Resolution Foundation

Tackling the adequacy trap: earnings, incomes and work incentives under the Universal Credit

Produced for the Resolution Foundation by
Donald Hirsch and Jacqueline Beckhelling
Centre for Research in Social Policy, Loughborough University

February 2011

RF

E: info@resolutionfoundation.org T: 020 3372 2960 F: 020 3372 2999

Summary

- *Under existing tax and benefit rules, households on low-to-middle incomes frequently face high rates of withdrawal of state support as they increase their earnings.*
- *The introduction of the Universal Credit does not fundamentally change this situation, though there will be a complex mix of winners and losers.*
- *For households with the lowest earnings, the very highest withdrawal rates (where each additional £1 of income is reduced by 90p or more) will be abolished. However for others, withdrawal rates will get steeper (rising from 70 per cent to 76 per cent for existing tax credit recipients).*
- *Under reasonable assumptions about the structure of the future system, full-time workers on low wages will tend to be better-off under Universal Credit if they are supporting partners and children , but slightly worse-off if they are single. Lone parents working less than 16 hours a week will benefit, but those working longer than this will be worse-off.*
- *People who are not working will have increased incentives to do small amounts of work if they do not have a working partner, but in many cases less incentive if their partner does work. The precise pattern of winners and losers is highly sensitive to as yet unresolved details of the Universal Credit, such as how the childcare tax credit will be replaced.*
- *The nature and level of childcare support introduced will affect the ability of many families with children to earn a reasonable income, and determine whether work continues to pay.*

1 Introduction

Most households in Britain with low earnings find it very difficult to become better-off, even with extra effort. If they earn more – for example by working longer hours, getting a pay rise or increasing the number of workers in their household – their disposable income typically rises by only a fraction of their extra earnings. This is because each additional pound earned may not only incur tax, but also reduce entitlements to tax credits and benefits. Those receiving Housing Benefits may keep 10p or less of each extra pound earned (meaning they have a *marginal withdrawal rate* of 90 per cent); more commonly, people on tax credits keep 30p (marginal withdrawal rate of 70 per cent).

For this reason, the tax credit system, while helping to make people better-off in work than out of work, traps many low earning households at a particular income level. This level is often below the official poverty line, and is generally well below the income that members of the public consider necessary for an acceptable standard of living – as measured for example by the UK *Minimum Income Standard* (MIS).[1]

From 2013, the Government plans to replace most means-tested benefits and tax credits for working-age adults with a single benefit, the Universal Credit. This briefing explores the relationship between *gross earnings* and *net incomes* at various points in the bottom half of the income distribution, under both the current tax and benefit system (Section 2) and the future Universal Credit model (Section 3). Section 4 considers how these alternative systems relate to poverty and adequate income levels. Section 5 concludes with some general observations about what difference the new Universal Credit system might make.

[1] MIS is an ongoing programme of research to define what level of income is adequate to provide a minimum acceptable standard of living in the UK today, based on responses from members of the public. Funded by the Joseph Rowntree Foundation, it is carried out by the Centre for Research in Social Policy (CRSP) at Loughborough University, having been developed in partnership between CRSP and the Family Budget Unit at York University. See for example, Davis, A, D Hirsch and N Smith (2010), *A Minimum Income Standard for the United Kingdom in 2010*, York: Joseph Rowntree Foundation.

2 The present (2010-11) system

The interaction of the benefits, tax and tax credit system creates, broadly, the following stages of income withdrawal for people on low earnings in work:

- At very low levels of household net income, people in work may be entitled to Housing Benefit as well as tax credits. As both these payments fall with rising income, marginal withdrawal rates can be 90 per cent or higher.
- Once income is too high for Housing Benefit to be payable, tax credit withdrawal (tapered at 39 per cent – that is, for every additional £1 in earnings, tax credit receipt is reduced by 39p), payment of income tax (20 per cent) and National Insurance Contributions (11 per cent), combine to create a 70 per cent withdrawal rate.
- Once income is too high for tax credits to be payable,[2] income tax and National Insurance Contributions are withdrawn at a combined rate of 31 per cent.

The precise income levels at which each of these withdrawal rates applies varies from family type to family type. Chart 1 shows the relationship between gross earnings and net incomes at a range of points in the bottom half of the income distribution using two examples – a single person and a couple with two children, both with one full-time wage.

