1,650	10,200	14,700	24,900

Notes: Estimates are rounded to the nearest 100,000 families. Totals may not sum due to rounding. An * denotes where an estimate is greater than 0 but less than 50,000.

Source: Resolution Foundation analysis using the IPPR tax-benefit model

Winners and losers and policy rules

The patterns shown in Figure 3 and Table 1 are dictated both by the underlying structures of UC, and by deliberate policy choices. Without any additional significant funding, the introduction of a single taper and the simplification that that entails inevitably creates winners and losers.

[16] See M Brewer and P De Agostini, Credit crunched: Single parents, universal credit and the struggle to make work pay, 2013 for a detailed analysis of the impact of UC on single parents

[17] DWP, Universal Credit policy briefing note - Transitional Protection and Universal Credit, 2012. Our analysis does not account for transitional protection.

Some families in each group gain in cash terms and some lose. However, an element of the pattern shown above flows from policy decisions that affect different groups in specific ways:

- A significant proportion of people who gain or lose do so **because they either become entitled to UC (having not been entitled to support in the current system)**, **or they lose entitlement to any support following the change in the system**. 45 per cent of working couples with children who lose do so because they no longer have any entitlement under UC. Among working families without children, 44 per cent of those who gain compared to the current system do so because they become entitled under UC, while 56 per cent of those who lose do so because they are no longer entitled. Overall, there are almost twice as many in this group who lose than gain (600,000 v 350,000) for this reason.
- Around 85 per cent of the losers among out-of-work single parents are aged under-25 and lose because of a **deliberate decision to reduce the basic allowance paid to single parents aged between 18 and 24** by £15 a week. In the current system, young single parents receive the same benefit level as older single parents rather than the under 25 rate. Under UC, this has been reversed, significantly penalising young single parents whose life chances are already poor.
- UC also has stronger **capital rules** than the current system of in-work support. Any capital, except pension savings, in excess of £16,000 results in a loss of eligibility, due to a change which **imports the rules in the current out-of-work system into the system of in-work support**, making UC a source of income of last resort for those in- *and* out-of-work. Tax credits, by contrast, only take account of the interest from savings not the capital itself. Up to 20 per cent of those who lose in each group have capital of more than £16,000, with families without children and working couples with children being most affected.
- **Unearned income**, such as occupational pension and adult maintenance payments, is treated more harshly than the current in-work system, withdrawing UC on a pound for pound basis for unearned income (rather than the standard 65 per cent taper for earned income). In the current system occupational pension income would be subject to the 41 per cent tax credit taper, while adult maintenance payments are not taken into account at all. This particularly affects single parents.40 per cent of families with disabilities and caring responsibilities who are in work and 15 percent of working families with children who lose have sources of unearned income.
- The **rules governing the self-employed** are far stricter than under the current system and differ to the treatment of employees. Under UC, after the first year of self-employment, individuals will be assessed on the basis of a minimum income floor equivalent to full-time minimum wage earnings – effectively a form of conditionality. This means that their UC award will assume they earn at least the minimum income floor, in reality they may well earn less than this. The introduction of a minimum income floor is intended to prevent the self-employed fraudulently lowering their earnings to claim additional UC as well as to prevent people remaining in low paid, low productivity self-employment when they would be better off returning to employment. We estimate that at least 45 per cent of the self-employed who will be eligible for UC currently earn less than the minimum income floor.[18]
- Finally, our modelling includes **entitlement to Council Tax Support (CTS)**. In the real world, since 2011 councils have been able to vary the rules that apply to eligibility and generosity of CTS, so that the scheme that applies to individuals varies significantly at a local level. DCLG have set out default schemes which are a starting point from which councils can vary their schemes. We assume that the default schemes are in place under UC and the current system. The main difference between the two is that under UC, CTS will be withdrawn at 20 per cent on all earnings, while in the current system CTS is only withdrawn once entitlement to out-of-work benefits is exhausted (typically until earnings reach up to around £82 a week) although there are few people working at these hours. This has the result of maintaining the level of entitlement for out-of-work families. For families in work and entitled to Council Tax Support the impact is mixed and dependent on how UC has affected a family's income as well as the new council tax support rules.

[18] It should be noted that available data on self-employed earnings from the Family Resources Survey is not wholly reliable and nor does it provide information on monthly variations of income.

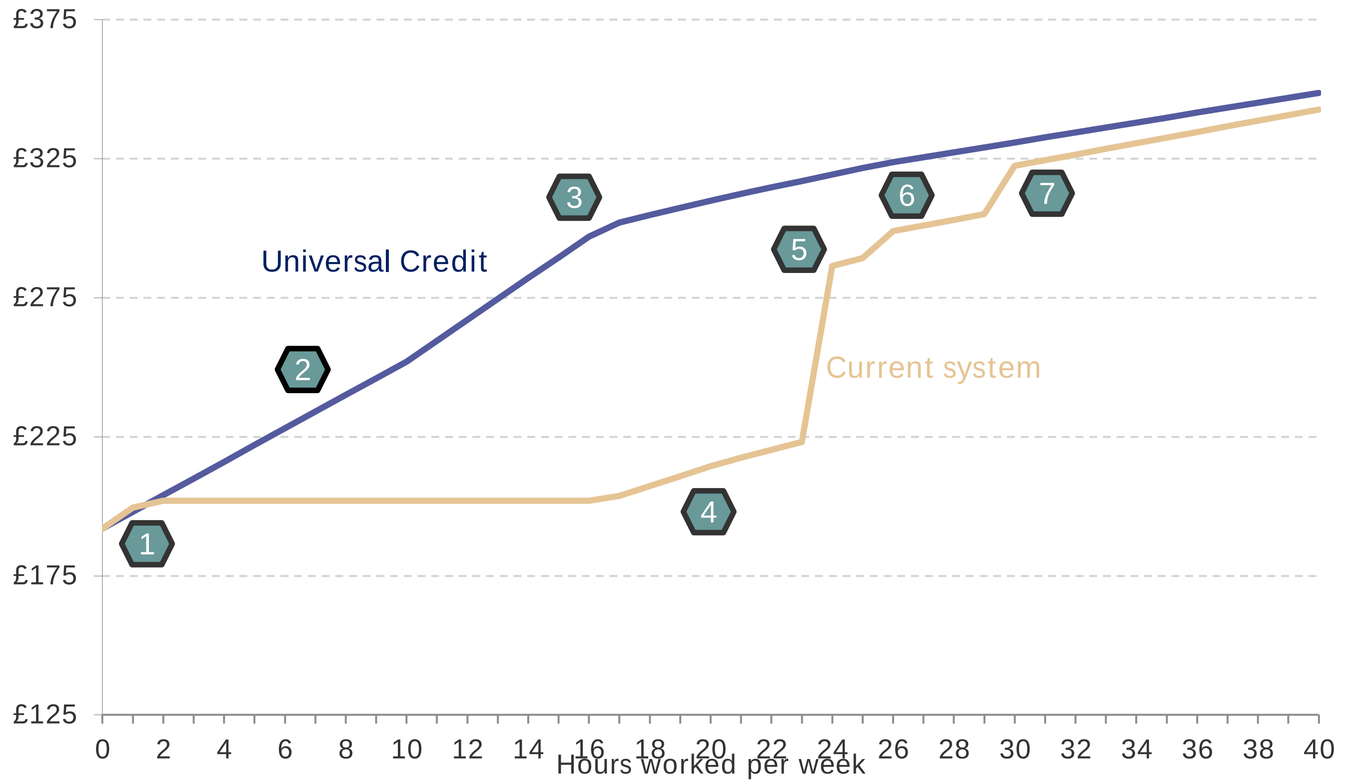
Winners and losers and work incentives

Alongside these policy choices, the difference in the basic structures of UC compared to the current system is also significant in shaping the pattern of winners and losers. The introduction of the work allowance creates a strong incentive for a first earner in the household to move into work. Overall, UC is more generous than the current system to first earners. As Figure 5 shows, the household ends up better off under UC than in the current system when the first earner is in work. This is partly due to maintaining the level of entitlement in the basic and child allowances of this group (the vast majority (95 per cent) of whom are over 25); it is also due to the trajectory created by the work allowance and taper compared to the tax credit system. The main earner is particularly better off at part-time hours of work where there is a 'triangle' of extra support created between the work allowance in UC and pound for pound withdrawal of benefit and the boost in income from the working tax credit in the current system. Differences with the current system are much smaller towards full-time hours.

This reflects the government's decision to focus UC on eradicating worklessness at the household level. UC strengthens the incentive for one person to enter work. Although first earners tend to work full-time, UC supports any move into work, even at low hours, in contrast to the current system in which minimum hours rules exist to disincentivise low hours of work (in order to qualify for Working Tax Credit, for example, couples have to work at least 24 hours a week). The difference in emphasis here reflects the fact that the current system is arguably more focused on supporting families to work a minimum number of hours, thus earning a higher income, than it is with tackling worklessness. Interestingly, the overall number of workless households has been falling over the last two decades, leaving worklessness (where no-one in a household works) as principally a problem among single parents, particularly those with young children, and households of people aged 50 to 64 who are either sick or disabled or have retired early.[19]

Figure 5:
Net income at different hours worked for the main earner in a couple with one child aged two years old

Net income as hours worked increase, £ per week



[19] ONS, Working and workless households 2014, October 2014

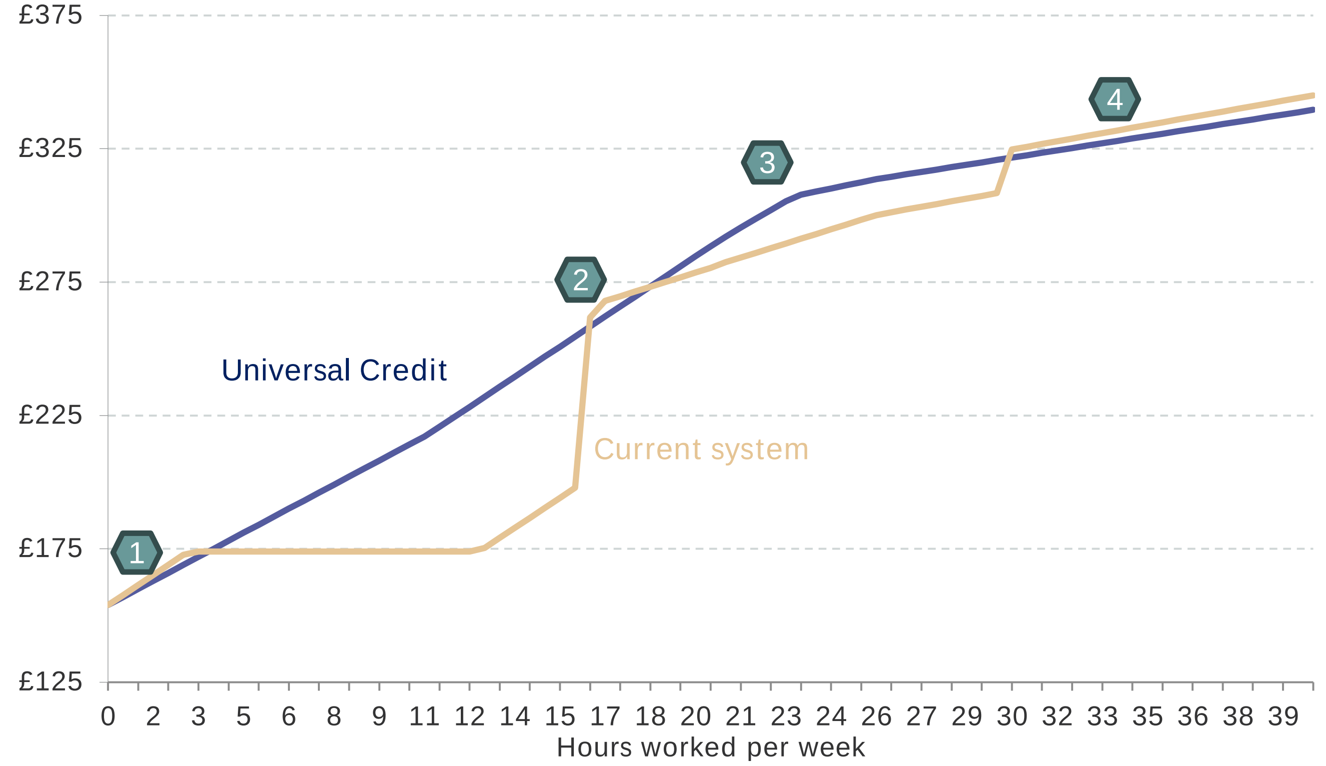
1	£10 earnings disregard in Jobseekers Allowance means no benefits are withdrawn in the current system until 2 hours are worked, then Jobseekers allowance is withdrawn at a rate of a £1 for each additional £1 of earnings.
2	The work allowance means no Universal Credit is withdrawn on intial earnings, although council tax support is withdrawn on a taper of 20 per cent until 10 hours are worked.
3	The work allowance is exhausted after 22 hours of work at £7.50 an hour, beyond this point Universal Credit is withdrawn at 65 per cent of each additional £1 of net earnings
4	Council Tax Support starts to be withdrawn against earnings in the current system and Jobseekers allowance has now been fully tapered away
5	Income is boosted once 24 hours are worked through entitlement to Working Tax Credit, beyond this point tax credits are withdrawn at 41 per cent of additional gross earnings
6	Both income tax and National Insurance are paid creating a combined taper of 73 per cent in the current system and 76 per cent under Universal Credit.
7	Increased entitlement in Working Tax Credit from working 30 hours or more.

Source: Resolution Foundation analysis using the RF micro-simulation model

Similarly for single parents, the biggest gains from UC are seen at low hours of work where the 'triangle' of extra support, shown in Figure 6, significantly boosts income at those hours. Single parents have to work at least 16 hours a week to qualify for support in the current system, but under UC they receive support for working even a small number of hours. For the single parent already in work, entitlement is broadly the same at 16 hours; beyond this point, whether the family gain or lose will depend on their precise pattern of earnings and hours worked.

Figure 6:
Net income at different hours worked for a single parent earning £7.50 an hour with one child aged two years old, 2014-15

Net income as hours worked increase, £ per week



1	£20 earnings disregard in income Support means no benefits are withdrawn in the current system.
2	Income is boosted once 16 hours are worked through entitlement to Working Tax Credit
3	The work allowance is exhausted after 22 hours of work at £7.50 an hour.
4	Whether the parent gains or loses will vary due to simplifying the taper rate at which benefits are withdrawn and removing hours rules.

