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BRIEFING

A Budget for workers?

The impact of the Summer Budget on work incentives in Universal Credit

David Finch

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RF resolutionfoundation.org info@resolutionfoundation.org +44 (0)203 372 2960 @resfoundation

The combination of increases in the minimum wage (via the introduction of a National Living Wage), cuts to income tax and sharp reductions in working-age welfare presented in the Summer Budget produces a complex mix of winners and losers. Those not currently in receipt of benefits and tax credits (or Universal Credit) are likely to gain overall, while others face losing up to several thousands of pounds a year. For families moving onto these benefits after April 2017, the losses could be far greater still, with future generosity being cut further for new claimants.

Alongside these income effects, the cuts in welfare have major and damaging implications for work incentives in Universal Credit for many families. These have received little scrutiny so far. In this note, we consider the impact on work incentives in Universal Credit with a number of stylised examples of different family types.

The Budget policies

The Summer Budget set out a number of measures to save £12 billion from the working age welfare bill (by 2019-20, rather than 2017-18 as previously pledged). Although initially relating primarily to tax credits and Housing Benefit, these cuts will apply to Universal Credit (UC) as it is extended to more working families over the Parliament (it is expected to be fully rolled out early in the next decade).[1] This note focuses on how changes announced at the Summer Budget will affect work incentives in Universal Credit. Two key changes that affect both the financial return from working and the incomes of families entitled to UC are:

» The **freezing of the basic entitlements** that UC pays to families out of work – these are the standard allowances and child elements and are broadly equivalent to existing rates of out-of-work support (such as Jobseekers Allowance or Income Support) and Child Tax Credit respectively.

» A **radical re-shaping and reduction in the value of Work Allowances**. Work Allowances determine how much a family can earn before UC entitlement starts to be withdrawn. Therefore they play a large role in determining how worthwhile it is to start working and the level of income a family has once in work.

The introduction of a 'National Living Wage' (NLW) will also heavily influence the income of low paid workers – or at least those aged 25 and over. OBR projections suggest the National Minimum Wage (NMW) will reach £8.25 an hour in 2020, whereas the NLW is set to be £9.35, meaning a boost to hourly pay of £1.10 an hour in 2020 for those 25 and over.[2]

The NLW will therefore provide a boost to income for low paid workers, but is unlikely to fully offset cuts to benefit entitlement for many families. In simple terms, the NLW is estimated to provide a £4 billion direct boost to gross earnings in 2020 – well short of the £12 billion being taken out of the welfare budget. The two measures will have a varying impact on different households at different parts of the income distribution.

Our analysis suggests that of the population expected to be entitled to Universal Credit **around half of workers were paid less than the NLW per hour, and a fifth of these were under-25** (under its design before changes in the Summer Budget were announced). This suggests that 40 per cent of workers currently expected to be in receipt of Universal Credit will benefit directly from the NLW.

The impact on work incentives

In combination, the introduction of the NLW and changes to UC are set to increase the likelihood

[1] OBR (2015) *Welfare trends report June 2015*

[2] HMT (2015) *Summer Budget 2015*

that low paid parents get stuck at low levels of earnings with little incentive to progress.[3]

For some it may make the decision to start work at all much less appealing. The measures will:

- **Significantly reduce the incentive to work for parents who do not rent** – single parent non-renters will see the return from starting work at 22 hours reduce by over a quarter;
- **Increases the risk that single parents become stuck at low levels of earnings** (even more so for the under 25s) **or may reduce their hours;** and for single parents who rent in particular this also increases the risk that they choose not to enter work; and,
- **Reduce the incomes of many working couples with children;** and make little difference to the already very weak incentives facing second earners.

By reducing the generosity of UC and therefore moving some families off the benefit at lower levels of income, the Budget policies might *improve* incentives for some (while still making them worse off overall). For example, they will:

- **Marginally raise the incentive to start working for second earners in couples**. That's because the lowest paid will receive a higher wage (via the NLW). In addition, families are likely to move off UC entitlement sooner – and therefore no longer face the high withdrawal rate – because it is less generous; and
- **Improve the incentive to work for people without children** by more quickly moving them out of entitlement.

