

# Resolution Foundation

## *All work and no pay*

### *Second earners' work incentives and childcare costs under Universal Credit*

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## Introduction

At the Budget earlier this year, the Government announced that it will spend an extra £1 billion per year on two types of childcare support:

- 600,000 working families eligible for Universal Credit (UC) will be potentially eligible for extra childcare support from 2016
- 2.5 million higher income families not eligible for UC will be able to claim tax-free childcare through a new system of vouchers worth up to £1200 a year per child from 2015 .

Parents will be eligible for only one of the two schemes.

On 5 August, the Government opened these proposals up to a 12-week consultation. The consultation publication confirms that the extra support under UC will be for those families in which all adults earn above the income tax threshold – expected to be £10,000 in 2016.<sup>1</sup> These parents will be able to claim back 85 per cent of their childcare costs rather than 70 per cent, up to a maximum value. This additional support is intended to ensure that work pays for part-time second earners who want to increase their hours towards full-time.

Our analysis shows that the proposed additional support for childcare will benefit higher paid second earners and their families far more than those who are low paid, despite lower income families facing higher barriers to work from childcare costs. For example, a teacher on £11.50 an hour with two young children in childcare would be £58 a week better off if she worked 25 hours a week than if she did not work at all. In contrast, a cleaner with two young children in childcare earning the minimum wage would be £6 a week worse off if she worked 25 hours a week than if she did not work at all.

Of the 1.5 million lower income working families with children within UC, 900,000 (60 per cent) will miss out on this additional childcare support because all adults in the family do not earn enough to pay income tax.<sup>2</sup> As a result, low paid second earners will be no better off if they move from part-time to full-time work, despite the government's intention to make work pay. In fact, lower income families within UC will be largely worse off if low paid second earners increase their hours. Additional earnings from work are offset by the high out of pocket costs of childcare and, in some cases, the withdrawal of UC support (as higher earnings result in a smaller UC award), leaving low wage second earners paying to work.

The consultation provides an opportunity to improve the poor work incentives faced by lower earners in UC by extending the 85 per cent rate of childcare support to all families rather than only those in which all adults pay income tax. The additional £200 million needed to extend 85 per cent to all families using childcare could be found from the £1 billion new investment in childcare by limiting the eligibility criteria for the tax free childcare voucher that goes to better off families.

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<sup>1</sup> HM Treasury and HMRC (2013) Tax Free Childcare: Consultation of design and operation, London: HM Treasury.

<sup>2</sup> Resolution Foundation (2013) Resolution Foundation analysis of the 2013 Budget

## Methodology

We use two example families to illustrate the impact of the proposed extra childcare support: one low earning and one higher earning family. The details of these example families are shown in Table 1 below. Both families are a couple with two children (aged 2 and 4), and both have a first earner in full-time work. They live in privately rented accommodation for which they receive some housing support.<sup>3</sup> In the low earner family, the first earner is an administrative worker on a wage of £7.50 per hour and the second earner is a cleaner on the minimum wage (£6.19). In the higher earning family, the first earner is a manager on £13.50 per hour and the second earner is a teacher on £11.50 per hour. We look at their disposable income as the second earner increases her hours in work. We recognise that there are a growing number of couple families in which the female partner is the first and higher earner but these families are still in the minority.<sup>4</sup> We, therefore, assume in this note that the second earner in both families is the female partner.

**Table 1. Household characteristics of example families**

	Example 1: Lower earners	Example 2: Higher earners
Family type	Couple, two children (aged 2 and 4)	Couple, two children (aged 2 and 4)
First earner	Full-time (37.5 hours per week) admin worker on £7.50 per hour	Full-time (37.5 hours per week) manager on £13.50 per hour
Second earner	Cleaner on £6.19 per hour (minimum wage)	Teacher on £11.50 per hour