Source: Resolution Foundation analysis using the RF micro-simulation model

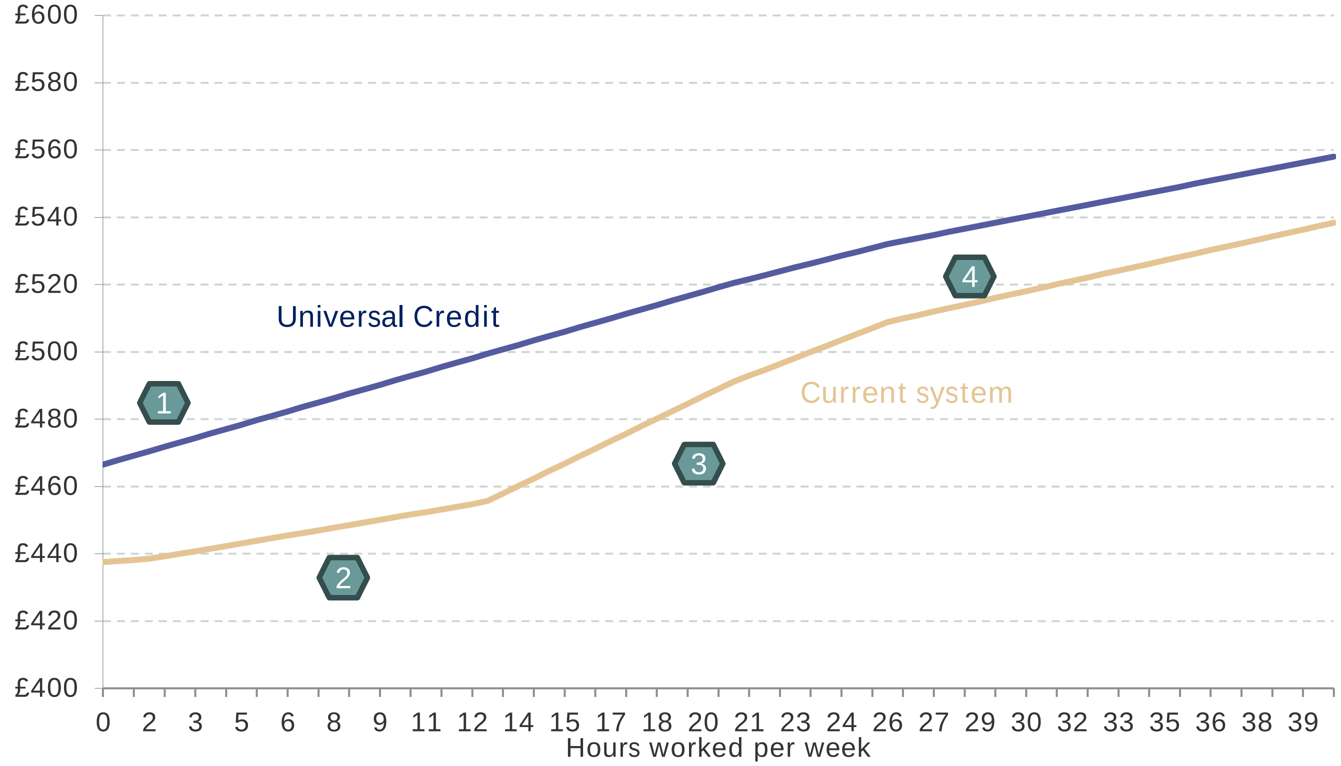
The decision to implement a 65 per cent taper rather than a 55 per cent one as originally proposed by the Centre for Social Justice[20] reduces the incentive to progress in UC for those who already work part-time. In this respect, UC makes no improvement on the current system, and is marginally worse for many. It builds on a rise in the Marginal Effective Tax Rate (METR) from 70 per cent before the downturn to 73 per cent (National Insurance (NI) and the tax credit taper rate were both increased to improve government finances). With UC the METR will have risen by more than six per cent. When combined with tax and NI a 55 per cent taper rate would bring the overall taper back to 69.4 per cent, only a fraction of a percent better than the previous 70 per cent. So while a 55 per cent taper would not have created a much more powerful incentive to progress, particularly in light of historical rates and once additional costs such as childcare are taken into consideration, it would have been a very marginal improvement on the existing system rather than a further deterioration. For a person with housing benefit and working tax credit the 65 per cent taper of UC is a significant improvement. They would have an overall taper of 79 per cent increasing to 91 per cent when also paying tax and NI.

A similar point affects the incentives of second earners. The changed incentives brought about by UC advantage first earners and single parents who choose to work short hours. The fact that the work allowance exists on a household rather than an individual basis, and the fact that the taper applies to net, not gross, earnings together mean that many second earners lose compared to the current system, facing weaker incentives to work. This arises because in the vast majority of cases the work allowance is used up by the first earner, leaving the second earner's earnings subject to the 65 per cent taper from the first pound earned compared to 41 per cent in the current system.

[20] The Centre for Social Justice first proposed the system of Universal Credit in their publication Dynamic Benefits: Towards welfare that works, September 2009.

Figure 7:
Net income at different hours worked for a second earner with 2 children aged 2 and 4, earning £7.50 an hour, rent of £100 a week and main earner working full time

Net income as hours worked increase, £ per week



1	Universal Credit award is withdrawn at 65 per cent taper rate on all earnings
2	Housing benefit and tax credits being withdrawn at combined taper of 91 per cent
3	Tax Credit award withdrawn at 41 per cent taper rate
4	Income tax and NI are paid, overall withdrawal rate is 76 per cent in Universal Credit and 73 per cent in the curent tax credits system

Source: Resolution Foundation analysis using the RF micro-simulation model

Figure 7 shows, although the UC system is more generous than the current system at the household level, as discussed above, making the household is better off if the second earner does not work, the incentives for the second earner to work are weaker. If the second earner chooses to work full-time, for example, they keep less of what they have earned under UC than under the current system.

Impact of reductions in spending on Universal Credit by 2018

The discussion of winners and losers so far in this chapter is the result of comparing the current tax credit and benefits system with UC as it would be if it were introduced in 2014. However, the current picture will change over time *as already announced cuts to UC continue to erode the generosity of the system.*

The original design of UC as set out by the Centre for Social Justice was predicated on more generous funding than is now earmarked for UC. Among other things, this would have enabled a lower taper rate of 55 per cent to improve work incentives for those already in part-time work. Even the government's original proposal for UC as set out in *Universal Credit: Welfare that works*, was based on a more generous settlement than will now be the case. Since 2010, fiscal tightening has resulted in significant reductions in the generosity of the welfare system. While these cuts have affected the current in- and out-of-work benefit systems, they have also fed through into UC, incrementally eroding the support that will be offered. However, the cuts to UC go beyond simply mirroring the cuts to out-of-work benefits in the standard allowances.

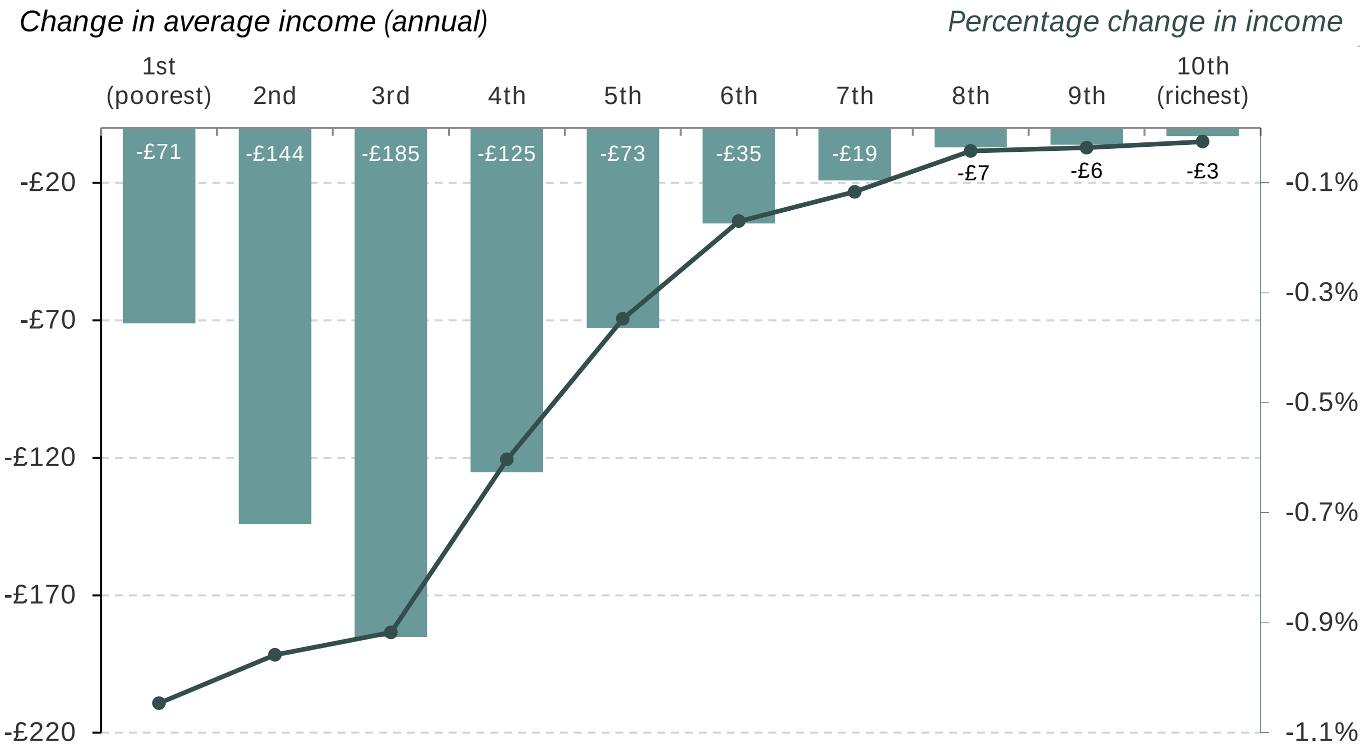
The most significant cut has been to the work allowances whose values have been frozen since they were introduced in 2013, while uprating of the standard allowances have been capped at 1 per cent until 2016-17, in line with other working-age benefits. The Autumn Statement 2014 announced a further one year freeze to the work allowances, meaning that they will be frozen for four years by the end of 2017-18. Taken together these cuts amount to a total of £1.8 billion[21] taken away from predominantly low- to middle-income families entitled to UC in 2018.

Furthermore, with less than half of the fiscal tightening deemed necessary completed in this parliament, it is clear that further cuts to public spending will follow in the next parliament. The Conservatives have already committed to reduce welfare spending by £12 billion a year within the first two years of the next parliament, and have hinted that further cuts could follow. With state pensions protected, this puts working age benefits (and therefore UC) directly in the firing line for further cuts. Although other parties are likely to adopt a different balance between welfare cuts, reductions in public spending and tax rises, it seems likely that some welfare cuts will arise.

As Figure 8 shows, the combination of freezing allowances and capping the uprating of the elements by 2018 affects those in the lower deciles of the distribution the most, with those in work being hit hardest as a result of the work allowance freeze.

Figure 8:

Distribution of losses across households from the cuts to Universal Credit by 2018 compared to uprating UC elements by CPI from April 2014



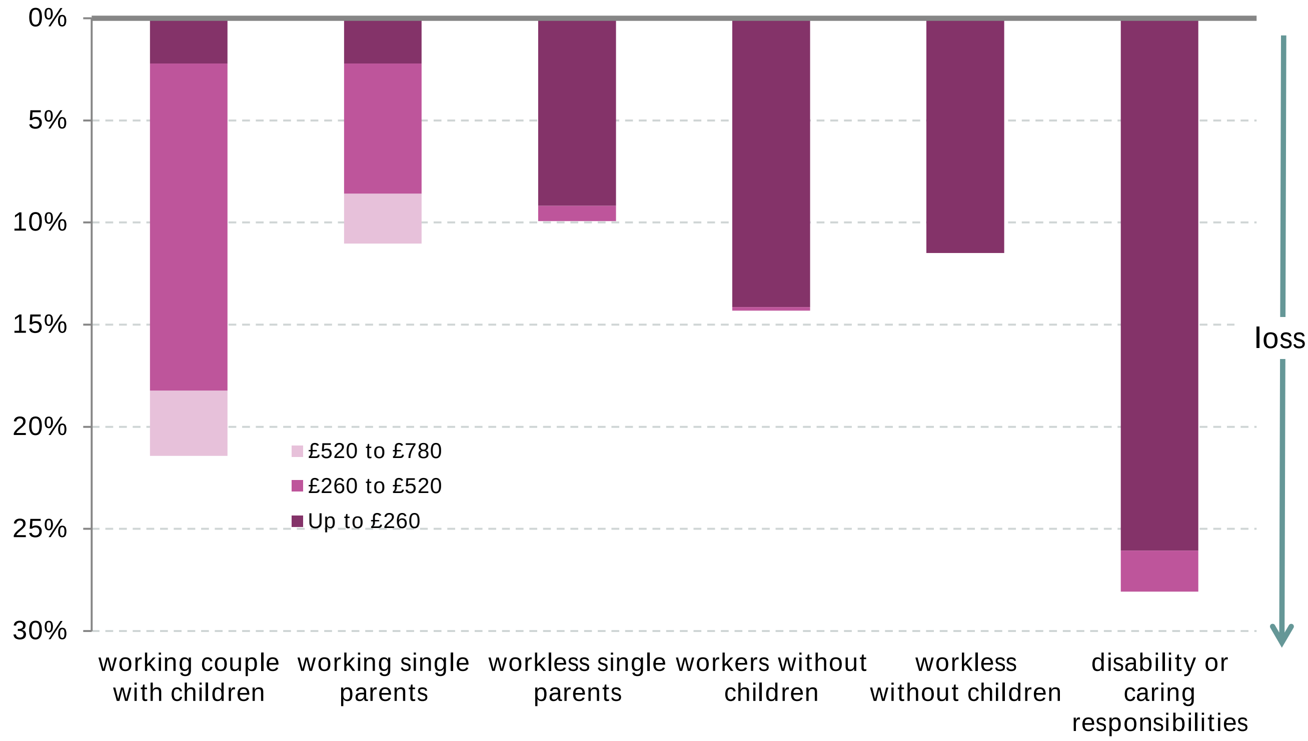
Source: Resolution Foundation analysis using the IPPR tax-benefit model

[21] Office for Budget Responsibility (2014) Policy Costings Database Budget 2014 and HMT (2014) Autumn Statement 2014: Policy costings.