But it should be remembered that where incentives to work appear to be improved, it is largely driven by the reduction in the value of out-of-work benefits (via the freeze) relative to the boost in earnings (via the NLW) or the earlier starting point for the withdrawal of UC entitlement. People who are under 25 will not receive this boost, making their work incentives weaker.

Our analysis does not include the additional losses faced by families with children making new claims to UC. The removal of the 'family premium' and the capping of support at two children for new families of three or more children after April 2017, will lead to some families facing losses of around £3,500 a year by 2020.

Reducing the UC work allowance

The original design of UC sought to improve the incentive to enter work through the introduction of work allowances which determine how much a family can earn before benefit entitlement is withdrawn. These were set at different rates depending on a family's circumstances (single/couple, renting/owners, children, disability) and were designed to overcome the problem in the existing benefits system whereby there is little incentive to enter work at low hours because out-of-work benefits are lost pound-for-pound as earnings rise. These proposals were widely welcomed.

Previous fiscal events had repeatedly chipped away at the value of these work allowances. However, the substantial reforms set out in the Summer Budget go further still – consolidating the number of work allowances to just two: one for those who rent and one for those who do not. This is a major change in policy. Families without children will no longer have a work allowance at all (unless a recipient is deemed to have 'limited capability for work').

[3] This note only considers new changes to Universal Credit announced at the Summer Budget. However, to give a balanced account we should also recognise that childcare arrangements will affect these incentives. On the one hand if families pay for their childcare to work additional hours their financial return from work is reduced. But on the other, the previously announced extension of the free entitlement – to provide an additional 15 hours of free childcare for working parents with three and four years olds at some point in the parliament – will improve incentives for those who currently pay for childcare. However, only in certain precise circumstances will this additional support be enough to fully offset income lost from wider cuts to entitlement.

Table 1 sets out the expected work allowances before and after this change from April 2020. For non-renters they are significantly lower; for renters – who already faced low work allowances – the reduction is smaller but still significant.

For example, before the Budget, a single parent non-renter in 2020 would have been able to work 22 hours at the NMW before their UC began to be withdrawn. With the significant cut in work allowance, together with the higher NLW, that figure falls to 10 hours.

Table 1: Work allowances in 2020, pre- and post-Summer Budget 2015

	Pre-Summer Budget			Post-Summer Budget		
	Annual limit	Hours at NMW	Hours at NLW	Annual limit	Hours at NMW	Hours at NLW
Higher work allowance - without housing costs						
Single parent	£9,300	22	19	£5,000	12	10
Couple with children	£6,800	16	14	£5,000	12	10
No dependent children	£1,400	3	3	£0	0	0
Limited capability for work	£8,200	19	17	£5,000	12	10
Lower work allowance - with housing costs						
Single parent	£3,300	8	7	£2,400	6	5
Couple with children	£2,800	7	6	£2,400	6	5
No dependent children	£1,400	3	3	£0	0	0
Limited capability for work	£2,400	6	5	£2,400	6	5

Source: Based on new work allowances and NMW/NLW rates in Summer Budget 2015, OBR projections of CPI and benefit rates announced for April 2015. New work allowances are increased by CPI from April 2018 - see (HMT) *Summer Budget 2015: policy costings*

Stylised case studies

The changes to work allowances vary by family type and will therefore have a different impact on work incentives for different families. What is clear is that the stated aim to boost the incentive to enter work has been significantly reduced. In general – and as our major review of UC[4] showed – single parents and second earners tend to be more responsive to work incentives, so we might expect them to do more to adapt their pattern of work to maximise their return from employment. Main earners in couples with children tend to be less responsive.

Below we set out four specific – and non-exhaustive – examples, by way of illustration of changes in incentives.

Single parent renters

As Table 1 shows, even before the Budget reforms, the UC work allowance for a single parent renter was relatively low. For those earning the NMW, it was entirely exhausted at around eight hours a week. We can think of this as the potential 'sweet spot' faced by an individual. At this point, they retain full access to their out-of-work entitlement alongside their earnings. Beyond this point, a worker can lose up to 76 pence of each additional pound earned (once paying income tax and NI).