We assume that each child requires 1.2 hours of childcare for every hour worked by the second earner. The analysis uses childcare costs based on *Family and Childcare Trust* surveys of providers.<sup>5</sup> The unit cost of nursery care for under-2s is £4.66 per hour. The unit cost of nursery care for children aged two and over is £4.65 per hour. Both families are entitled to 15 hours of free childcare for their four year old child for 38 weeks of the year. The 40 per cent least well off two year olds will be entitled to 15 hours of free childcare starting in September 2014. The lower earning family are entitled to this support if the second earner does not work. However they rapidly become ineligible for this support once she moves into work. The family moves above the means-test threshold for this support once the second earner works five hours per week. The higher earning family is above the threshold for this support irrespective of the number of hours worked by the second earner. For the remaining hours of childcare used, both families can claim 70 per cent of the costs or 85 per cent once the second earner earns enough to start paying income tax (the full-time, first earner already pays income tax). It is assumed that these families do not opt out of UC to take up tax-free childcare, government's alternative form of childcare support, or use the current Employer supported childcare scheme.

Although the 85 per cent childcare support is not due to come in until 2016, we model the impact assuming that the new support were available in the UC system as it is in 2013-14 with the addition of the

<sup>3</sup> The family's eligible housing costs are £100 per week.

Childcare support is also provided through the incoming council tax support (CTS) system. However neither of the families considered here has a low enough income to qualify for CTS (assuming a typical CTS scheme).

<sup>4</sup> Ben Galim, D. (2013) *Who's Breadwinning: Working mothers and the new face of family support*, London: ippr.

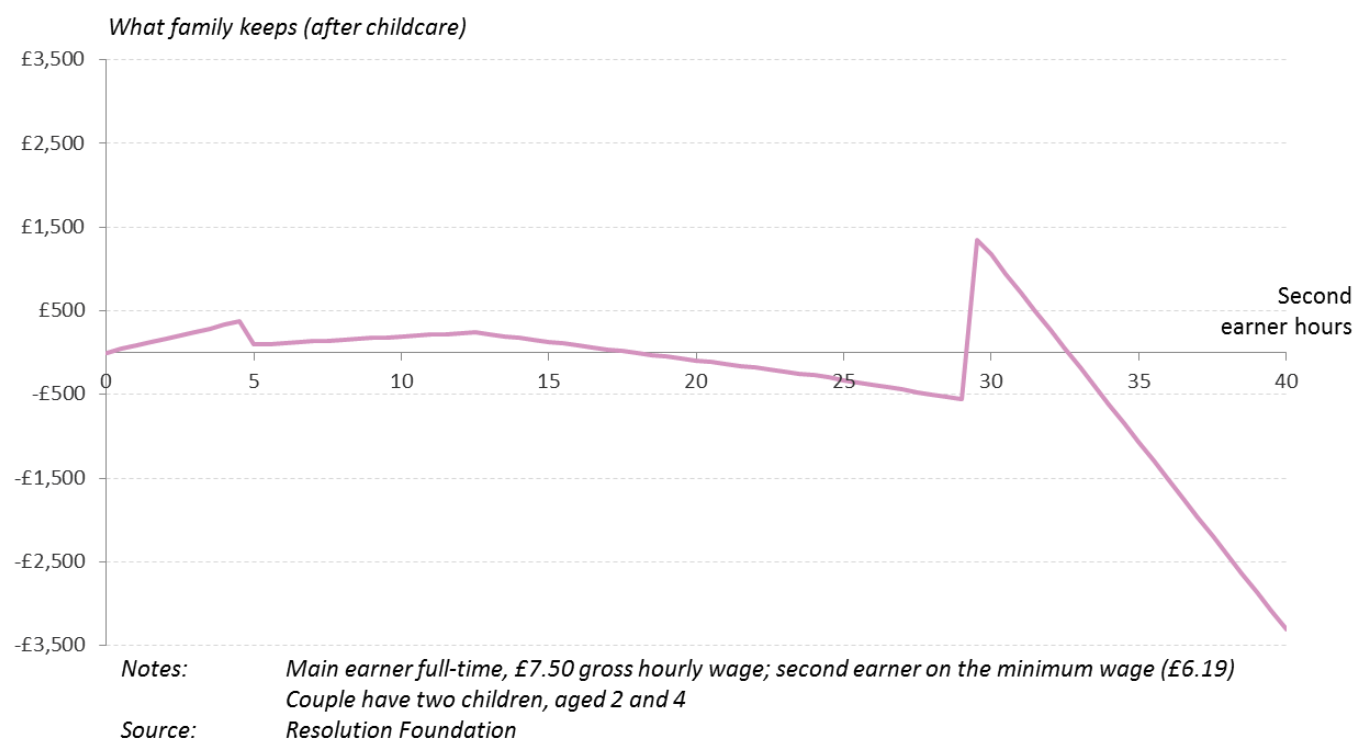
<sup>5</sup> The latest childcare cost data within these surveys refers to 2012-13. These unit costs have been updated to 2013-14 prices. The uprating factor used is the average annual growth in childcare unit costs for each type of childcare shown from 2010-11 – 2012-13, in England.