In cash terms, all groups in UC are affected because all are subject to the 1 per cent uprating of the elements. Those with the largest cash losses are those in work, because they are also affected by the freezing of the work allowances, and those with children, as each child entitles the family to further support through the child element. Some working couples with children and working single parents lose over £520 a year by 2018 (see figure 9) compared to a counterfactual in which UC was uprated by CPI. Similarly those entitled to the caring or disabled elements also have greater losses as they claim more elements of UC and have a greater reliance on benefit income, as shown in figure 8 below. These losses amount to up to 5 per cent of net income in 2018

Figure 9:
Cash change in net income due to cuts to Universal Credit by family group as a percentage of all families entitled to Universal Credit, 2018-19

Percentage of families with loss by size of annual loss



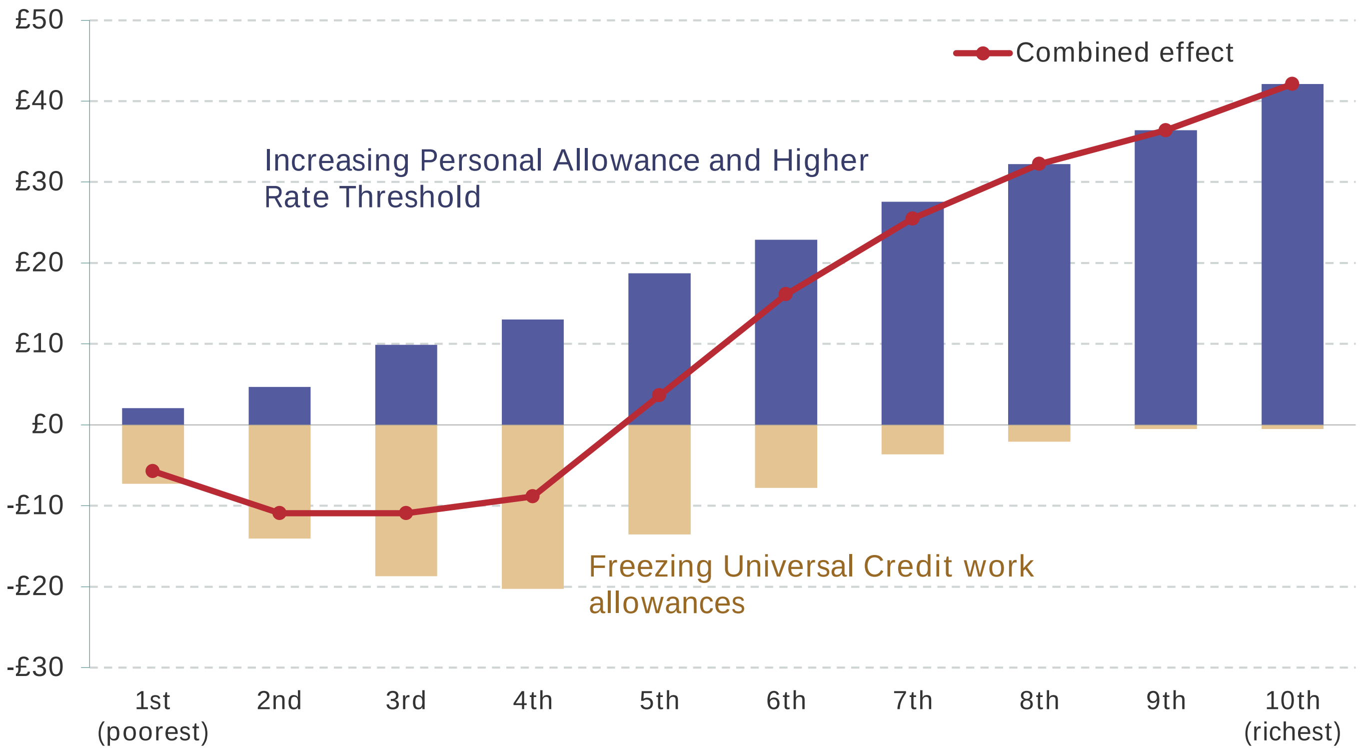
Source: Resolution Foundation analysis using the IPPR tax-benefit model

These reductions also need to be seen in the context of wider government policy. At the same time as government has capped or frozen working-age benefits, they have claimed to help those on low and middle incomes by raising the personal tax allowance and taking the low paid out of tax. Since 2010, £13 billion will have been spent on raising the personal tax allowance from £6,475 to £10,650 by April 2015, with both the Conservatives and Liberal Democrats pledging to get to £12,500 by the end of the next parliament.

These tax cuts benefit higher income households more than households lower down the distribution, as illustrated in Figure 10. In the Autumn Statement 2014 the government announced an additional year's freeze in the work allowance at the same time as it increased the personal tax allowance by £100 from April 2015 from £10,500 to £10,600. Although these two policy changes in isolation involve relatively small changes to income they both have an impact on working families, with changes to the personal allowance described as being of help to low paid workers. The distributional consequences of these two changes are shown in Figure 10. The 40 per cent poorest families in the income distribution are net losers, while those in the top half gain with the size of gains increasing with income.

Figure 10:
Distribution of gains and losses across households from a one year freeze to UC work allowances and increasing the personal allowance by £100, 2017-18

Change in average income (annual) by 2017-18



Source: Resolution Foundation analysis using the IPPR tax-benefit model

This would be true of any income tax cut, as families in the lower deciles are less likely to earn enough to pay income tax or contain dual earners. But there is a particular issue for those in receipt of UC who do not benefit fully from tax cuts because UC is awarded on the basis of net earnings: an increase in the personal allowance boosts net earnings and therefore 65 per cent of this increase in net income from the tax cut is then tapered away. A similar problem does not occur in the current system because tax credits are awarded on the basis of gross earnings. Overall, while UC recipients have seen their income reduced as a result of austerity, this has not been offset by the simultaneous raising of the personal tax allowance.

This chapter has focused on the population eligible for UC and the pattern of winners and losers created by the transition from the current system to the new structures of UC and how this will change as planned cuts to the generosity of UC are implemented.

We have seen that working families with children tend to gain more on balance, while younger, workless families tend to lose out compared to the current system. Out-of-work single parents and families containing an adult with a disability or caring responsibilities fare particularly badly, driven by the decision to pay a lower basic allowance to under-25s and the harsher treatment of unearned income.[22] The introduction of the work allowance and 65 per cent taper mean that people working low hours tend to gain more and those with higher earnings may lose or gain depending on their particular circumstances.

However, the further cuts to UC will mean that all UC recipients will lose out because of reductions in the generosity of the standard allowances and work allowances, with those in work being hit the hardest.

The next chapter focuses on the potential benefits of UC, highlighting areas of real improvement and others where the supposed improvement is more rhetorical than real.

[22] It is beyond the scope of this report to give a detailed assessment of the generosity of the disability related components of UC compared to the current system.

Section 3

Assessing the potential benefits of Universal Credit

There are three important design features of UC that underpin the main potential advantages it will bring. The first, and arguably most significant, is the **integration of six working age benefits** with different eligibility criteria and taper rates into one single benefit. This will simplify the claims process, increase take-up and help to remove the risk of losing entitlement to benefits people currently have when moving between the in- and out-of-work benefit system.

The second element that underpins the potential benefits of UC is the **introduction of a work allowance and single taper**. The work allowance will mean that recipients keep all of their benefit income until their earnings exceed the level of the work allowance improving the incentive to enter work, particularly at a low number of hours, while a single taper of 65 per cent removes some of the highest withdrawal rates in the current system and is intended to provide a clear understanding of the financial return from working more hours.

The third key advantage, potentially strengthening the benefits of integration, is **the introduction of Real Time Information** – the monthly employee earnings information reported to HMRC by employers – which will mean that the UC system can respond quickly where earnings fluctuate or a person moves between employment and unemployment. This will reduce the risk of over or under payments due to changes in circumstances, meaning that recipients can be more confident that the amount of benefit they receive is correct, increasing the impact of the financial incentives UC creates.

In this chapter we consider each of these advantages in turn, assessing the extent to which the reforms provide genuine improvement and the extent to which the improved incentives that aim to be achieved are being diluted or risk being lost altogether.

An integrated system

Bringing six benefits into one system means that individuals will only have to apply once to DWP for UC where they currently have to make separate applications to different central or local government bodies. They will also have their entitlement assessed against a single definition of income and single set of eligibility criteria, so will not have to supply different variations of the same information a number of times. This will make the system easier to interact with, potentially make it easier for recipients to understand their entitlements and increase take-up. These are the key benefits associated with integration.

Particularly important within this is the integration of in- and out-of-work benefits. Integration is likely to lower the perceived risk of moving into work because people who enter work will not have to apply for different benefits, and if they fall back into unemployment they will not need to reapply for out-of-work benefits. Instead their entitlement will continue as they change status and the value of their award will simply be adjusted according to their earnings. UC should, then, remove the fear of losing entitlements when starting work, which can be a significant barrier to entering employment, particularly for those who are far from the labour market. DWP estimates that of the 250,000 who will move into work as a result of UC, 60,000 will do so because the system is simpler, more transparent and removes barriers that deter some people from moving from out of work benefits into employment.[23] Remaining on the same benefit is also likely to increase take-up for those who are out-of-work and on UC who move into employment and remain entitled to some UC..

The work allowance and taper

The work allowance significantly improves the gains from moving into work at a small number of hours compared to the current system. In the previous chapter we focused on the gains or losses at different levels of earnings compared to the current system. Here we focus on the incentives to either enter work (measured by Participation Tax Rates (PTRs)) or earn more, either by working more hours or increasing pay (measured by Marginal Effective Tax Rates (METRs)).

i Box 2: Measuring work incentives

Participation Tax Rates

The participation tax rate (PTR) is a measure of how the tax and benefit system affects the financial gain to work. The PTR is calculated as the income that the state withdraws through either taxation or withdrawal of benefits as a percentage of the total amount an individual earns. It is expressed as a percentage, with higher percentages meaning weaker incentives to enter work. A PTR of 100 per cent would mean that there is no financial gain from entering work, and a PTR greater than 100 per cent would mean a person is worse off from entering work.

Marginal Effective Tax Rates

The marginal effective tax rate (METR) is a measure of the amount of additional earnings that are withdrawn through either tax payments or withdrawal of benefits. METRs are expressed as a percentage, with higher percentages meaning weaker incentives to work or earn more: a METR of 100 per cent would mean that all of any additional earnings would be offset by higher taxes or reduced benefit entitlement, while a METR greater than 100 per cent would mean someone was made worse off from increasing their gross earnings.

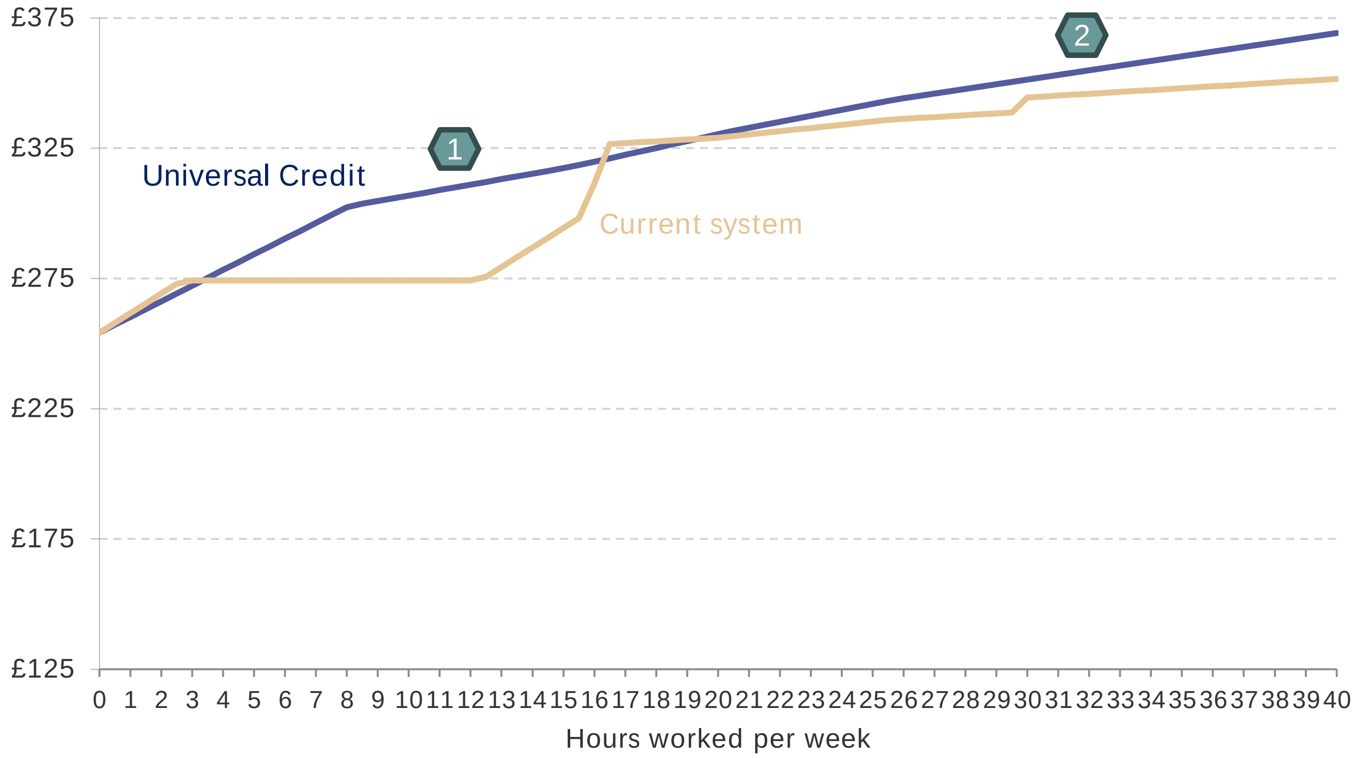
As an illustration, Figure 11 below shows how the introduction of the work allowance affects work incentives for a single parent with one child and housing costs. Under UC, this single parent would keep all of what they earn until reaching the end of their work allowance, making her better off compared to the current system where there is often no gain at all from working fewer hours than are required to claim the working tax credit, as out-of-work benefits are deducted pound for pound.

They will no longer face different withdrawal rates and a spike in income at 16 hours when she becomes entitled to the working tax credit. Beyond the work allowance, at the circumstances chosen for this illustration, she is slightly better off than in the current system as her UC is withdrawn at a rate of 65 per cent (76 per cent when tax and NI are paid), while in the current system her tax credits and housing benefit are withdrawn at a combined rate of 79 per cent (increasing to 91 per cent when paying tax and NI).

[23] NAO, "Universal Credit: progress update" November 2014

Figure 11:
Net income at different hours worked for a single parent with 1 child aged 2 earning £7.50 an hour and rent of £100 a week

Net income as hours worked increase, £ per week



1	The work allowance and taper provide a smooth income as the parent enters work
2	Withdrawing housing as part of UC at a 65 per cent taper rate reduces the withdrawal rate as earnings increase

Source: Resolution Foundation analysis using the RF microsimulation model

The introduction of the work allowance, effectively a substantial earnings disregard, also carries with it risks that will be discussed in the next chapter. However, for those who are more likely to enter work if they can work short hours, UC is likely to do a lot more than the current system to encourage them into employment.

Figure 12 shows the proportion of people currently out-of-work with different participation tax rates (PTR) if entering work at various numbers of weekly hours worked while earning the National Minimum Wage. It compares outcomes under UC with outcomes under the current system. Under UC, entering work at all hours shown, less than 5 per cent of those currently out of work are left with PTRs of over 90 per cent, compared to between 12 and 35 per cent in the current system.

The greatest improvement in PTRs under UC occurs when entering work at low hours:[24] the work allowance means that people keep all of their earnings at lower hours of work, compared to the pound for pound withdrawal in the current system. For those who would start work at either 10 or 20 hours a week, UC leads to a large increase in the proportion who have a PTR of less than 10 per cent.

[24] Our modelling does not take into account the disregard that exists in the tax credit system. This prevents a change in income having an immediate impact on a family's entitlement (for increases in income of less than £5,000 and falls in income of less than £2,500 in the previous 12 month period). This means that families with a relatively small change in income would not have their entitlement affected immediately.

The incentive to start working is also improved where the single taper rate of 65 per cent is lower than the combined tapering of tax credits and housing benefit in the current system. However, at higher hours of work, while still reducing the very highest PTRs, UC increases the number of people with a PTR of between 50 per cent to 70 per cent – some of whom will previously have had much higher PTRS – largely reflecting the higher overall taper rate of 76 per cent that applies under UC (once paying tax and NI) and the increased taper that applies to second earners. This faster rate of withdrawal of UC at higher levels of earnings than under the current system partly reflects the trade-off with allowing people to keep more of their benefits when initially entering work through the work allowance.