[4] D Finch(2015) Making the most of UC: Final report of the Resolution Foundation review of Universal Credit, Resolution Foundation

Figure 1 shows that changes in the Budget will mean that:

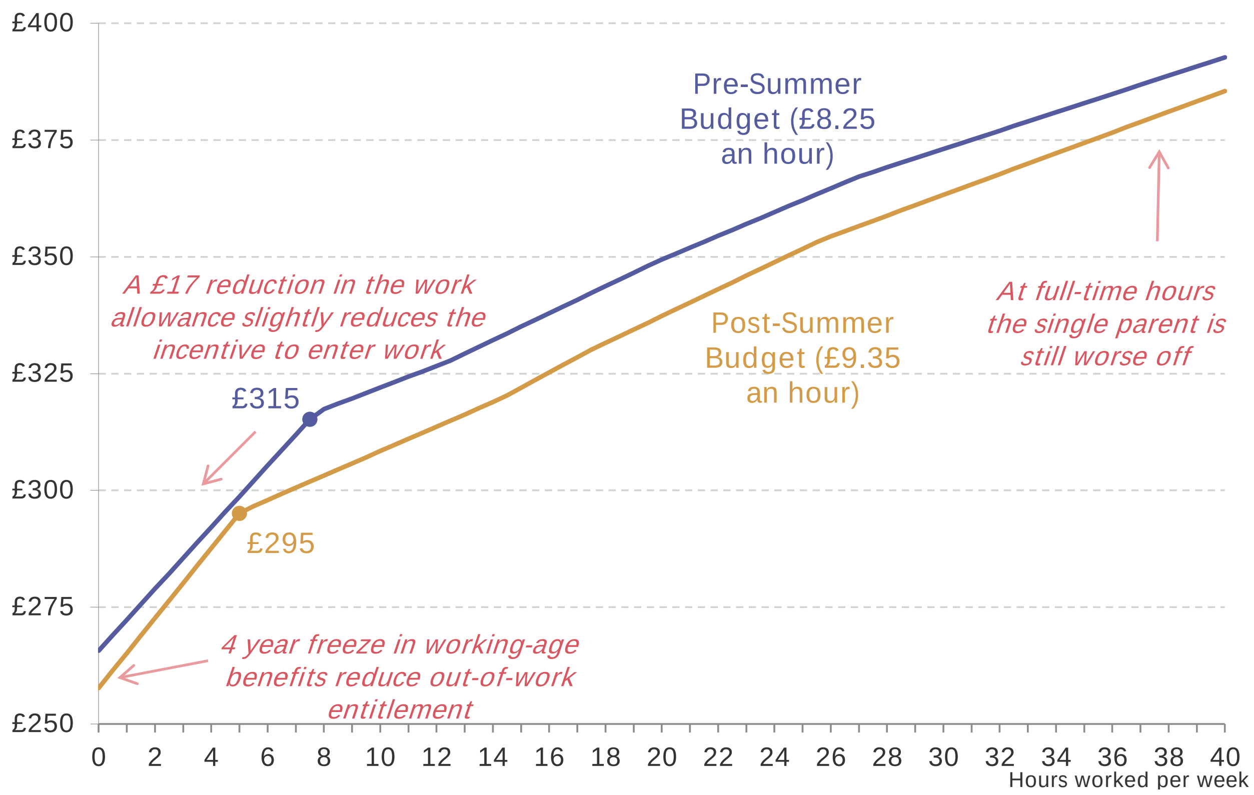
- The 'sweet spot' is reduced to just five hours at the NLW, or an annual income of around £15,400 in 2020 cash terms (which includes housing support income); and
- Incentives to progress beyond this 'sweet spot' remain weak.

For single parent renters who are under-25, and do not benefit from the boost to income from the NLW, incentives will be worse.

As a result of these changes, single parent renters find their incentive to enter work at anything above five hours is significantly lower – raising the prospect that they choose not to enter work at all.