The chart shows that 90 per cent marginal rates of withdrawal only apply to families on very low earnings (around £10,000-£20,000 a year for one full-time earner in a couple with two children) – and in the case of the single person, at below the earnings range shown (i.e. below £10,000 a year, meaning that it only applies to those working part-time, or full-time but at less than the minimum wage).

However, high rates of withdrawal – of 70 per cent or more – continue to just over one-quarter of the way up the income distribution for single people (gross earnings of around £13,000 a year), and about one-third for the family with children (at which point the working member of the couple has earnings approaching £30,000 a year). This difference is due to more generous tax credits for families with children.

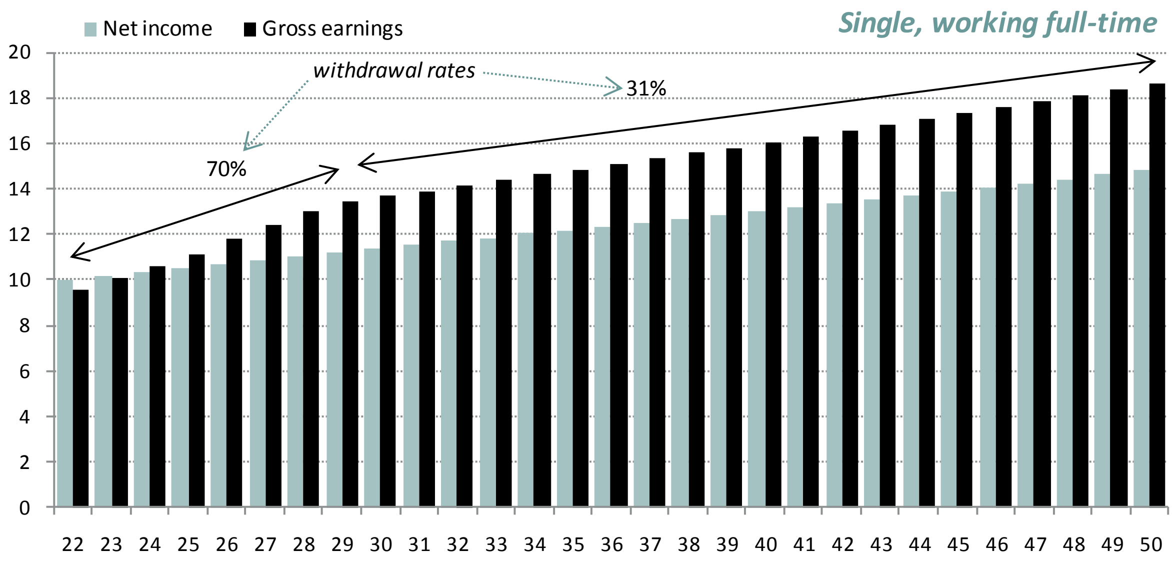
- It means, for example, that to get from one-quarter to one-third of the way up the distribution, someone supporting a partner and two children would need to raise their earnings by 50 per cent, from £18,700 to £28,100 a year. Yet this would produce a rise in net income of just 13 per cent, from £21,500 to £24,400.

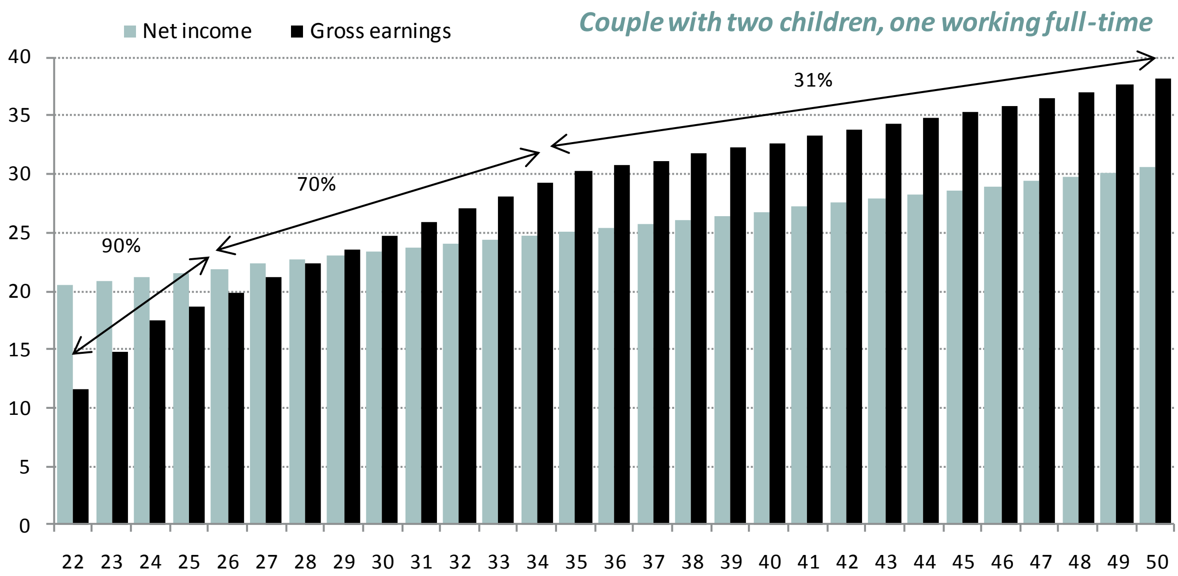
These broad patterns apply to other types of family, except two-earner couples and lone parents. Such families are likely to require childcare, and the picture is therefore more complex. Lone parents – who can get up to 80 per cent of the cost of their childcare paid for – in particular face high marginal withdrawal rates for a wider range of incomes. Even on a median net income (50th percentile in the distribution), they may still be losing 70 per cent of extra earnings, as this childcare support reduces.