Figure 12:
Distribution of participation tax rates for people out of work, entering work at different numbers of hours and earning the National Minimum Wage

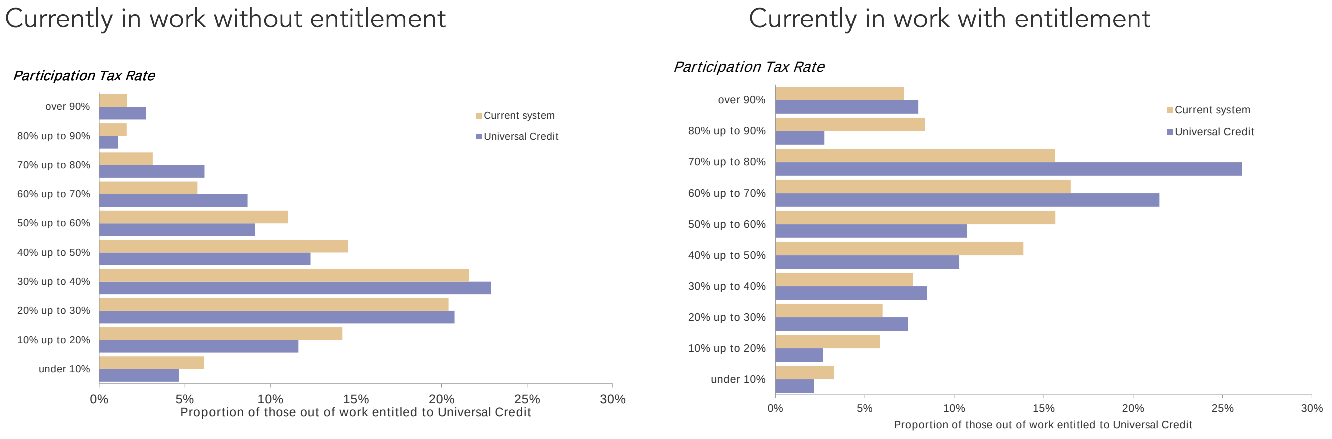
Source: Resolution Foundation analysis of the IPPR tax-benefit model

Notes: In couple households if both members are out of work only the head is assumed to enter, if there is already a single earner, the second earner enters work.

Figure 12 compares the PTR of people already in work who are entitled to in-work support (if they stopped working), with the PTR for those in work and not entitled to in-work support (if they stopped working) under both UC and the current tax credit system. Workers who are not entitled to in-work support have lower PTRs (most are between 10 per cent and 50 per cent) compared to workers entitled to in-work support (most are between 50 per cent and 80 per cent). These higher PTRs reflect the ratio of benefits to earnings for those entitled to in-work support to the ratio for higher earners who are not. Perhaps inevitable, but this shows that the incentive to work for lower earners is overall lower than for people with higher earnings.

Comparing incentives between the current system and UC also shows that overall UC will actually make it *less rewarding* to stay in work for those who are already in work. This is in part a result of the higher METRs people will be subject to in UC at full-time hours of work (as detailed below), and partly due to the overall level of generosity of in-work support compared to the current system.

Figure 13:
Distribution of participation tax rates for people out of work, entering work at different numbers of hours and earning the National Minimum Wage



Source: Resolution Foundation analysis of the IPPR tax-benefit model

Notes: In couple households if both members are out of work only the head is assumed to enter, if there is already a single earner, the second earner enters work.

It is very difficult to predict the behavioural responses that will result from these changes from UC. However, it seems highly likely that UC will both strengthen the simple financial reward of moving into work as well as reducing the uncertainty, at least to some degree, over how much and when in-work benefits will be paid. These should, then encourage some people who currently do not work to move into employment, particularly at low hours. For example, single parents who would choose to work a small number of hours (but less than 16 hours) may be attracted into employment under UC. The changes are also likely to increase the take up of in-work support, because with one system recipients moving into work will no longer need to make a new application.

Work allowances in 2018

The cuts to UC that have taken place since it was first proposed have, however, made the system less generous. Cuts to the standard allowances have actually improved work incentives, but only by lowering income for families who are not in work relative to earnings. At the same time announced cuts have also have reduced the incentive to enter work created by the work allowance.

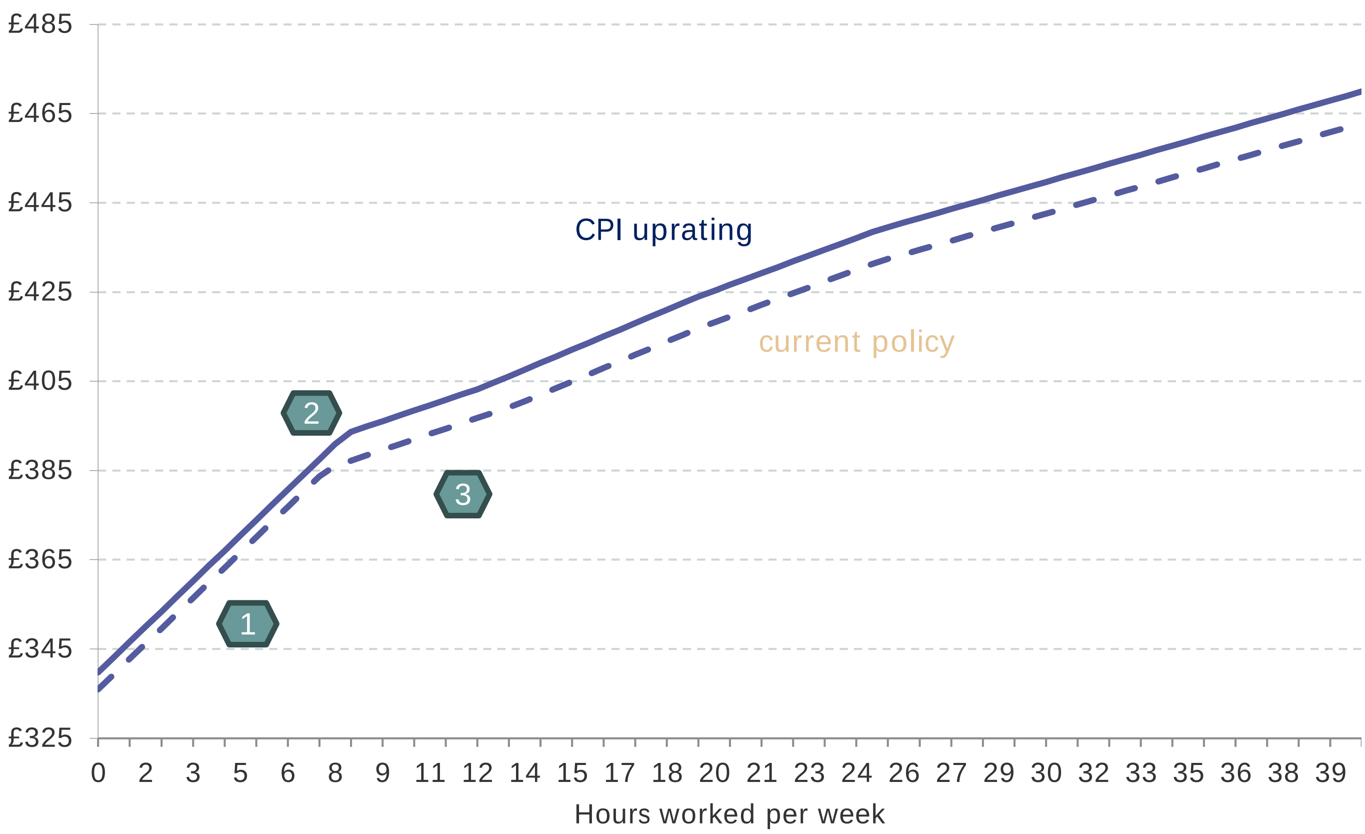
Given that UC does little to improve the incentive to progress, the most significant gain from the introduction of UC comes from improving the incentive to enter work, and often at a low number of hours worked. However, the freezing of the work allowance until 2018 gradually erodes that incentive, making it less advantageous to move into work.

If the value of work allowance does not keep up with earnings growth, the number of hours worked before benefits begin to be tapered away will fall, eroding the positive incentive. Uprating the work allowance by CPI, the default policy for UC, would help limit the weakening of incentives, (especially during a period of slow wage growth) but even this approach would result in the gap eroding over time, similar to fiscal drag where, historically, income tax and NI thresholds have increased at a slower rate than earnings.

As an illustration, Figure 14 shows how the year on year freezing of the work allowance means that by 2018 a single parent will be able to work fewer hours than in 2014 before their work allowance runs out. As a consequence, they will have to work additional hours to achieve the same level of income as in the current system. The same issue exists for other groups as shown in Table 2.

Figure 14:
Net income at different hours worked for a Single Parent, earning £7.50 an hour with 2 children aged 2 & 4 and rent of £100 a week

Net income as hours worked increase, £ per week



Source: Resolution Foundation analysis of the IPPR tax-benefit model

Notes: In couple households if both members are out of work only the head is assumed to enter, if there is already a single earner, the second earner enters work.

1	reduced income due to reduction in the value of the basic and child allowances
2	Universal Credit is tapered away sooner due to reduction in the work allowance
3	an additional 3 hours would need to be worked until income was the same following the cuts

Table 2 shows the number of hours that different groups can work before their work allowance runs out; in other words, before their incentives weaken. Comparing 2014 to different scenarios in 2018, it is clear that for single parents and couples, the freezing of the allowance erodes work incentives.

While the short-term impact is not dramatic, continuing reductions in the value of the work allowance in the next parliament will further undermine incentives to enter work particularly when entering work at lower hours where UC currently makes the greatest difference to work incentives.[25]

The erosion of the work allowance affects both those with and without housing costs in equal measure, as shown in Table 2. However, for those with housing costs, the reduction in an already small work allowance means that their PTR rises at a lower number of hours. This creates a risk that those who do enter work with housing costs will be trapped at increasingly low hours. This risk and other risks created by UC will be discussed in greater detail in the next chapter.

Table 2: Hours of work at which the work allowance ends if earning National Minimum Wage

work allowance	2013	2018	
		CPI uprating	current policy
Housing			
couple with children	8	8	7
lone parent	10	9	8
Single	4	4	4
no housing			
couple with children	20	18	17
lone parent	27	25	23
Single	4	4	4

Source: Resolution Foundation analysis

Single Taper: Myth or reality?

Alongside the benefits discussed above, one of the oft-claimed benefits of UC is the single, smooth taper which contrasts with the current system in which the hours rules and other features of the out-of-work benefits system and in-work tax credits create a series of spikes in work incentives, as already described and shown in Figures 5 and 6 in Chapter 2. The claim is that the single taper makes it easier for people to understand their incentives, and ensures that they are always better off if they take on additional hours. In reality, however, most people will not experience a single, smooth taper or METR. Several benefits, notably Council Tax Support, remain outside UC, and the effective taper on earnings increases when tax or NI is paid.

[25] It is worth noting that if inflation and earnings growth turn out to be stronger in the 2014 to 2018 period, than as currently anticipated, the erosion in work incentives would be greater still. Similarly, if inflation and earnings growth undershoot expectations the blunting of incentives will be that much smaller.

Figure 15 shows the range of METRs that workers will face when entitled to UC: most have an METR of either 65 per cent (the UC taper), 72 per cent (the UC taper and withdrawal of Council Tax Support), 76 per cent (the UC taper, income tax and NI) or 81 per cent (all four being paid or withdrawn at once).

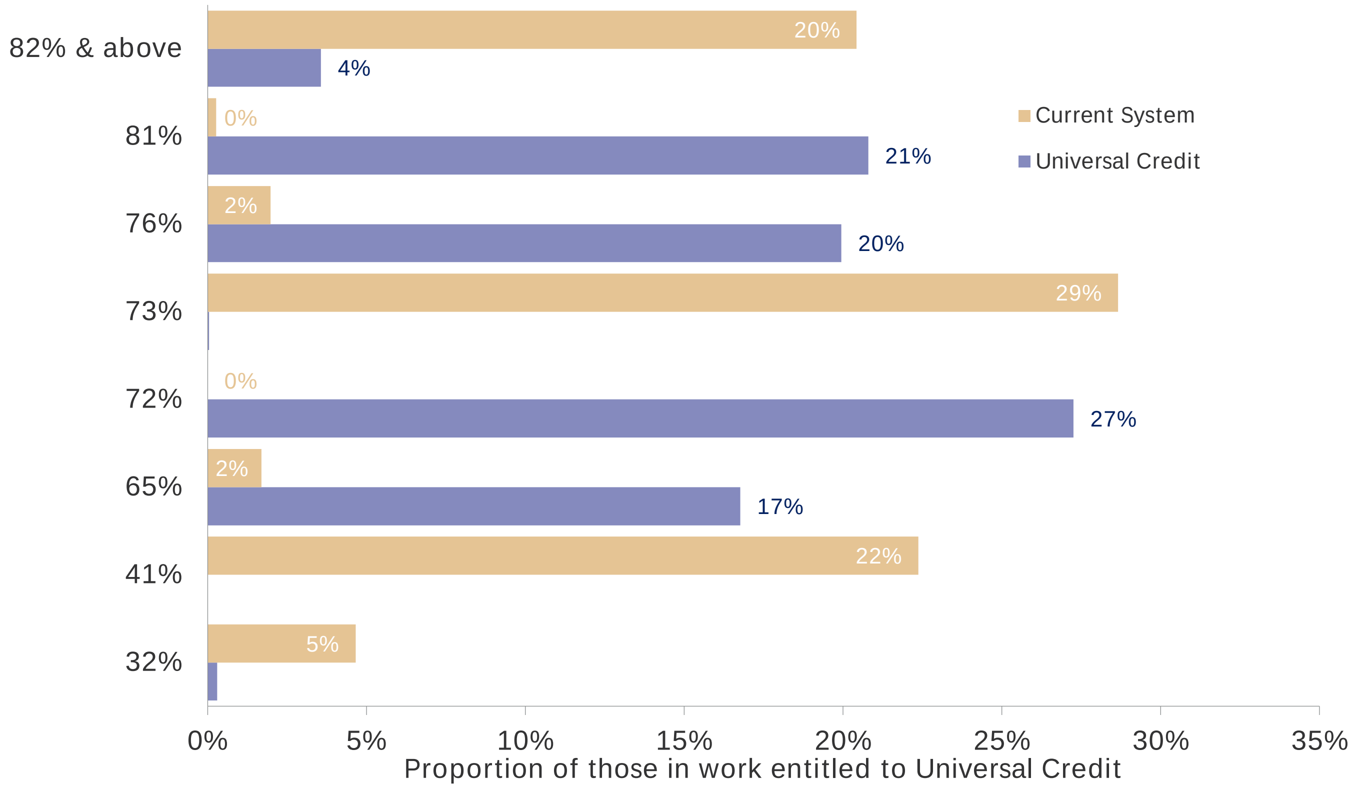
There are three main differences between UC and the current system. First, under UC, more workers (mostly second earners), have an METR of 65 per cent and none have an METR of 41 per cent: this arises because for workers no longer entitled to council tax support but not paying tax or NI , the current system withdraws their tax credits at 41 per cent, compared to 65 per cent in UC.