Figure 1:
Net income for a single parent renter with one child

Earning NMW (pre-Budget scenario)/NLW (post-Budget scenario), £100 rent: 2020 (£ per week, cash terms)



Source: Resolution Foundation analysis using the RF microsimulation model

Single parent non-renters

As Table 1 shows, prior to the Budget the UC work allowance for a single parent not in receipt of help with their housing costs (i.e. a non-renter) was relatively high, equivalent to around 22 hours at the NMW. When working beyond this point a worker faced losing up to 76 pence of each additional pound earned.

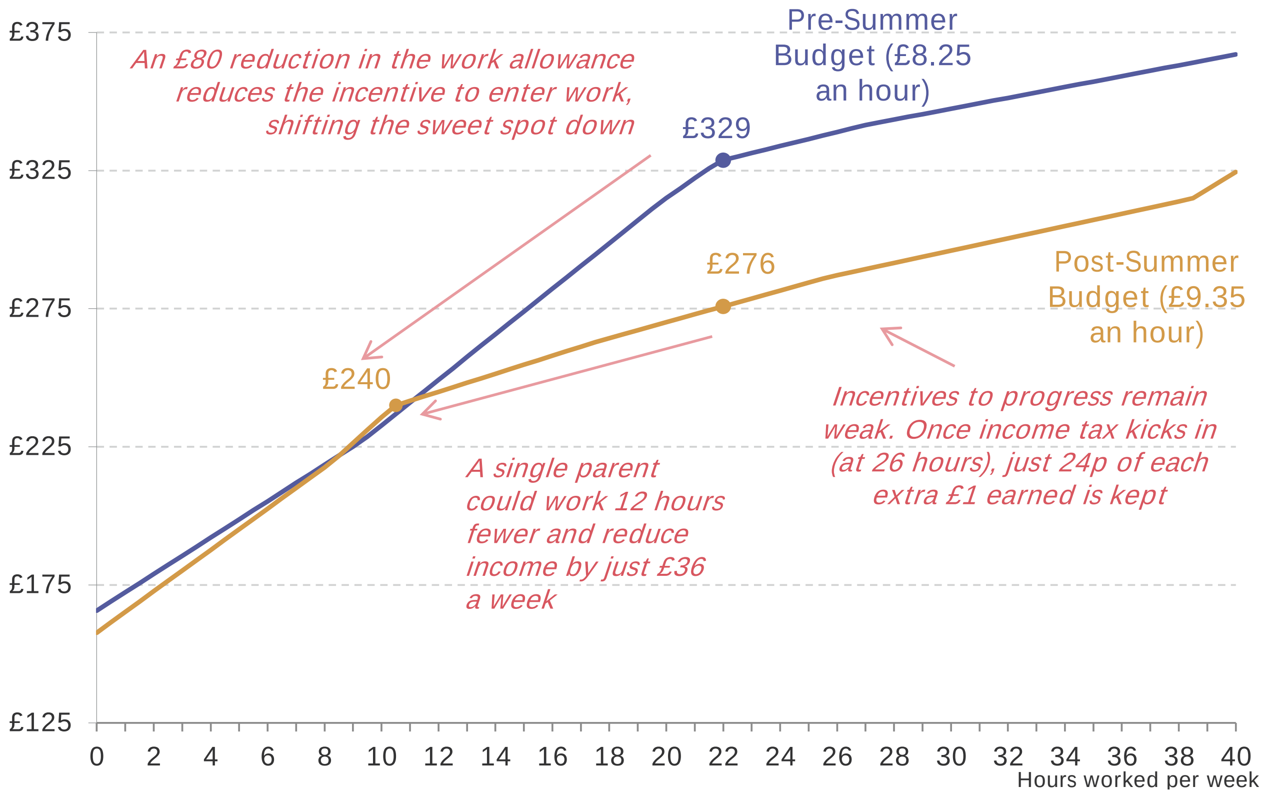
Figure 2 shows that changes in the Budget will mean that:

- The 'sweet spot' is reduced to 10 hours at the NLW, or an annual net income of around £12,500 (including UC entitlement); and
- Incentives to progress beyond this point remain weak.
- As before, under-25s, who do not benefit from the boost to income from the NLW, face worse incentives.