free entitlement for disadvantaged two year olds as discussed above. The 2013-14 baseline is used as there are large uncertainties about the level of the minimum wage and inflation in the cost of childcare in future years. It is likely that using a 2013-14 baseline, the marginal gains to work are likely to be overstated and the actual work incentives faced by second earners in these example families are likely to be worse in 2016. This is because growth in childcare costs is likely to far exceed growth in government support to cover these costs.<sup>6</sup>

### *The low earning family: An admin worker on £7.50 and a cleaner on the minimum wage, two children*

The low earner family consists of a full-time first earner on £7.50 per hour and a second earner working as a cleaner on £6.19 (the minimum wage). Figure 1 shows what the family keeps of the second earner’s wages as her hours increase from 0 to 40 hours per week. In general, higher gross earnings from working more hours do not translate into a similar rise in disposable household income. Disposable household income is used here to refer to income after taxes, benefits and childcare costs. However, the gains or losses to the family’s income from the second earner are very sensitive to the number of hours she works. This is discussed in detail below.

**Figure 1. What the family keeps from the second earner’s income (second earner wage of £6.19)**



As Figure 1 shows, the family keeps some of the second earner’s pay (after childcare costs) if she works **up to 17.5 hours** per week. However, the amount of earnings that the household keeps is small. For example, if the second earner works 10 hours per week the family is only £192 a year better off than if she did not

<sup>6</sup> This is demonstrated by comparing the growth in childcare costs, wage growth and the uprating factor used for UC. For example, from 2010-11 to 2012-13, the average annual growth in the cost of nursery care for under-2s was 7.3 per cent. In contrast, it is expected that UC elements will be uprated by no more than CPI. The OBR project CPI to be just above 2 per cent in 2015. This is far below the projected growth in childcare costs. Combined with poor wage growth and a likely decline or freeze in other working-age benefits, the estimates given here for disposable household income are likely to be very conservative.

work at all. This is equivalent to keeping only 37p for every hour worked by the second earner (see Table 2).

At very small hours (less than 5 hours per week) the second earner benefits from the free entitlement for disadvantaged two year olds as well as the free entitlement for three and four year olds. If she works four hours per week, for example, she does not have to pay for childcare for either child. The two year old support is no longer available once the second earner works more than five hours per week. Therefore, if her hours increase, she pays 30 per cent of childcare costs for her two year old (and receives the other 70 per through UC). This explains the early dip in the line shown above.

Although the family keeps little of the second earner's income under UC, they are better off under UC than under the current system of tax credits if the second earner works fewer than 16 hours. Under tax credits, families are not entitled to any childcare support when working fewer than 16 hours per week. The childcare support provided under UC to those working few hours vastly improves the work incentives for second earners to move into small hours jobs.

However, the incentives for the second earner deteriorate rapidly after 17.5 hours. If the second earner works **between 18 and 29 hours** per week, her family ends up worse off than if she did not work at all. For example, if she works a 25 hour week, the family's disposable household income is £327 less a year than if she did not work. The second earner's increased earnings are not sufficient to make up for the high out of pocket costs of childcare.

At **29.5 hours** worked, the second earner reaches the personal tax allowance and the household becomes eligible for the 85 per cent rate of childcare support. This support halves the out of pocket childcare costs that the family pays, and as a result, they are able to keep some of what the second earner is paid. At this point, the family is £1,342 better off than if the second earner did not work at all.