- This means, for example, that a lone parent with two children working 16 hours a week on the minimum wage (earning around £5,000 a year) would need roughly to quadruple her earnings to £20,000 a year just to raise her net household income (after tax and childcare costs) by less than one-fifth, from £19,300 to £22,700.

[2] Other than the Family Element of the Child Tax Credit, which is paid at a flat rate for most families with children.

Chart 1 Comparison of gross earnings and net incomes under 2010-11 tax-benefit system at different equivalised net income percentiles: £000s a year





Note: These calculations require assumptions about housing and council tax, and these have been taken from Minimum Income Standard research (Davis et al., op cit). Both families are assumed to face only modest rents. For those with higher rents, Housing Benefit – and hence potentially marginal withdrawal rates of 90 per cent or more – will go further up the income distribution. However, recent limitations to Housing Benefit entitlements will make such cases rarer.

The horizontal axis sets out percentiles in the 'equivalised' net income distribution,[3] while the vertical axis shows annual earnings/income levels. So, for example, the columns presented at percentile 25 describe the level of gross earnings required to achieve a net income sufficient to make the household better-off than one-quarter of households in the UK. The lowest figures shown are for earnings of about £10,000 a year. Anyone working full-time – 30 hours a week or longer – will earn at least this amount on the minimum wage.

[3] That is, the post-tax incomes of all UK households are 'equivalised' (or adjusted) to account for the fact that larger families generally face higher living costs than smaller ones, and are then ranked by size and split into 100 equally-sized percentiles.

3 *How will the Universal Credit change the picture?*

From 2013, the Government proposes to introduce a Universal Credit to replace tax credits and most means-tested benefits. The exact terms of this credit have yet to be finalised, but given illustrative figures shown in the Universal Credit White Paper,[4] and based on certain assumptions about unannounced aspects (see Box 1), we can compare the general pattern of income withdrawal rates with the present system, based on values for the current financial year (2010-11).

Box 1: Universal Credit assumptions

The Universal Credit will replace the existing system of means-tested benefits and tax credits for working-age adults. The calculations in this paper assume that:

- Universal Credit replaces Income Support, Housing Benefit, Council Tax Benefit and all personal tax credits.
- The maximum amount of Universal Credit available to a household is calculated as the total of:
  - Income Support, Working Tax Credit and Child Tax Credit at the 2010/11 rate; plus
  - Housing Benefit and Council Tax Benefit (using Minimum Income Standard 2010 levels for rent and council tax and assuming full eligibility – i.e. HB=rent; CTC=council tax);
- Maximum Universal Credit is payable up to the post-tax, post-National Insurance income at the level of the disregards suggested in the Universal Credit White Paper.
- Above this level, the Universal Credit is reduced by 65p for each extra £1 of post-tax, post-NI income, and by £1 for each extra £1 of unearned income.

The tax and National Insurance regime shown in the Universal Credit calculations simulates Budget announcements taking effect in 2011-12, using 2010-11 values. Specifically:

- National Insurance Contributions are deducted at 12 per cent rather than 11 per cent as in the present regime;
- The above-inflation increase in the tax allowance taking place in April 2011 is simulated by using the 2010-11 tax allowance, plus the £1,000 rise, minus an inflation element of £200 (based on 3.1 per cent inflation, which is the September 2010 rate on which uprating would have been based).