In this instance then, the risk is that the Budget changes encourage single parent non-renters to reduce their working hours in return for a proportionately small drop in their weekly income (with UC cushioning the impact). As Figure 2 shows, the individual could work 12 fewer hours and 'only' lose £36 of net income.

Figure 2:
Net income for a single parent with one child

Earning NMW (pre-Budget scenario)/NLW (post-Budget scenario), no rent: 2020 (£ per week, cash terms)



Source: Resolution Foundation analysis using the RF microsimulation model

Couple with children – main earner

As shown in Table 1, the UC work allowance available to couples with children who do not rent was roughly equivalent to 16 hours at the NMW prior to the Budget. This will fall to 10 hours at the NLW. The work allowance applies to a couple's overall earnings but in practice it is almost always entirely accounted for by the primary earner (typically a man).

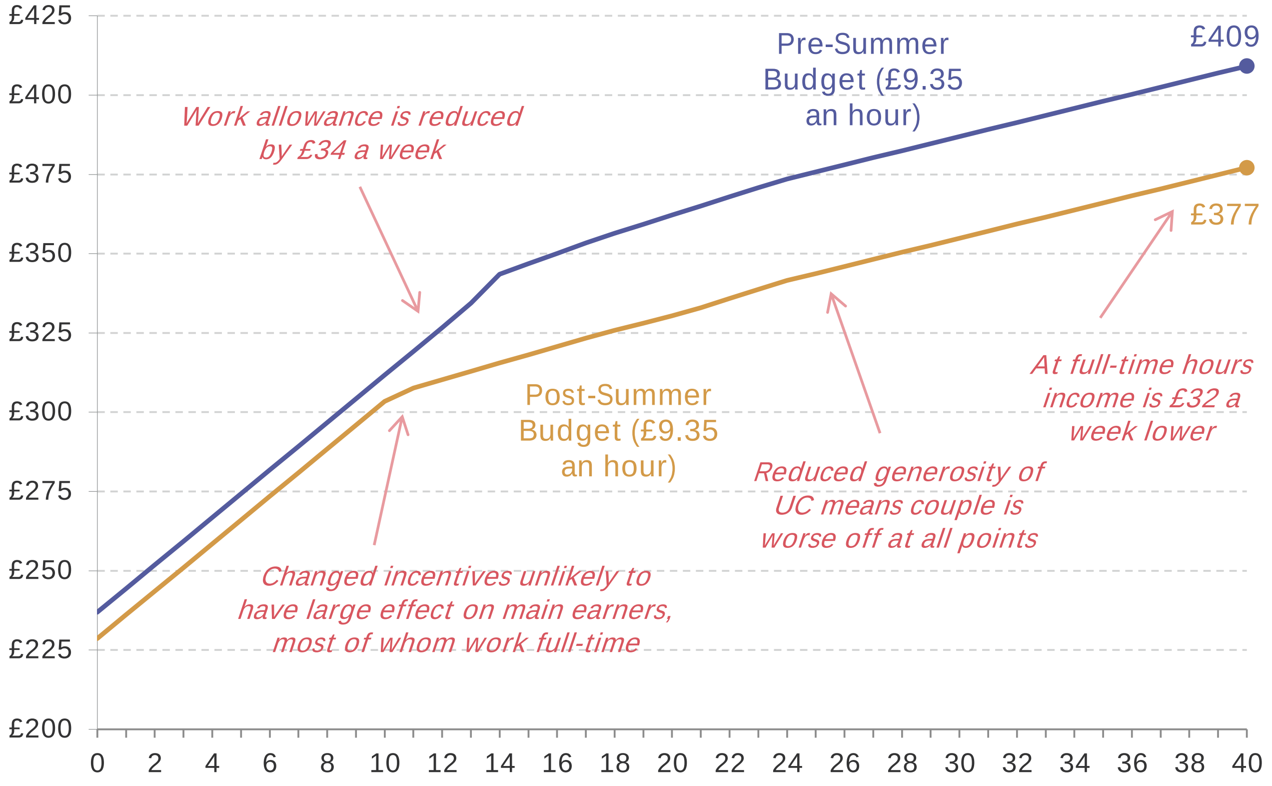
Figure 3 shows that changes in the Budget will mean that:

- When working full-time, and if already earning close to the NLW, a couple with children will be worse off;
- A similar impact is expected for couples with children that rent, although their overall loss of income would be smaller as their work allowance is reduced by less; and
- If earning the NMW, the boost to income from the higher NLW for couples tends to offset the reduction in the work allowance at full-time hours.