However, the positive impact of the additional support is short-lived for this family. Childcare support is no longer provided once costs exceed a maximum value (£145 per week for one child or £248 per week for two or more children).<sup>7</sup> Once this family hits the cap (at 30 hours) they no longer receive childcare support. This leaves a narrow window during which the family benefits from the 85 per cent support and are better off from work - **between 29.5 hours and 32.5 hours** of work for the second earner per week. After this point, they would be better off if the second earner did not work or worked only a small number of hours. For example, if the second earner increased her hours to 35 per week, the family would be £1,070 less well off than if the second earner did not work at all. This is equivalent to losing 59p for every hour worked by the second earner. The picture looks even starker for a second earner working 40 hours per week. In this case, the family would be just over £3,300 worse off a year than if the second earner stayed at home.

Table 2 shows the disposable household income that the family would gain or lose from the second earner working compared to if she did not work. The changing work incentives that the second earner faces as she increases her hours make it very difficult for her to reliably calculate whether or not her family will be better off if she increases her hours. Furthermore, she is unlikely to be able to tailor her hours to take advantage of the very short window during which she can benefit from 85 per cent childcare support to boost her family income.

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<sup>7</sup> Under UC, families that receive 70 per cent support for their childcare are covered up to a maximum of £175 of childcare costs for one child or £300 of childcare costs for two or more children. This is equivalent to £123 per week of support (rather than the costs to which the support applies) for one child or £211 per week for two or more children. Families that receive 85 per cent support have a lower threshold for the childcare costs that are covered (£145 per week and £248 per week for one child or two or more children respectively). This is because the maximum level of support remains unchanged (at £123 and £211 respectively).

**Table 2. Impact on disposable income if second earner works compared to income if she did not (second earner wage of £6.19)**

Hours worked by second earner	Disposable household income gain or loss compared to if second earner did not work (annual)	Disposable household income gain or loss compared to if second earner did not work (per second earner hour worked)	Total disposable household income (after taxes, benefits and childcare – annual)
0	+ £0	+ £0	£23,749
5	+ £96	+ £0.37	£23,845
10	+ £192	+ £0.37	£23,941
15	+ £129	+ £0.17	£23,878
20	- £93	- £0.09	£23,656
25	- £327	- £0.25	£23,422
30	+ £1,169	+ £0.75	£24,917
35	- £1,070	- £0.59	£22,679
40	- £3,308	- £1.59	£20,440

*Notes: Main earner full-time (37.5 hours per week), £7.50 gross hourly wage; second earner on £6.19 gross hourly wage. Couple have two children, aged 2 and 4*