Secondly, the overall METR faced by workers paying income tax and NI is increased to 76 per cent instead of 73 per cent under existing tax credits – affecting almost 20 per cent of people in work and on UC. Under UC there are additional groups of workers with METRs of 81 per cent and 72 per cent: these correspond to the METR faced by those who are also subject to a withdrawal of council tax support.

Finally, and more positively, the very highest METRs seen in the current system when housing benefit, tax credits and council tax support are withdrawn at the same time are not found under UC: fewer than 5 per cent of workers on UC will have an METR of higher than 81 per cent, compared to over 20 per cent in the current system (taking into account CTS). This is a direct result of UC integrating what are now separate, overlapping, benefits and tax credits.

Figure 15:
Distribution of marginal effective tax rates for all people entitled to Universal Credit who are in work

Marginal EffectiveTax Rate



Notes: METRs are calculated for each individual but couples will face the family METR based on their partner's current earnings level and family benefit entitlements. Low population values have been suppressed to show the main METRs in the working population.

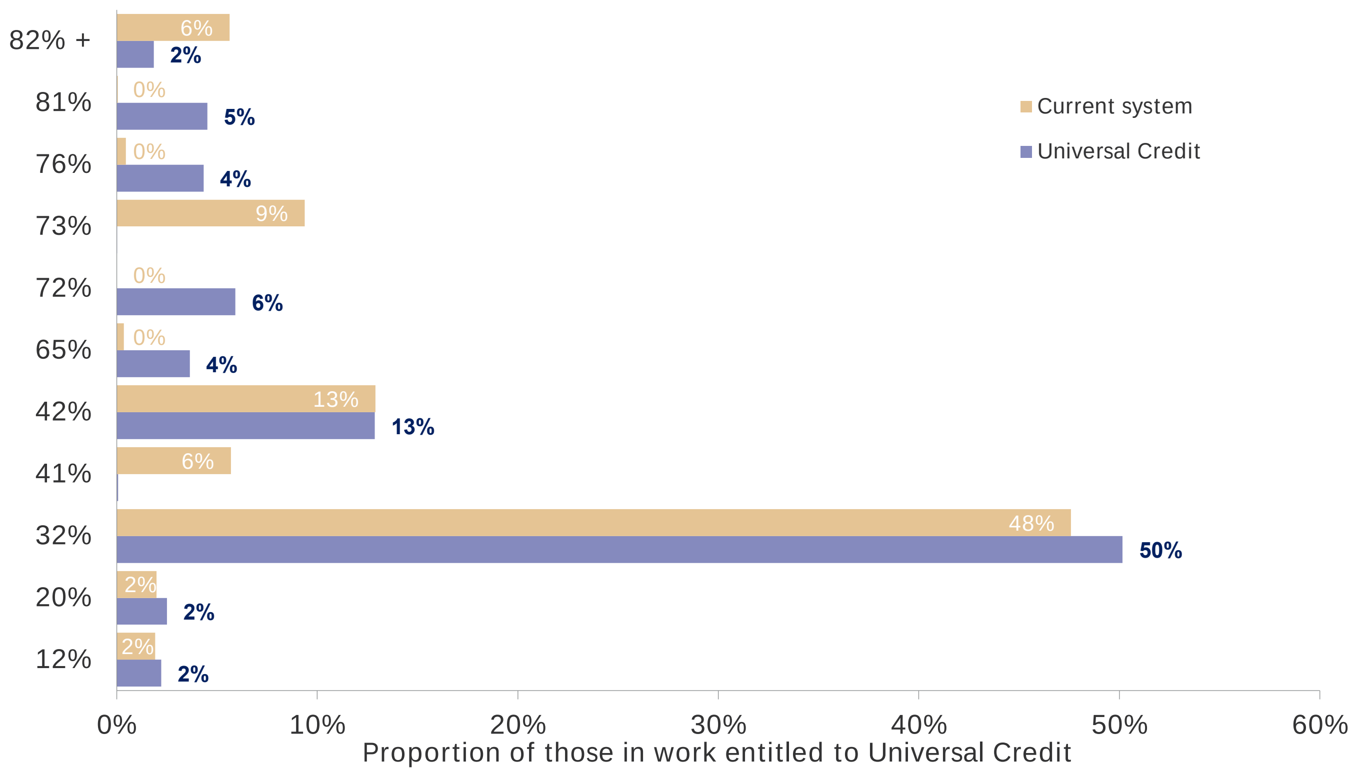
Source: Resolution Foundation analysis of the IPPR tax-benefit model

These estimates do not reflect the costs of childcare in either system, which for working parents make work incentives significantly worse, nor the treatment of passported benefits, such as free school meals – which will be withdrawn at a yet to be announced level of earnings, something that is likely to re-introduce cliff-edges into the system, reducing even further the 'smoothness' of the taper.

Of course it must not be forgotten that workers entitled to either UC or tax credits have much weaker incentives to progress in work than other workers. Figure 16 shows that the majority of those outside the in-work benefit system have an METR of either 32 per cent (paying NI and income tax) or 42 per cent (paying higher rates of tax and NI).

Figure 16:
Distribution of marginal effective tax rates for all people who are in work

Marginal EffectiveTax Rate



Notes: Low population values have been suppressed to show the main METRs in the working population.

Source: Resolution Foundation analysis of the IPPR tax-benefit model

A single smooth taper is often purported to be easier to understand than the hours rules in the current system, but it is unclear whether this is the case.[26] There is considerable evidence that financial incentives in welfare systems are poorly understood. For there to be a strong response to positive incentives the incentives must be comprehended, and it would appear that this advantage of UC maybe more rhetorical than real. That said, with a single taper applying to the withdrawal of the equivalent of housing benefits and tax credits, it should be easier for recipients, or advisers, to calculate their potential net income when entering work, working more hours or earning more.

[26] DWP (2014) Universal Credit Pathfinder evaluation

But given the potential benefits that could arise from the integration of benefits, there are, in principle, opportunities to strengthen this dimension of UC by extending it to include benefits that remain outside of UC.

The current concerns around the deliverability of UC mean, though, that there are limits to extending its scope at this stage. But in time there could be scope for integrating council tax support and passported benefits into UC given their significance for low income households. The current exclusion of council tax support from UC means there is an additional taper rate that applies on top of UC and an additional benefit to claim where people are entitled to both. In the longer term a functioning UC system may also provide a vehicle to better distribute other benefits subject to a means test, such as child benefit.

Complying with the system

Realising many of the benefits of UC critically rests on the system being easy for people to use and to comply with; otherwise, people are more likely to be risk-averse in their approach to work. We cannot assume that UC will automatically be easier for people to use just because UC involves a single application for what are currently six separate benefits. In addition to that, the type of information that must be provided when claiming UC needs to be easy for people to find and input into the system, and the penalties for not providing the right information need to be highly transparent so that people are not hit by unexpected costs, or such large costs that they are deterred from trying. Here, there are concerns with the current design.

The introduction of Real Time Information should mean that people's earnings are automatically updated within the UC system with the information that employers submit to HMRC. It is significant in ensuring that UC is better able to respond to those whose earnings fluctuate, or who move between employment and unemployment, and it should reduce the risk of families incurring over or underpayments to the extent that happens in the current tax credits system.[27] So this increased accuracy and automation will not only make the system easy to comply with, but also improve the accuracy of delivery.

However, in some areas, complying with UC is more challenging and also looks likely to be harder than under the current system. This stems from two issues. First, in the context of housing, the complexity relates to the decision *to pay rent directly to tenants* in social housing as well as in the private rented sector. In the current system, rent information in the social sector is provided directly by landlords, and benefit payments to cover rental costs are made directly to landlords. This direct contact between social landlords and the government helps to reduce errors in under or over payments of housing benefit when rent changes, and ensures that the benefit to cover rent is paid efficiently to the landlord.

The second is that the monthly payment cycle and automated reporting of earnings in UC has led to a need for other *information required to process a UC claim to be reported on a monthly basis* as well. With childcare costs this could create difficulties, as these are often paid termly, and costs can vary between term-time and school holidays. In the current system, an average weekly cost is claimed taking into account expected costs over the coming year. Support in UC will relate to the specific cost paid out in the previous month, which may not relate to the childcare actually used in the same period, and may not match with the invoicing process of the childcare provider.

The *self-employed* will also be required to report their income on a monthly basis, whereas, in the current system, they can report their income on an annual basis in line with the tax system. This new requirement places an additional reporting burden on the self-employed who will have to separately calculate a monthly figure to report to UC on a different basis to the one they report annually to HMRC. The self-employed also have to contend with the Minimum Income Floor

[27] Autumn Statement 2014 announced the intention for Real Time Information to be used to make in-year adjustments to tax credit awards, although the disregards in the current system which already allow for some in-year variation will limit the impact of this.

(MIF) as explained in Chapter 2, but imposing the MIF as a fixed monthly amount could lead to some self-employed being worse off in UC than employees despite having identical earnings in a year. Here it is the application of a fixed monthly value to an income measure that fluctuates from month to month that causes a problem. Compared to in-work conditionality, and despite its time-limited nature, the application of the MIF is potentially far easier to administer. Although the level of the MIF will still vary by individual circumstances (as it is lower for people that are the main carer of a young child) it will automatically reduce UC entitlement if earnings are not at the appropriate level, whereas sanctions would need to be applied on a case-by-case basis for employees.

Ensuring that these elements of compliance do not erode the wider benefits of UC will be important as it is expanded to cover groups of people with more complicated household characteristics. The need for the system to work effectively is especially important as, with increased integration of the benefits system, any error in payment could mean that a family receive no benefit income at all (while the current system is less efficient in many ways, problems with one part of the system do not prevent benefits from other areas being paid).

This chapter has investigated the potential benefits that UC can bring through the better integration of the working age benefit system, a clearer structure to withdraw entitlements as earnings increase, and the use of real time information to assess eligibility in a more accurate and timely fashion.

However, we have also seen that integration has been limited, with some significant working age benefits, such as council tax support left out of the system, and it is still unclear how passported benefits will interact with the system.

Providing a smooth taper is largely rhetorical, particularly for families with children who may be entitled to passported benefits or claim for help with childcare costs. Changes to work incentives are largely limited to improving the incentive to enter work, particularly at low hours of work, with little, if anything to improve incentives to progress in work. Similarly, the complexity created by the reporting of information such as self-employed income and childcare costs could prevent the system from being easy to comply with.

The next chapter looks at the additional costs to government created by the underlying structures of UC, and the potential risks that arise from the incentives they create.

Section 4

Assessing the potential costs and risks created by the design of Universal Credit

As discussed in Chapter 3, the basic design of UC with a work allowance and single taper has some advantages in theory over the current system, such as encouraging people to enter work at low hours who would not do so under the current system. But the same structures also potentially create additional costs, new behavioural risks and weaker incentives for some groups. These stem from two factors: new entitlements, and potential changes in behaviour. These new risks are risks to the exchequer, in that they might increase the level of welfare spending or the costs of administration compared to the current system, and risks to households, in that they might reduce their ability to earn their way to a higher standard of living. Three groups are of particular concern:

- Working families without children;
- Working single parents; and
- Second earners.

The government appears to at least recognise some of these risks and plans to introduce a system of in-work conditionality to help mitigate them. This chapter considers the risk created for each group in turn, and then discusses the role that in-work conditionality could play.

Working families without children

As currently designed many working households without children will be entitled to significantly larger amounts of UC compared to the current benefit and tax credit system, shown by the number of winners among this group identified in Chapter 2. Currently, for this group to receive in-work support, they need to work at least 30 hours, but not earn too much, as eligibility ends once earnings reach £13,300 for a single person. For those working fewer than 30 hours, any out-of-work benefits are withdrawn pound for pound as an individual increases earnings. People under the age of 25 are not entitled to any support from working tax credit. As a result, combining part-time work and benefit receipt is relatively uncommon, and many of those in full-time work earn too much to be eligible for working tax credit or housing benefit. This is shown in Figure 17.

Box 3: Working families without children

Characteristics

- 1.2 million families eligible for UC
- 0.4 million are entitled to support with housing costs
- 81 per cent are single
- 50 per cent are aged under 30

Entitlement in UC

- UC award consists of:
  - Basic allowance (£72 a week for single over 25)
  - Housing element based on housing costs
  - Work allowance (£25 a week)
- Mean award:
  - £36 without housing element
  - £96 with housing element

Take-up

In the current tax credit system only 33 per cent of working-age families without children claim (or take-up) the working tax credit they are entitled to, with around 80 per cent of all families without children but only 45 per cent of all working families taking up their housing benefit. This could suggest a substantially lower caseload for this group in UC compared to the estimate of the entitled population. However, a number of factors could increase take-up:

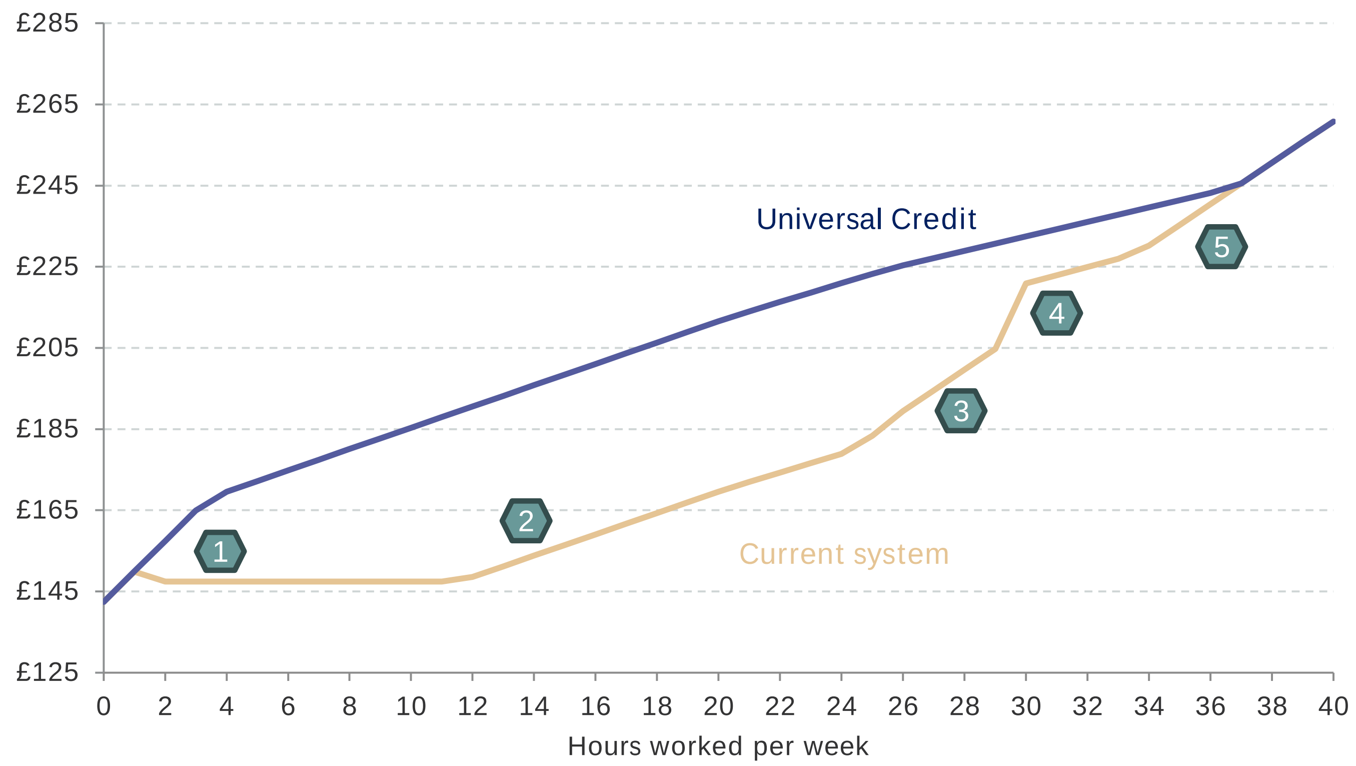
- the combined housing and in-work elements mean families that would only claim one in the current system will now get both
- people moving into work, from out-of-work benefit will now automatically receive their in-work benefits
- UC will be more generous to this group and the take-up rate increases with generosity

HMT have estimated that 77 per cent of newly entitled families paying rent, and 33 per cent of newly entitled families not paying rent but in work will take-up their UC entitlement, based on the current rates of take-up of these groups. Taken together this broadly suggests that approximately 0.7 million of our 1.2 million entitled families would claim their UC award. Families paying rent are far more likely to claim making up the bulk of recipients, and the group most at risk of reducing hours with the taper partly absorbing this fall in income.