In the particular example shown in Figure 3, the main earner is already earning £9.35 an hour so does not gain from the boost to income from the NLW. While at full-time hours they gain a little from the Summer Budget's boost to the personal tax allowance, the loss from the work allowance offsets this. The 'sweet spot' has fallen slightly, but main earners in couples tend to be unresponsive to changes to incentives applying at low hours because most work full time.

Figure 3:
Net income for a single-earner in a couple with one child

Earning £9.35 an hour, no rent: 2020 (£ per week, cash terms)



Source: Resolution Foundation analysis using the RF microsimulation model

Couple with children – second earner

As noted above, for couples the household work allowance tends to be exhausted by the earnings of the main earner. With the reductions announced in the Summer Budget, the probability that this is the case will increase.

For the second earner in a couple, the incentive to enter work is already weak. Without any remaining work allowance, anything they earn will reduce their UC entitlement by 65 per cent. If they earn an extra £10, their UC entitlement falls by £6.50 meaning they are only £3.50 better off.

As Figure 4 shows, the Budget does little to improve this:

» Incentives to enter work for a second earner in a renting couple with two children are weak in UC – before and after the Budget

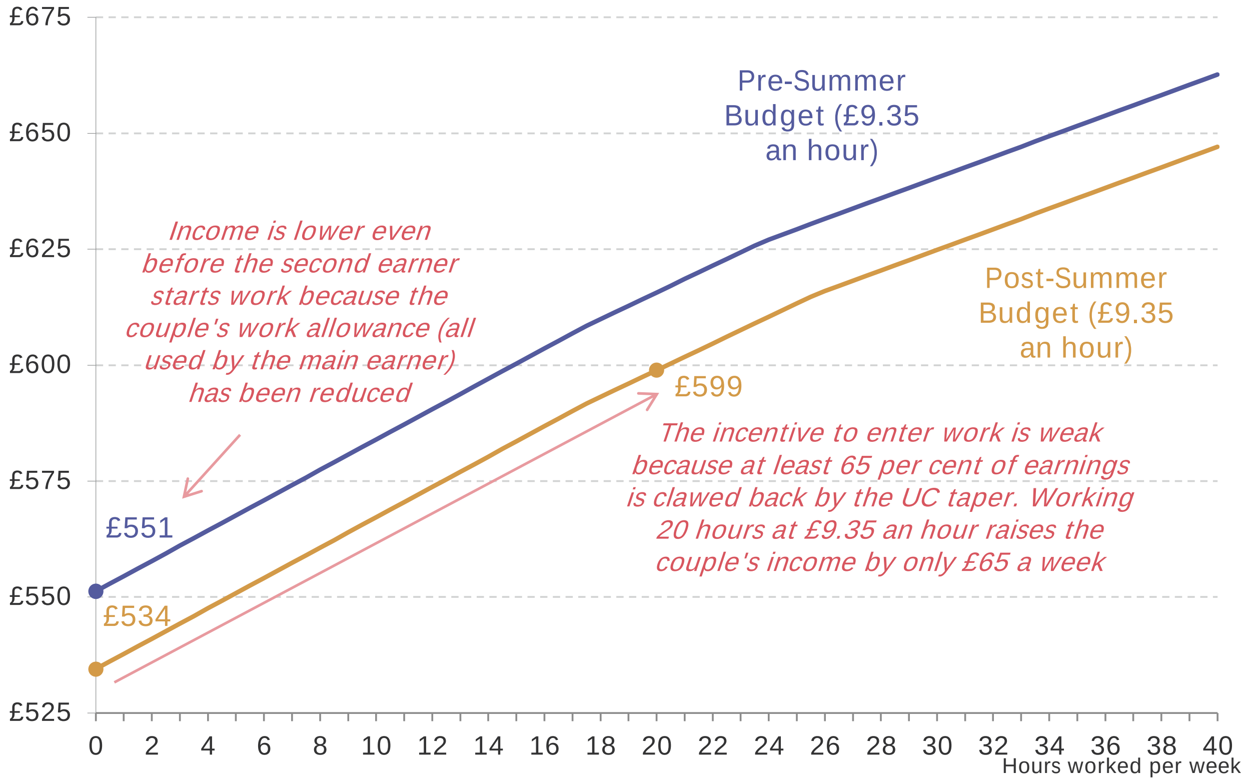
» Working 20 hours only raises the couple's income by £65 when earning £9.35 an hour; and