*Source: Resolution Foundation*

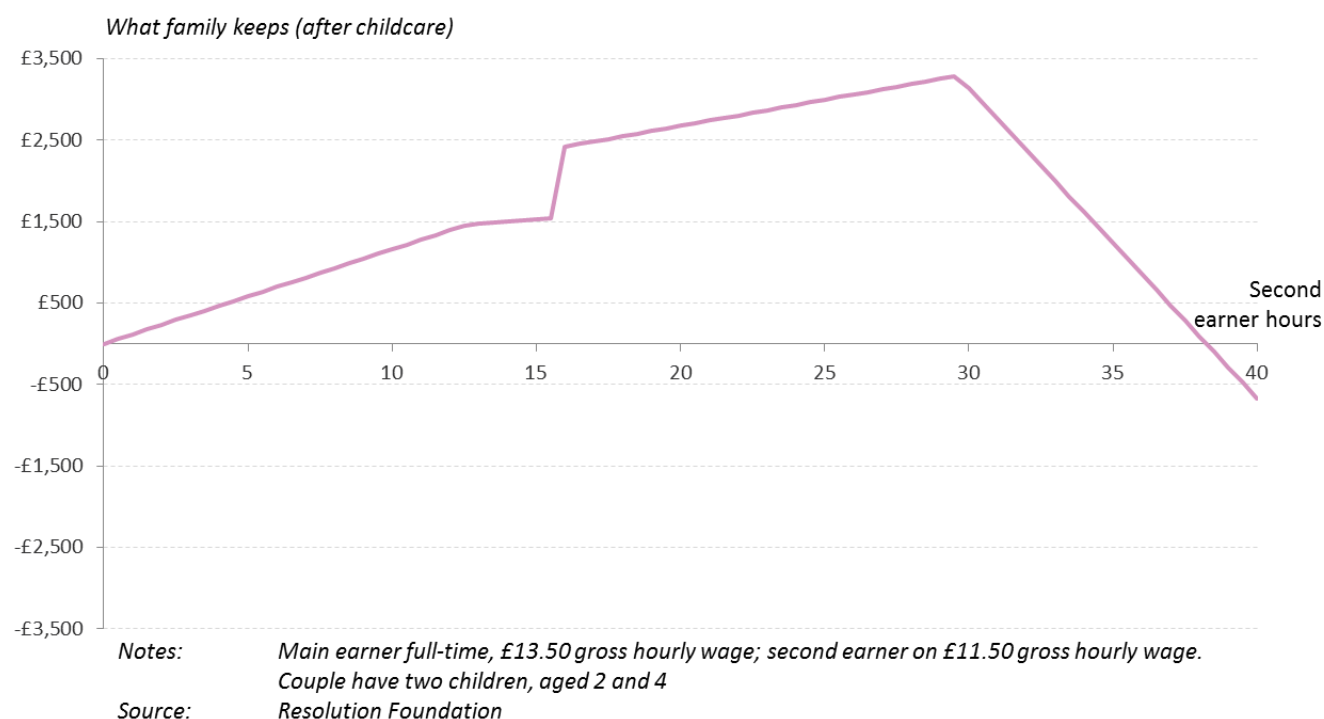
Looking at the household as a whole, including the earnings of the first earner, we can see how changing incentives for the second earner affect overall household income (see final column, Table 2). This low earning family has an income of £23,749 if the second earner does not work. If the second earner works part time for 15 hours a week, the household is barely better off: its household income remains relatively unchanged at £23,878. As we have seen, working full-time as a low wage second earner leaves the family finances in a worse state than if the second earner did not work at all. If the second earner works 40 hours per week, household income is £20,440 – £3,308 less than if the second earner did not work at all.

## The higher earning family: A manager on £13.50 and a teacher on £11.50 per hour, two children

The situation described above changes significantly if the second earner is on a higher wage. To demonstrate, we will now look at a family in which one adult works full-time on £13.50 per hour and the other adult is on £11.50 per hour. Although the first earner's income is also higher than in the lower earning couple, this does not impact the work incentives faced by the second earner. The differences in the work incentives faced by the second earners in the two families are due to the difference in the second earner's wage. Figure 2 shows the income that the higher earning family keeps as the second earner increases her hours.

A second earner on £11.50 per hour keeps some of what she earns (after childcare costs) for every hour she works **up to 38.5 hours** per week.

**Figure 2. What the family keeps from the second earner's income (second earner wage of £11.50)**



At **16 hours** she reaches the personal tax allowance and the household benefits from the extra 85 per cent childcare support rather than the standard 70 per cent rate. This additional support provides a clear boost. At 15.5 hours, just before the second earner becomes eligible for the extra support, the household gains £1,545 from the second earner working compared to if she did not work. At 16 hours, just 30 minutes more work per week, the second earner is able to keep almost £1,000 more of her earnings and brings in £2,421 after tax, benefits and childcare compared to if she did not work. The family gets the greatest benefit from the 85 per cent support if the second earner works 29.5 hours per week. At this point, they gain £3,286 from her working compared to if she did not work at all.

Beyond **30 hours** worked, the second earner does not gain any additional income from increasing her working hours. The household has reached the upper limit for childcare support and all further childcare costs come directly out of the extra wages earned. The household is left with approximately the same final income if the second earner works 35 hours per week than if she works 10.5 hours per week (around



£27,800). However despite falling marginal returns from increasing working hours, working longer hours does not make the household worse off up to **38 hours** per week. Beyond this point, the household loses income if the second earner works compared to if she did not.