Figure 17:

Net income at different hours worked for a single person, aged over 25 and earning £7.50 an hour and rent of £70 a week under the current system

Net income as hours worked increase, £ per week



1	Pound for pound withdrawal of Jobseekers allowance and a £10 earnings disregard in the current system. A £25 earnings disregard in UC, followed by a 65 per cent taper.
2	Housing benefit is withdrawn with a 65 per cent taper
3	Brief period of no benefit entitlement
4	A small window of entitlement to working tax credit
5	end of benefit entitlement in the current system
6	end of benefit entitlement under Universal Credit

Source: Resolution Foundation analysis using the RF microsimulation model

Under the smooth taper of UC, this same group will be entitled[28] to support at a higher level of earnings than the current system. This arises because their first £25 a week of earnings are kept under the work allowance, with the housing element and the basic allowance (equivalent to JSA) then being withdrawn at the 65 per cent rate. Overall this group are entitled to £0.4 billion more support in UC than they would be under the current system.

But a second potential source of additional costs related to this group stems from the risks that people respond to the new incentive structures by working fewer hours than they currently do or by entering work at a smaller number of hours. The risk of such a change in behaviour seems particularly relevant to those who receive support with housing costs, as they are more likely to keep their entitlement to UC as their earnings rise. This is illustrated by the contrast between Figure 17 and Figure 18.

[28] Not all people entitled to benefits – that is meet the eligibility criteria whether that is a characteristic such as age or income – claim them. The proportion of people entitled to benefits who actually claim them is referred to as the take-up rate.

Figure 17 shows the situation for a single person who receives housing support. This person remains eligible for UC up to full-time hours. At full-time hours, and as a result of the 76 per cent EMTR they face, the penalty for working fewer hours is relatively small: working one fewer eight hour shift at £7.50 an hour leads to only £14 less disposable income.

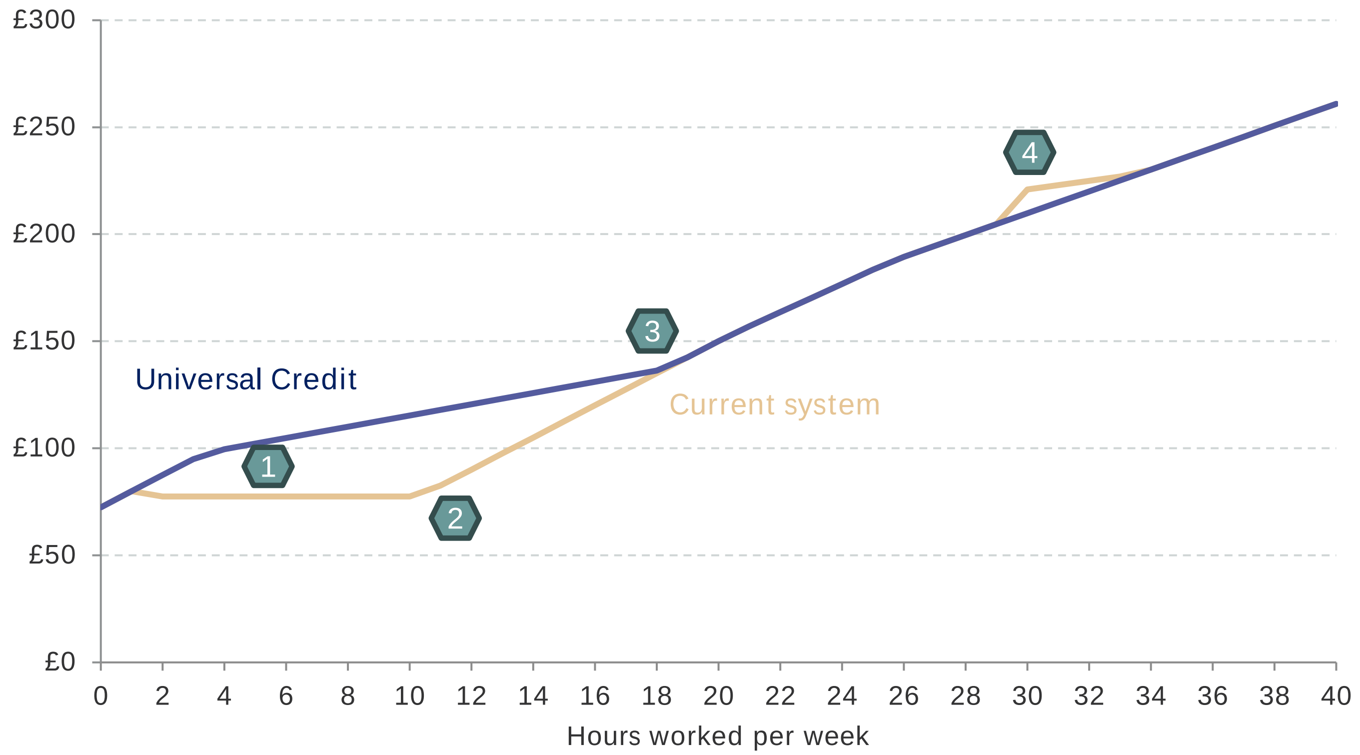
However, as Figure 18 shows, a single person without children and no housing costs loses entitlement to UC once they are working just 18 hours. Given that the majority of households without children work full-time or close to full-time hours, we would not expect the change in incentives created by UC to result in much behaviour change for such individuals.

So there is a risk that individuals *with housing costs* may decide to reduce their hours, as the cost to them of doing so is a very small drop in net income. To give an indication of the scale of possible costs, we estimate that if the 0.3 million people in this group that we expect to take-up their UC entitlement were to work one fewer eight hour shift, spending on UC would rise by around £0.5bn a year.

Of course, this situation exists in the current system for those in work and subject to a withdrawal of tax credits or housing benefit. But there will be many more such individuals under UC, partly because it is more generous to this group, and partly because take-up of in-work support should be higher. Furthermore, individuals currently on WTC can only reduce their hours to 30 before seeing a significant drop in their income, but the lack of hours rules in UC means that there is no longer this backstop.

Figure 18:
Net income at different hours worked for a single person, aged over 25 and earning £7.50 an hour

Net income as hours worked increase, £ per week



1	Pound for pound withdrawal of Jobseekers allowance and a £10 earnings disregard in the current system. A £25 earnings disregard in UC, followed by a 65 per cent taper.
2	End of benefit entitlement in the current system
3	End of benefit entitlement under Universal Credit
4	A small window of entitlement to working tax credit

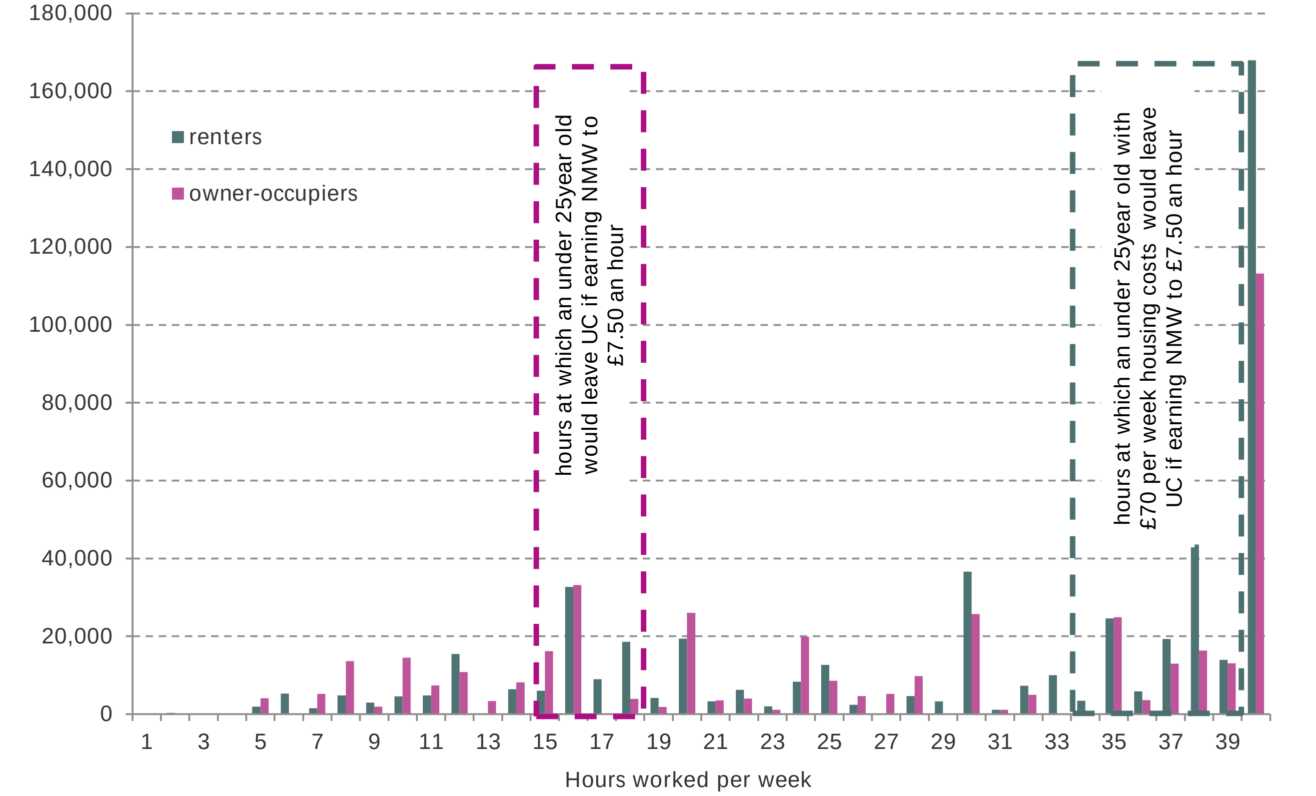
Source: Resolution Foundation analysis using the RF microsimulation model

There are definite advantages to encouraging some individuals to undertake small hours of paid work, such as single parents with young children or those returning to work after ill health. But these advantages are far less clear cut for other groups, and there may even be risks in encouraging younger, physically able adults to work in part-time jobs, as, given the poor status of many part-time jobs, this may well damage their longer term earnings and career trajectories. On the other hand, it might be seen as punitive to deny in-work support to such individuals if they are unable to find full-time work at present.

As Figure 19 shows, part-time work is currently not an especially common choice amongst families without children who would be entitled to UC (although it appears to be more prevalent than among families without children who are not eligible for UC). But it would be a strange priority for the state to support shorter working hours for this group, particularly at increased cost to the public purse. The majority of families without children are working full-time hours, with the chart showing that even the lowest paid with a modest weekly rent would be entitled to UC at full-time hours of work.

Figure 19:
Hours worked by head of families without children entitled to Universal Credit

Number of workers without children (main earner hours shown)



Notes: Some sample sizes are small where low number sof hours worked are reported but values are not suppressed to provide an indication of the spread of hours worked.

Source: Resolution Foundation analysis using the IPPR tax-benefit model

Working single parents

The risk that UC induces single parents to work fewer hours appears greater than for those without children, due to the current prevalence of part-time working for the main carers of children in a family, and the poor marginal incentives to work more (which are weaker still once childcare costs are taken into account). The small work allowance for single parents with housing costs under UC makes them particularly at risk of working less than in the current system. Under the current system, single parents have to work at least 16 hours before they receive any in-work support and help with childcare costs. Changes to incentives could result in parents working fewer hours than they currently do or that they enter work at a smaller number of hours.

Box 4: Working single parents in Universal Credit

Characteristics

- 0.8 million families eligible for UC,
- 53 per cent entitled to support with housing costs
- 84 per cent are age between 25 and 50
- 60 per cent have one child, 33 per cent have two children

Entitlement in UC

- UC award consists of:
  - Basic allowance (£72 a week for over 25s) plus child element (£63 a week
  - Housing element based on housing costs
  - Work allowance £170 a week without housing element, work allowance only £60 a week with housing element
- Mean award:
  - £120 without the housing element
  - £220 with the housing element

Take up

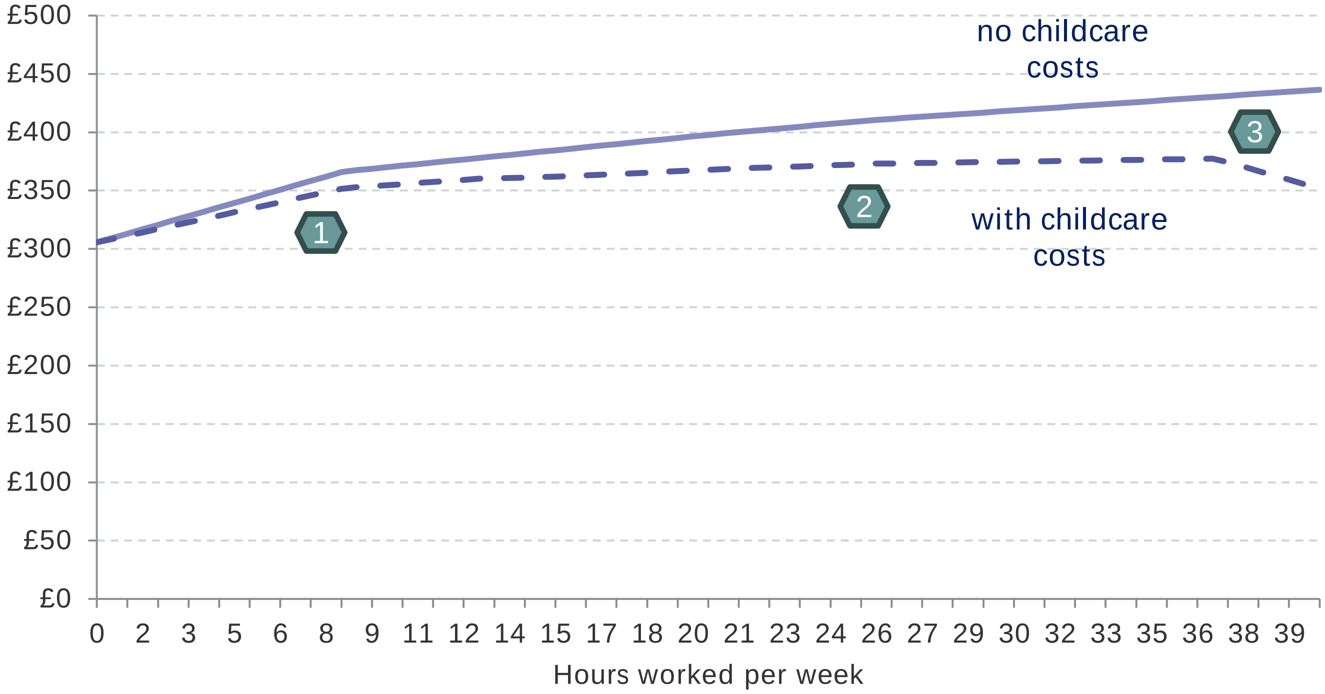
In the current tax credit system 97 per cent of single parents entitled to working tax credit and/or child tax credit claim their award, with 99 per cent of potential expenditure claimed. We would expect virtually all single parents in work and entitled to UC to claim. This would also provide a small boost to take-up of housing support as in the current system 89 per cent of entitled single parents claim 93 per cent of potential expenditure, with those on higher incomes and entitled to smaller amounts least likely to claim.