Chart 2 shows two things:

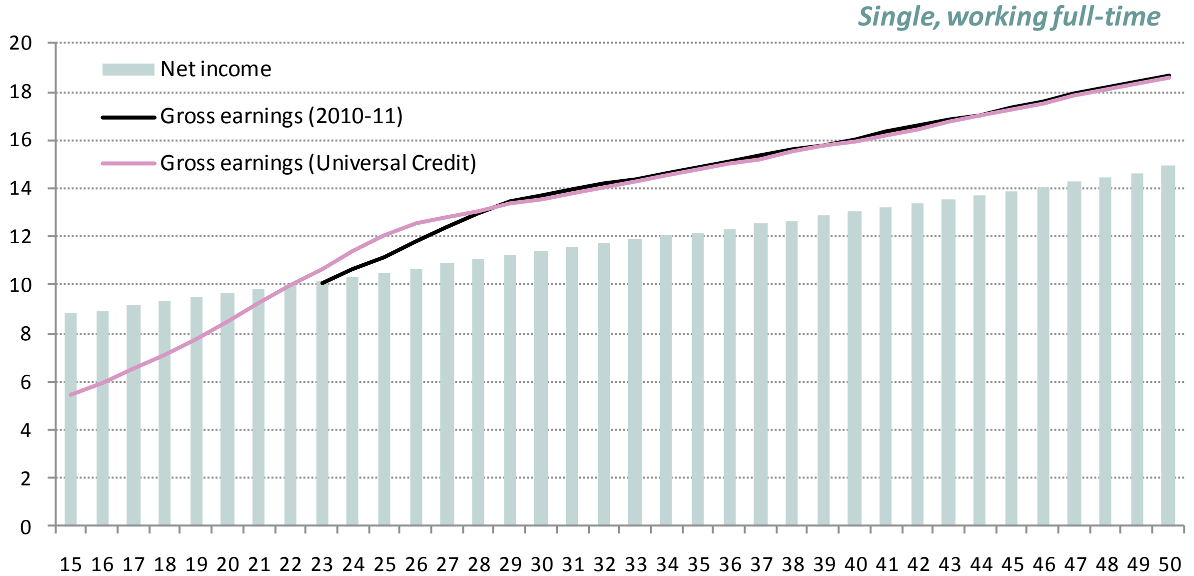
- First, it shows how amounts of earnings required to reach various points in the (existing) income distribution under the 2010-11 system compare with amounts required under Universal Credit; and
- Secondly, the slopes of the lines reflect the marginal deduction rates applying at different points in the (existing) income distribution under the two systems.

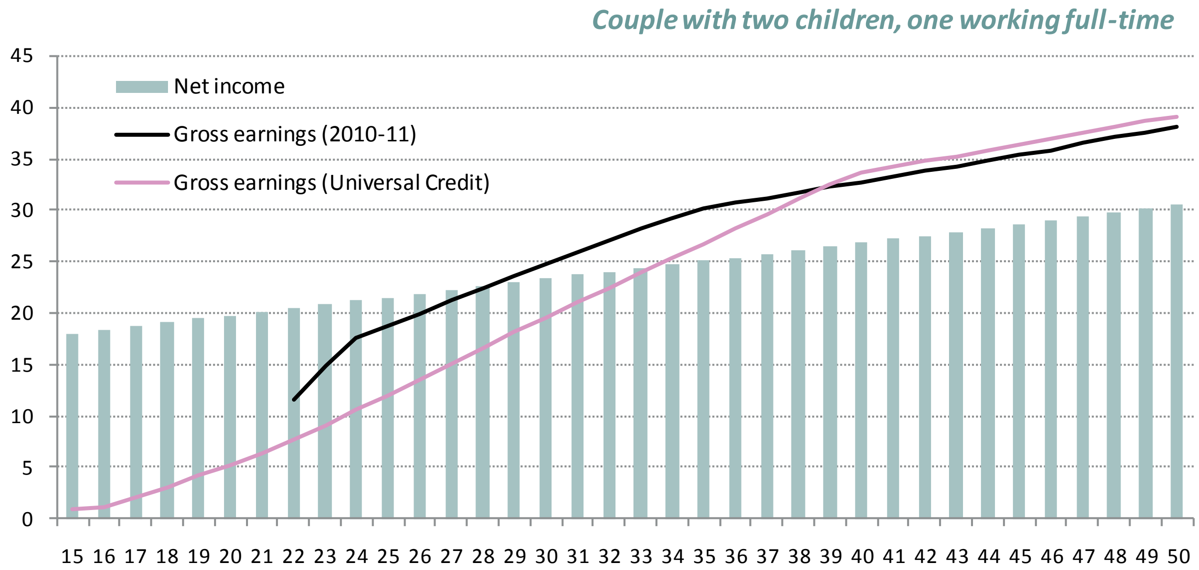
As in Section 2, two examples are presented – a single person and a couple with two children, both with one full-time wage.