» Those second earners currently on the minimum wage and over 25 will earn more money per hour as a result of the NLW but their incentives will remain weak.

The incentive to start work is slightly stronger following the reforms because their family income when not working is lower (ie they are poorer), therefore any additional income would represent a greater proportional increase. The reduction in generosity of UC will also mean that they exhaust their entitlement at a lower level of earnings. After this point their earnings will no longer be subject to the UC taper.

Figure 4:
Net income associated with a second earner in a dual-earning renting couple with two children

Earning £9.35 an hour, £100 rent: 2020 (£ per week, cash terms)



Source: Resolution Foundation analysis using the RF microsimulation model

The analysis in this note has taken no account of the impact of childcare costs on incentives to work. In general paying childcare costs in order to work will weaken work incentives because it reduces the amount of each additional pound earned that is 'kept' by the family. After accounting for benefit withdrawal and taxation, the payment of childcare costs can leave families with just 5 pence of each additional pound earned.[5]

The Summer Budget restated the government's intention to provide an additional 15 hours a week of free childcare for three and four year olds in working families (on top of the existing 15 hours a week offer that is available to all three and four year olds),[6] though only pilots of this offer will commence in September 2016. For those benefiting, this will of course help with incentives. But it is unlikely to fully offset the weakening of incentives associated with the work allowance reductions explored in this note. Because UC already provides support with up to 85 per cent of childcare costs, the additional free hours effectively cover the remaining 15 per cent of costs: that's typically the equivalent to around a £11 boost to weekly income.[7] This boost to income may offset losses for some families, but it should be noted that we have also excluded the impact of cuts to entitlement for new claims to UC. The removal of the family premium alone for new claims (which is likely to apply for many families with three and four year olds in 2020) is the equivalent of an up to £11 a week reduction in income for families with children.

Conclusion

The changes to UC announced at the Summer Budget will reduce incentives to enter work, particularly for non-renting single parents who previously had a much higher work allowance. For renters, the risk of becoming trapped at low levels of income has been increased.

Some second earners will find their UC entitlement ends sooner (ie they lose income), improving their incentive to earn more as their earnings are no longer subject to the taper. However for many, particularly those who rent, the incentive to start working and then progress remains weak.

The potential boost to earnings from the NLW will help to mitigate in part some of the financial losses created by these changes, but is unlikely to do enough to offset poorer work incentives (though this varies with household circumstance). The NLW will also do nothing to help under-25s who lose out from cuts to entitlement.

Overall, these changes will do very little to improve the incentives for low paid families to find a path into work and then to progress – seen as a key route out of poverty – and for many they will make a difficult situation worse.

[5] ibid

[6] Working families are where a single parent works or both parents in a couple with children work. The policy provides the equivalent of an additional 15 hours of free childcare for 38 weeks of the year.

[7] The Family and Childcare Trust *Childcare Cost Survey 2015* shows the average cost of a 25 hour nursery place for a child aged 2 and over was £109.83 a week, or £4.39 an hour. £4.39*15 hours*15%=£9.88; increased by OBR projections of CPI inflation to 2020 gives a figure of £10.55. Gains will be greater for families with much of their UC entitlement tapered away who effectively have less than 85 per cent of their childcare costs covered.

Resolution Foundation

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- *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 report, contact:

David Finch
Senior Economic Analyst
david.finch@resolutionfoundation.org
020 3372 2956