**Table 3. Impact on disposable income if second earner works compared to income if she did not (second earner wage of £11.50)**

Hours worked by second earner	Disposable household income gain or loss compared to if second earner did not work (annual)	Disposable household income gain or loss compared to if second earner did not work (per second earner hour worked)	Total disposable household income (after taxes, benefits and childcare - annual)
0	+ £0	+ £0	£26,541
5	+ £581	+ £2.23	£27,122
10	+ £1,161	+ £2.23	£27,702
15	+ £1,531	+ £1.96	£28,073
20	+ £2,677	+ £2.57	£29,219
25	+ £2,998	+ £2.30	£29,539
30	+ £3,145	+ £2.01	£29,687
35	+ £1,236	+ £0.68	£27,778
40	- £673	- £0.32	£25,869

*Notes: Main earner full-time (37.5 hours per week), £13.50 gross hourly wage; second earner on £11.50 gross hourly wage. Couple have two children, aged 2 and 4*

*Source: Resolution Foundation*

Again, we can also look at overall household income. This higher earning family has an income of £26,541 if the second earner does not work. If the second earner works 15 hours per week, household income increases to £28,073. Household income continues to increase for each hour worked before peaking at 29.5 hours at £29,827. At this point, the second earner has no financial incentive to increase her hours. If the second earner increases her hours from 30 to 35 per week, the family loses more than half what they gain from work, leaving them just over £1,236 better off than if the second earner did not work at all. If the second earner works 40 hours per week, total household income falls to £25,869 - £673 less than if the second earner stayed at home.

## *Comparing lower paid and higher paid second earners under UC*

As the above discussion has shown, the 85 per cent support for childcare that the government is proposing to introduce under Universal Credit in 2016 benefits higher earning second earners such as the teacher illustrated here far more than lower earning second earners such as a minimum wage earning cleaner. Since higher earners hit the income tax threshold after fewer hours of work, the increased support ensures that work always pays right up to full time hours. As the costs of childcare increase with more hours in work, the extra support provided by the 85 per cent rate ensures that the second earner keeps some of her take home pay.

This contrasts with the situation for lower earners within UC for whom work pays up to 17 and a half hours per week and in the narrow window between 29.5 and 32.5 hours. On a lower wage, they become eligible for the 85 per cent rate of childcare support once they are almost full time, creating a significant gap between 18 and 29 hours a week in which they are worse off if they increase their hours. The narrow window in which they can benefit from the higher rate of support is so limited that it is unlikely that many second earners will be able to target the right number of hours of work, even if they were able to calculate the exact window in which they could benefit from the higher rate.

Higher earners also gain more from each hour of work than lower earners, both in absolute terms and as a proportion. This is in part because they earn more per hour and can, therefore, more easily absorb childcare costs. However it is also because once higher earners hit the income tax threshold, their childcare costs are half that of lower earners as they receive 85 per cent rather than 70 per cent support. For example, if the minimum wage earning cleaner works 25 hours, her family loses 25 pence for every hour she works compared to if she stayed at home because her earnings are not enough to absorb the costs of childcare, even with 70 per cent support. The teacher's family, on the other hand, is £2.30 better off for every hour she works because not only can her wage of £11.50 more easily absorb childcare costs, her childcare costs are half that of the cleaner. With 85 per cent support, she only pays 15 per cent of her childcare costs rather than 30 per cent as the cleaner does.

## *Conclusion*

A higher level of childcare support is welcome news for those families in Universal Credit that will be eligible for more help. However the proposed extra support will not benefit the majority of families with children, particularly those who are on low wages and struggle most with the escalating costs of childcare. As it stands, low paid second earners who work part-time will be worse off if they increase their hours than if they did not work at all. They will be paying to work in contrast to the government's stated objective for work to always pay. Higher earners, who already face stronger work incentives than second earners on lower wages, benefit more from the proposed new support. In some cases, higher earners will find that work will always pay (up to 38 hours a week), as the government has committed. This is good news, but positive incentives to work should not be exclusive to those on higher wages.

It is crucial to improve childcare support for low paid second earners who tend to be in the poorest working families. Extending 85 per cent support for childcare to all families in receipt of Universal Credit would help make work pay for all second earners. The additional £200 million needed could be found from within the £1 billion investment in childcare the government has already made by limiting eligibility for the tax-free childcare voucher available to better off families. This could most likely be done through a combination of lowering the income threshold for the voucher from £300,000, reducing the maximum amount of support that can be claimed per child and limiting support to two children as is the case for families receiving childcare support in Universal Credit. The consultation provides an opportunity to address these issues and ensure that the 900,000 lower income families who currently miss out on this new childcare support also benefit.

## *The Resolution Foundation*

The 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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