Unlike tax credits, the Universal Credit will be available on a continuous scale according to income, regardless of hours worked. This makes it possible to show the earnings needed to reach even very low net incomes, just above what someone would get on benefits alone.

[4] DWP 2010, *Universal Credit: Welfare that Works*

Chart 2 *Comparison of gross earnings requirements in 2010-11 and under Universal Credit to reach given points in equivalised net income distribution: £000s a year*





The charts highlight a number of interesting features of the change.

The key characteristic of the current system – steep withdrawal rates as income rises – continues under the Universal Credit:

- Although the very steepest withdrawal rates of 90 per cent and above are abolished under Universal Credit, the more common rate of 70 per cent will rise to 76 per cent, and will continue to affect people (especially families with children) on a wide range of incomes.
- For singles, the Universal Credit will run out a bit sooner than tax credits do at present, so the point at which only tax and National Insurance Contributions are withdrawn is lowered slightly from the 28th to the 25th percentile of net income.

For the couple with two children, on the other hand, the Universal Credit will persist for longer, with a 76 per cent withdrawal rate extending right up to the 39th percentile in this example, rather than the 34th under the present system.

Full-time workers in receipt of tax credits will tend to be better-off if they have families, but worse-off if they are single:

- In relation to the single adult shown in the first of the two charts, the black (dark) line is *higher* than the pink (light) line – meaning that the level of gross earnings required to achieve a given level of net income is higher under the Universal Credit than it is under the current system. *For example, a full-time single worker on the minimum wage earns £11,600 gross, producing weekly take-home pay of £204 under the current system and £199 a week under Universal Credit: a loss of £5 a week.*
- In relation to the couple with children shown in the second chart, the black (dark) line is *lower* than the pink (light) line – meaning that the level of gross earnings required to achieve a given level of net income is lower under the Universal Credit than it is under the current system. *For example, a household with one full-time worker earning £17,500 a year, one non-working partner and two children, currently takes home £407 a week. This will increase to £439 under Universal Credit: a gain of £32 a week.*

Incentives to work will be strengthened for some and weakened for others:

- Because the Universal Credit will not be subject to the same minimum-hours eligibility as existing tax credits, out-of-work families will have the chance to raise their net incomes through small amounts of work. *For example, a couple with two children on benefits, who receive income putting them around the 14th percentile of the net distribution, could get a job for ten hours on the minimum wage to reach the 18th percentile. They would keep the first £25 of the £59.30 earned, and have two-thirds of the rest withdrawn in reduced Universal Credit; at present, the same person would be able to keep only £10, and have the rest deducted pound-for-pound in reduced Income Support.*
- Even though the Universal Credit will often improve the situation of a single earner on very low earnings, a low-wage family will still often need a second wage in order to escape poverty. However, while Universal Credit gives more support to single-earner couples than the current system, this assistance is withdrawn more quickly (65p in every £1 *net* earnings) than currently (39p in every £1 *gross* earnings) once a second-earner moves into work. This will make it much harder to use second earnings as a route out of poverty. *For example, the partner of a low-paid worker working 16 hours on the minimum wage would be £25 a week worse-off under Universal Credit (the family keeps £1,750, rather than £3,050, of her £5,000 earnings).*[5]
- At present, there is little incentive for lone parents to work fewer than 16 hours, because tax credits are not available, but once this threshold is reached, lone parents receive incomes well above benefit levels and usually above the poverty line. While Universal Credit will raise incomes for those with 'mini-jobs', it will reduce them for lone parents working 16 hours or more. *For example, a lone parent with one child working 16 hours and earning £5,000 a year would take home £318 a week under Universal Credit, rather than £351 a week under the current system: a loss of £33 a week (this will, however, vary according to Housing Benefit entitlements).*

Actual gains and losses highly sensitive to exact levels and rules still to be announced:

- The gains and losses shown above are highly sensitive to the exact levels and rules still to be announced in the new credit. For example, the inclusion or exclusion of council tax compensation in the Universal Credit will have a significant impact.