Figure 20 highlights that under UC their incentives to work are strongest up to the point where the work allowance runs out, around eight hours of work per week. Beyond this point, they would still be better off if they worked more hours (if we disregard childcare costs) but the returns are low: beyond the work allowance, they would keep just £2.60 of each £7.50 they earned (£1.80 when paying tax and NI), gaining only £50 for an additional 20 hours of work. If such individuals are paying for extra childcare they face an even weaker incentive to work longer hours: in the example below, a single parent would keep only 44p of extra £7.50 earned once withdrawal of UC and payment of tax, NI and childcare are taken into account. Under these circumstances, it seems entirely sensible that a single parent may want to forego a small amount of income to spend more time with their children.

Figure 20:

Net income at different hours worked for a single parent earning £7.50 an hour, rent of £100 a week and 2 children aged 1 and 3

Net income as hours worked increase, £ per week



1	Income is slightly lower until the work allowance runs out as the parent pays childcare costs for their youngest child (the 3 year old recieves 15 hours a week free from the early years entitlement
2	Childcare costs reduce net income and create an effective 94 per cent taper rate when income tax and NI are also paid
3	The limit for childcare costs that can be claimed in UC is reached, hours beyond this point are paid in full making the parent worse off

Notes: Net income figures are a weekly average of annual net income. Childcare use also reflects a weekly average of annual usage, taking into account variation in childcare costs across the year.

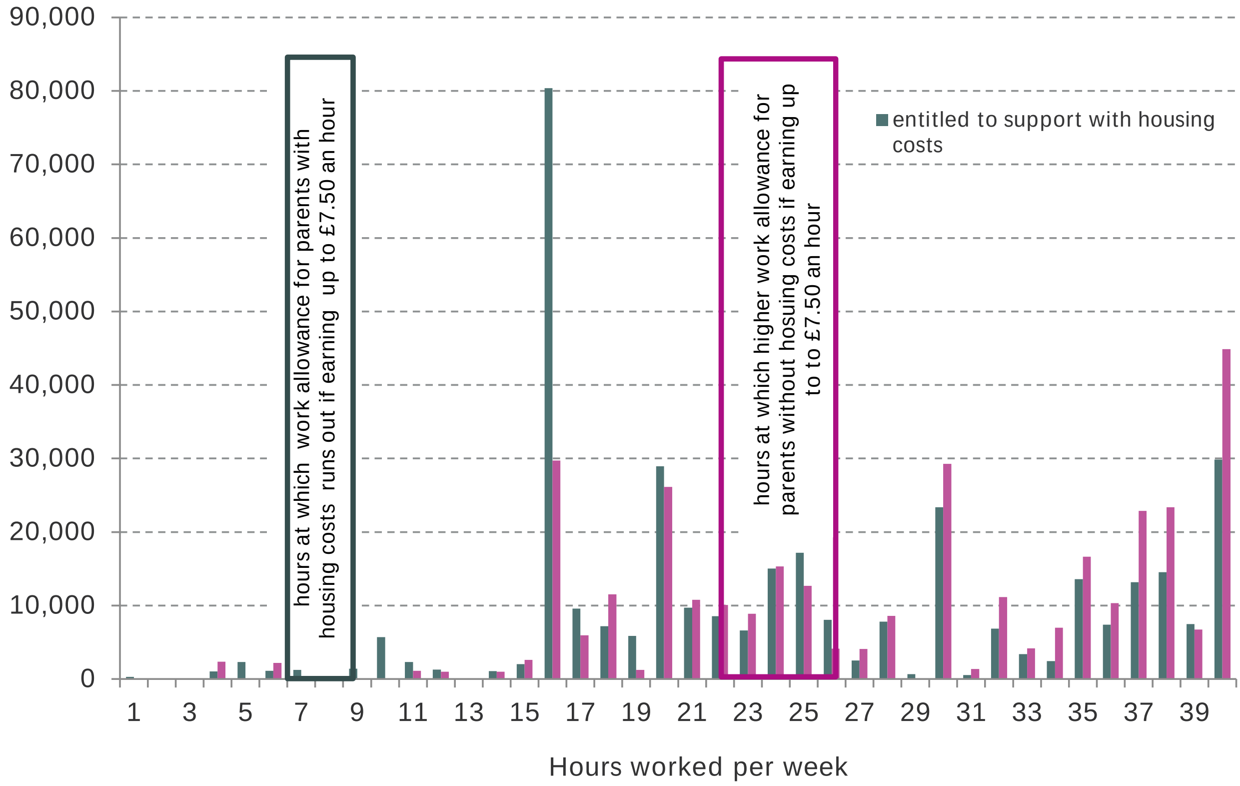
Source: Resolution Foundation analysis using the IPPR tax-benefit model

And existing research tells us that single parents are relatively responsive to financial incentives.[29] The hours rules in tax credits appear to have driven the labour market behaviour of single parents more than any other group, with a significant number working 16 hours. There appears to have been specific creation of '16 hours jobs' in sectors like retail and hospitality that are significant employers of single parents. This is reflected by the spike in employment at 16 hours in Figure 21, which also shows that single parents who rent (and so are more likely to be claiming support with their housing costs and experiencing the highest taper rates in the current system) are more likely to work part-time than those who own their homes.

[29] For example, M. Brewer, E. Saez, A. Shepard, Means-testing and tax rates on earnings, 2008

Figure 21:
Hours worked by Single Parents entitled to Universal Credit by housing tenure

Number of Single Parents



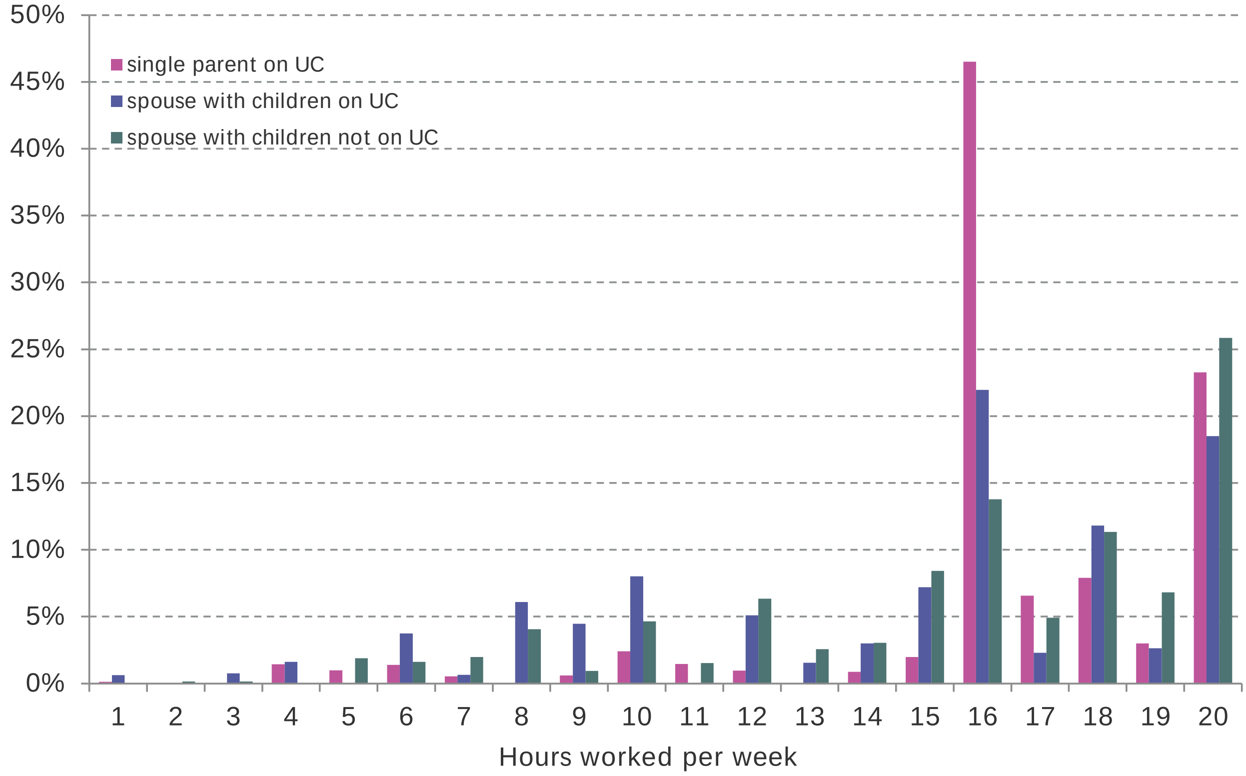
Notes: Some sample sizes are small where low number sof hours worked are reported but values are not suppressed to provide an indication of the spread of hours worked.

Source: Resolution Foundation analysis using the IPPR tax-benefit model

Furthermore, although few single parents currently work fewer than 16 hours a week, it seems very likely that this is a product of the incentives they face rather than their preferences for combining work and family life. An obvious comparison group is mothers in couples who also face similar constraints on their ability to work - as they also have children who need to be looked after while they work - but are less affected by 100 per cent withdrawal rates and cliff-edges in tax credits. Figure 22 shows that this group has a more diverse pattern of working hours. This suggests that once the requirement to work 16 hours or more to get in-work support is removed some single parents will want to work in jobs of less than 16 hours with the point at which the work allowance runs out perhaps acting as a new focal point.

Figure 22:
Hours worked by single parents and second earners at less than 20 hours

Percentage of workers



Notes: Some sample sizes are small where low number sof hours worked are reported but values are not suppressed to provide an indication of the spread of hours worked.

Source: Resolution Foundation analysis using the IPPR tax-benefit model

This change in incentives is most likely to affect those who currently work part-time (or who would work part-time when they started to work) because those who already work full-time under the current system – given the current system also provides relatively poor incentives to progress beyond 16 hours of work – are probably more strongly motivated to work for reasons beyond immediate financial incentives. But, to take an extreme case, if all those who currently work less than 35 hours change their earnings to be equal to the point at which their work allowance runs out, this would result in *£0.5 billion* of extra spending in UC. This estimate includes an offsetting response from some part-time working single parents without housing costs to increase their earnings as their work allowance is equivalent to working 26 hours at the national minimum wage.

There is an additional and important consideration concerning those who are induced to work under UC (but not in the current system) at relatively fewer hours. There is a trade-off here between the risk that single parents who currently work at least 16 hours reduce their hours, and the positive incentive under UC for those who want to only work a small number of hours to gain employment. It is difficult to estimate the scale of this risk, and existing research is not clear on how beneficial moving into jobs providing low hours of work is. However, it would again appear to be a strange priority for the state to encourage single parents, many with low incomes, to work significantly fewer hours than they currently do.

Second earners with children

The third group who could potentially reduce their hours in UC are second earners. Here, there is a risk under UC that second earners choose not just to reduce their hours but to not work at all. As we saw in Chapter 3, the incentives for second earners in UC are weak, particularly once they have paid for childcare, and are usually worse than the already weak incentives created by the current system. This arises in part because UC is overall more generous to working couples with children than the current system – so that the extra income a second earner generates is smaller relative to overall income when they do not work – but also because of the shift to a 65 per cent taper, which considerably reduces the reward to earning more.

Box 5: Second earners with children in Universal Credit

Characteristics

- 1.3 million working couple families with children
- 55 per cent are entitled to support with housing costs
- 400,000 spouses are in work
- 38 per cent have one child and 40 per cent have two children
- 45 per cent have a youngest child aged two or under

Entitlement to UC

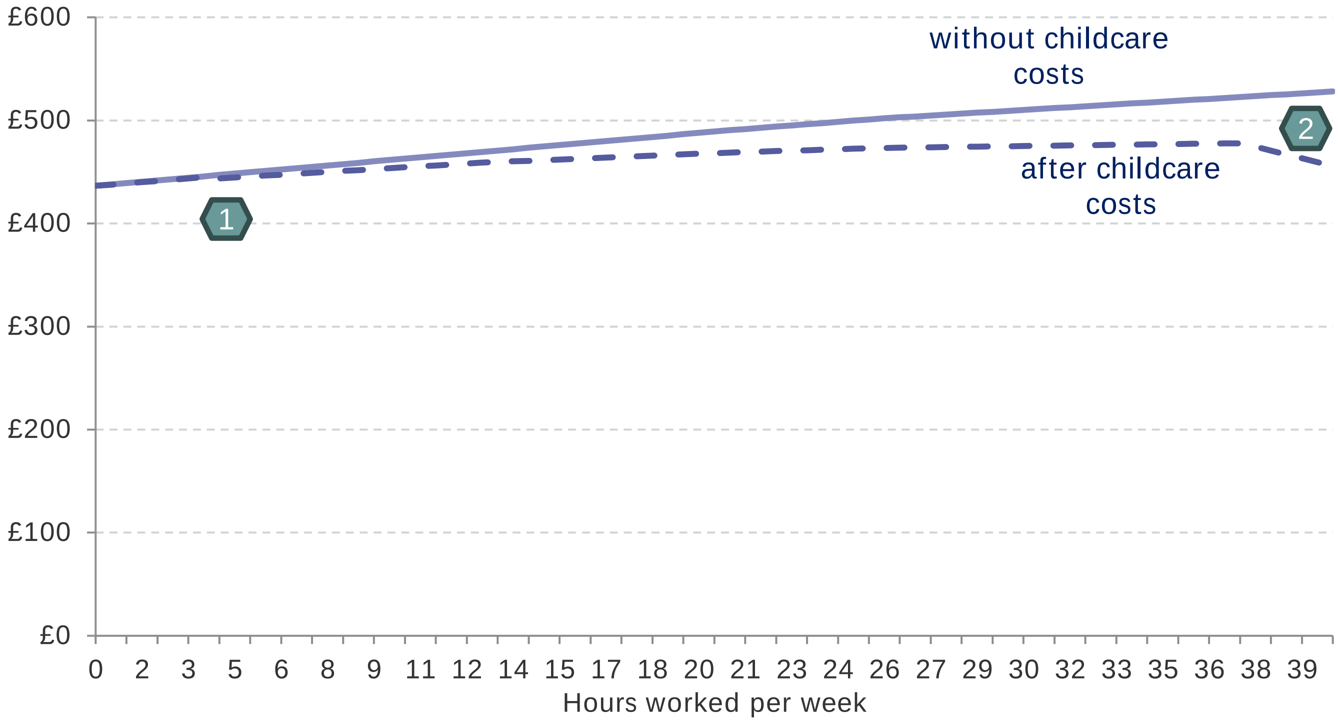
- UC award consists of:
    - Basic allowance – (£114 a week for over 25s) plus child (£63 a week)
    - Housing element based on housing costs
    - No dedicated allowance. Work allowance provided on a household basis
- Mean award:
    - £105 without housing element
    - £185 with housing element

Take up

In the current tax credit system 77 per cent of couples with children entitled to tax credits claim their award, with 92 per cent of potential expenditure claimed. Take-up for all working families with children is higher at around 87 per cent, but also lower amongst families with higher incomes, lower awards and younger children. HMT also anticipate that 77 to 78 per cent of newly entitled families with children would claim their new entitlement. Therefore we might expect take-up for this group in UC to be over 80 per cent, so that around 1.1 million of the 1.3 million families entitled would claim their award, with families where both parents work and have much smaller entitlements least likely to take it up

Figure 23:
Net income at different hours worked for a second earner, earning £7.50 an hour, with rent of £100 a week and 2 children aged 1 and 3, the main earner works 37.5 hours a week

Net income as hours worked increase, £ per week



1	A lack of a work allowance means that there is little incentive to start work, even at very low hours of work
2	In either scenario there is little improvement in income once working full-time hours due to the 65 per cent taper on all net income for the second earner

Notes: Net income figures are a weekly average of annual net income. Childcare use also reflects a weekly average of annual usage, taking into account variation in childcare costs across the year.

Source: Resolution Foundation analysis using the IPPR tax-benefit model

Figure 23 shows that a second earner paid £7.50 an hour has little incentive to work at all under UC. If they do not need to pay for childcare, then they earn an extra £85 for working close to full time compared to not working at all. If they pay for childcare,[30] then they earn only £50 and actually start to lose money if they work more than 37 hours and hit the ceiling on eligible childcare costs.

Table 3 expands on this to show how what a second earner takes home varies with earnings and childcare costs. Earning £6.50 an hour and working 35 hours a week, a second earner has gross weekly earnings of £228. Of this, they lose £16 to tax and NI, a further £137 from the withdrawal of UC, leaving them £74 better off a week. If they then pay for childcare for two children, they end up only £37 better off having worked 35 hours a week, equivalent to £1.05 an hour.

[30] The hourly rate of childcare is assumed to be £4.40 an hour for both the 2 and 4 year old. Both children are entitled to 15 hours of free childcare through early years provision. The chart provides a weekly average of income as hours worked increase, accounting for variation in costs between term time and school holidays.

Table 3: Income at different levels of earnings and hours worked under Universal Credit for a second earner

Hourly wages	Hours worked	Gross earnings	Tax & NI	Benefit tapered	What's left	After childcare costs	
						Age 3	Age 3 Age 1
£6.50	16	£104	£0	-£68	£36	£36	£25
	35	£228	-£16	-£137	£74	£61	£37
£9.00	16	£144	£0	-£94	£50	£50	£39
	35	£315	-£44	-£176	£95	£81	£58

Source: Resolution Foundation analysis

In-work conditionality

In-work conditionality is a new concept that has been brought in as part of UC. It imposes requirements on those who are in work in a similar, but less harsh way, to the requirements currently placed on those claiming an out-of-work benefit. According to current DWP plans, in-work conditionality will require workers to take steps to increase their hours or earnings until they earn at least the equivalent of full-time minimum wage earnings (currently £227.50 a week), with a reduced requirement for certain individuals, as shown in table 4.

Given the lack of precedent for this system, DWP intends to trial various approaches to supporting people to increase their hours or earnings as UC is rolled out. (As discussed above, the self-employed will be subject to a different type of in-work conditionality based around a minimum income floor which will take effect as UC is rolled out).

Table 4: In-work conditionality requirements for different groups

Group	In-work conditionality requirements
General rule for UC recipients	Earn at least the equivalent of full-time at National Minimum Wage (£227.50 a week for over-21s)
Exceptions:	
Individuals with caring responsibilities	None
Main carer of child under 1	None
Main carer of child aged 1 to 4	No in-work conditionality but limited requirements for work preparation activity
Main carer of child aged 5 to 12	Earnings threshold based on hours of work at National Minimum Wage to fit with school hours
Couples	A combined threshold equivalent to two earners at the full-time national minimum wage threshold or a combination of the relevant exceptions. The combined threshold can be met a household level, or by a single earner.

Currently, neither Jobcentre Plus nor Work Programme providers are incentivised to support the low paid to increase their earnings. Other state-funded bodies such as the National Careers Service or the Skills Funding Agency do play a role but their effectiveness in helping low paid individuals to move onto better pay is unclear. And, given that relatively few low paid employees manage to move consistently onto higher wages – only 25 per cent of workers who were low paid in 2001 escaped onto higher pay during the following decade[31] – providing additional support to

[31] 'Workers' are defined as being in employment for at least five of the nine years of the sample and 'Escapers' are workers how are above the relevant low pay threshold in each of the last three years. See the following publication for further details: C. Darcy & A. Hurrell, Escape Plan: understanding who progresses from low pay and who gets stuck, November 2014

low-income working families should in principle be a positive development.

However, in-work conditionality is also designed in part as a response to the risk, discussed earlier in this chapter, that some groups will choose to work fewer hours under UC than under the current system. Our view is that we should not count on in-work conditionality from preventing the – sometimes undesirable – moves to lower hours of work that we outlined above. We say this for a number of reasons. First, there is little international, let alone national, precedent for such an initiative and so there is little evidence with which to base such a system.

Second, much of people's ability to increase their hours or earnings depends on how employers respond, including whether they are willing to offer extra hours to those who need them and to create better paid progression possibilities for low paid workers. There can be little certainty about this at present, given that large numbers of employers have yet to engage seriously with UC. This dependence on the labour market and the behaviour of employers creates a risk that in-work conditionality will lead to individuals being unfairly sanctioned because they have not met their conditionality threshold, despite the fact that meeting it is not wholly within their control.

Third, several important groups who are at significant risk of reducing their hours are not subject to full conditionality. In fact, perhaps understandably, in-work conditionality does not go much further than the requirements of the hours rules in working tax credit, with the exception of single parents with older children who will be subject to full conditionality in the same way as households without children. Among single parents with children under 12 and second earners who are the main carer in the household, there are either no requirements or the requirements are relaxed.

Depending on their personal circumstances, in-work conditionality could allow some single parents to work fewer hours than the current 16 hours rule. This may cause its own complexity because the expectations for those with school-aged children will be decided on a case by case basis, making it challenging for individuals to anticipate the requirements they will have to meet. For most second earners, the conditionality requirements can be met by the first earner in the household, as the earnings requirement applies at a household level. Despite this presenting a higher bar, only around 50,000 of the 400,000 spouses in work and eligible for UC will be subject to in-work conditionality.

The limits of in-work conditionality – both in its reach and its untested nature – weigh heavily against relying on it to address the potential new costs that could result from UC. Potentially the effect on income of in-work conditionality could mirror the impact of hours rules in the current system, the difference being that in the current system people are not entitled to financial in-work support until they work a certain number of hours, in UC entitlements could be taken away from people unless they work to the required level of earnings.

For single parents, second earners, and those entitled to the housing element in UC (whose work allowance is dramatically smaller) part of the reason they may wish to reduce their hours is that the pay-off to working more is relatively small, and so measures to strengthen the return to moving into long part-time or full-time work may be appropriate, thus reducing the reliance on in-work conditionality. For young single person households, there may be a case for having UC mirror the current system in which young adults have relatively little entitlement to in-work support.

This chapter has identified important costs and risks brought about by the design of UC. Incentivising some groups to reduce their hours of work goes against the original policy intent of UC and creates risks to government spend if workers, especially people without dependent children and single parents, become more dependent on income from in-work support. Additionally, the UC deal for second earners is much worse than the current system, raising the possibility that fewer of these individuals would work at all.

The system of in-work conditionality, intended to prevent people working less than they do now, and to encourage people to work more is untried and untested, and cannot be relied upon immediately to achieve its goals. This could lead to a significant extra burden on the public finances that could potentially be prevented by improving the shape of incentives created by UC.

Section 5

Conclusion

UC involves a major reform of the welfare system. Much has been claimed about the new structures it puts in place and the impact they will have on people's ability to move into and progress in work. Taking a step back from the rhetoric of UC and from the controversy surrounding its implementation, it is clear that **UC offers some clear benefits** compared to today's system of in- and out-of-work support. These stem largely **from the integration of benefits**, which means that recipients make a single application for support rather than multiple applications to different agencies, and, critically, that the **transition from being out of work and into employment does not carry the risk of losing benefit entitlement**. Instead, UC will adjust its support through the transition, and remain should an individual fall back out of work. Coupled with the stronger incentive to enter work at low hours, UC should reduce the risk for people of entering work.

There is also **a need to protect and enhance the benefits that UC offers**. It is clear that in some areas, the **benefits of integration are threatened by the potential difficulties of complying with the system**. If it proves difficult to make a claim because of the complexity of the information required or because the risk of wrongly claiming appears too high, then the benefits of integration will be eroded. Here, there is **cause for concern related to childcare costs, self-employed earnings, housing costs and the in-work conditionality rules** related to those with school-age children. Before UC is rolled out, further attention should be paid to how these areas of compliance could be improved to reduce risk for individuals.

Beyond compliance, the **benefits of UC are also threatened by the fact that integration within UC remains incomplete**, with several important areas of support still outside UC. This means that, while individuals will have to make fewer claims than before, they will still **have to interact with several systems outside UC**, notably 'passported benefits' such as free school meals and council tax support. As well as making the system more complex, these interactions **affect work incentives**, affecting the overall taper rate, and potentially introducing cliff-edges. Although significant concerns about the implementation of UC means caution needs to be paid when thinking about bringing additional benefits in, there is a strong case for exploring the extent to which some of the important benefits that remain outside UC can be sensibly be brought within it in the longer term in order to reinforce its positive impacts.

Alongside the benefits that UC creates compared to the current system, this report has also revealed the **limitations of UC as currently designed**. In some areas, it makes little improvement over the current system and may in fact weaken incentives. **Progression for those already in work** is a case in point, as are **incentives for second earners**. In both areas, different policy choices are needed to improve incentives and make work pay adequately to change behaviour. In other areas, UC creates new **risks that could increase public spending** by incentivising certain groups – single parents with housing costs, workers without children and second earners – to enter work at low hours, **reduce their current hours or possibly not work at all**. There is little evidence that short hours jobs lead onto longer working hours and, therefore, these groups could find themselves **stuck in low hours of work**, costing the state more in UC support and eroding their ability to reach an adequate standard of living.

Whether or not individuals will **change their behaviour** in line with the incentives UC creates for low hours of work and which groups will be more affected is very difficult to predict. Historically, it has been shown that **single parents responded to the incentives** created by both the tax credit system and the in-work benefit regimes that preceded it. Few second earners in couples claiming tax credits currently work – and the incentive to work for this group is being made worse. On the other hand, there is little evidence about the interaction of workers without children with the in-work system of support, largely because they have never had such a level of entitlement either in this country or internationally.

However, it nevertheless seems clear that **in-work conditionality as a response to this new risk is inadequate**. It is untested, and, it does not reach large numbers of those who could potentially reduce their hours. In advance of further roll out of UC, it will be important to consider how the incentives in UC could be strengthened to mitigate against the risk of individuals reducing their working hours. This appears challenging in an environment of ongoing fiscal tightening, with cuts to public spending expected every year in the next parliament. However, **further cuts could make UC** increasingly unlikely to achieve the government's anticipated dynamic benefits of 250,000 people moving into work.

The final report of the review, to be published in the coming months, will provide our expert panel's set of recommendations that seek to address the concerns set out above and provide a package of reforms, and their funding implications, that we believe are necessary if UC is to deliver on its potential.

Annex A: Benefit rates in the current system and Universal Credit

Comparison of weekly entitlements in Unversal Credit and the current benefit system, 2014-15 rates

Current system			Universal Credit	
Out-of-work				
Basic allowances for out-of-work income-related			Basic allowances	
Income Support	Jobseeker's allowance, Employment Support Allowance			
singles			*singles*	
under 18s	under-25s	£57.35	under-25s	£57.35
over 18s	over-25s	£113.70	over-25s	£72.40
couples			*couples*	
Income Support, Jobseekers allowance, Employment Support Allowance				
under 18		£86.65	under-25s	£90.05
both over 18		£113.70	over-25s	£113.70
Housing benefit			Housing element	
Full payment of rent up to the relevant rent restriction			Full payment of rent up to the relevant rent restriction	
Child Tax Credit			Child element	
Family element		£10.45	First child	£63.20
Per child		£52.75	Subsequent children	£52.75
In work				
WTC award when working			Work allowance (income threshold before is withdrawn)	
Basic element		£37.20	no dependent children	
16 hours for single parents		£38.15	single	£25.55
24 hours for couples with children		£38.15	couple	£25.55
30 hours boost		£15.35		
			with dependent children and housing costs	
Income threshold before tax credits are withdrawn		£123	single	£60.50
			couple	£51.10
withdrawal rate of tax credits		41 per cent	with dependent children and no housing costs	
			single	£168.90
measure of earnings used in income definition		Gross earnings	couple	£123.35
Housing benefit			Housing element	
rent is subject to a taper beyond an the point at which entitlement to out-of-work benefits ends			part of UC award that is withdrawn once income exceeds the work allowance	
rent is subject to a taper beyond an the point at which entitlement to out-of-work benefits ends			part of UC award that is withdrawn once income exceeds the work allowance	
withdrawal rate		65 per cent	UC withdrawal rate	65 per cent
income definition	net income after accounting for income tax, NI and tax credits		measure of earnings used in income definition	earnings net of income tax and NI
Council Tax Support – default scheme			**Council Tax Support – default scheme**	
award is subject to a taper on income above the point at which entitlement to out-of-work benefits end			award is subject to a taper on all income	
withdrawal rate		20 per cent	withdrawal rate	20 per cent
income definition	net income after accounting for income tax, NI, tax credits and housing benefit		income definition	net income after accounting for earned income after tax, NI and UC

Resolution Foundation

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:

» *undertaking research and economic analysis to understand the challenges facing people on a low to middle income;*

» *developing practical and effective policy proposals; and*

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

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