[5] Note, this example is different from the others because it expresses the change in the additional effect of the second-earner rather than a change in overall family income resulting from the new system. The latter will vary according to the level of the first earner's earnings and other factors such as Housing Benefit. If joint family earnings remain very low, the family income could still be higher under the new system which, as shown elsewhere, is favourable to a low earning first earner in a couple. But, as overall family earnings rise, the overall family effect becomes less favourable.

- Even small differences in the base level of Universal Credit can have a much larger effect on the amount people need to earn to achieve a given income level. This is because the increased earnings needed to compensate for any cut in the baseline will be subject to the steep withdrawal rates described above – so you need to earn several pounds to compensate for each pound of loss.
- Another issue is the reduction of eligible childcare support from 80 per cent (of childcare costs) to 70 per cent from April 2011, and uncertainty about the level of that support under Universal Credit. Reducing it substantially would have big effects on parents' incomes and incentives to work, dwarfing the effect of other changes. *For illustrative purposes, if we assume that the new 70 per cent rate is replaced by a policy of giving low-income families a 50 per cent discount for childcare places, then the lone parent earning £5,000 a year described above, who currently takes home around £351 a week, would see their post-tax and post-childcare income fall to just £298 a week: a loss of £53 a week.*

4 Relationship with poverty and minimum income

The existence of in-work 'traps' that make it hard to improve net income through increased earnings raises the important issue of whether this income is enough to live on. If tax credits/Universal Credit produce an acceptable guaranteed minimum for those unable to earn enough themselves, it may seem reasonable to withdraw this support fairly quickly once people do not require it to reach this level. In fact, the baseline level of support often leaves families at or below the poverty line.

- For example, the official poverty threshold of 60 per cent median income for a couple with two children is around the 21st percentile of adjusted income. The household income generated by benefits alone is well below this, and people working part-time on the Universal Credit will often remain in poverty.
- Under both systems, full-time work normally lifts families out of poverty, but this can depend on individual circumstances: among families with one parent working full-time and one not working, one-child-in-five is poor.

Moreover, the official poverty line is an arbitrary measure, significantly below what people generally need for a minimum socially acceptable standard of living. The Minimum Income Standard[6] shows that typically, working-age families need net incomes around one-third of the way up the distribution in order to afford what most people consider to be the essentials of life in Britain today. This briefing has shown that many working families would have to raise their earnings by a large amount to reach this minimum level. In many cases, the tax credits that they get to support them at a lower level will largely or entirely disappear as their income approaches this acceptable minimum.

[6] This standard is researched and regularly updated by Loughborough University's Centre for Research in Social Policy (CRSP), based on research into what members of the general public think should be in a household budget to provide a minimum acceptable standard of living. See Davis et al., op cit.

5 Conclusion

This briefing has shown how the tax and benefit system puts a systematic squeeze on working households with low incomes. High rates of withdrawal of benefits and tax credits make it hard for those whose earnings provide for incomes that are just below what is considered an adequate level to make up the difference. This particularly hits full-time earners on the lowest wages – typically trying to move from one-quarter to one-third of the way up the income distribution.

The introduction of the Universal Credit does not fundamentally change this situation. Steep withdrawal rates for people struggling to earn a minimum will remain. For some people with very low earnings who get Housing Benefit and/or work too few hours to qualify for tax credits, the very highest withdrawal rates (90 per cent plus) will be abolished. On the other hand, for many other low earners the rates will get steeper (from 70 per cent to 76 per cent). Thus the Universal Credit fails to resolve one of the crucial weaknesses of the system criticised by the present Government.

The precise pattern of winners and losers is highly sensitive to small changes in entitlements. Final decisions on rates will be crucial, as will as yet unannounced features of the system, including the treatment of council tax and childcare costs in the Universal Credit. In particular, the nature and level of childcare support introduced will affect the ability of many families with children to earn a reasonable income, and determine whether work continues to pay.

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-modest incomes – who we refer to as low-to-middle earners (LMEs) – by delivering change in areas where they are currently disadvantaged. We do this by:

- undertaking research and economic analysis to understand the challenges facing LMEs;
- developing practical and effective policy proposals; and
- engaging with policy makers and stakeholders to influence decision-making and bring about change.

For more information on this Briefing Note contact Matthew Whittaker on 020 3372 2957 or matthew.whittaker@resolutionfoundation.org