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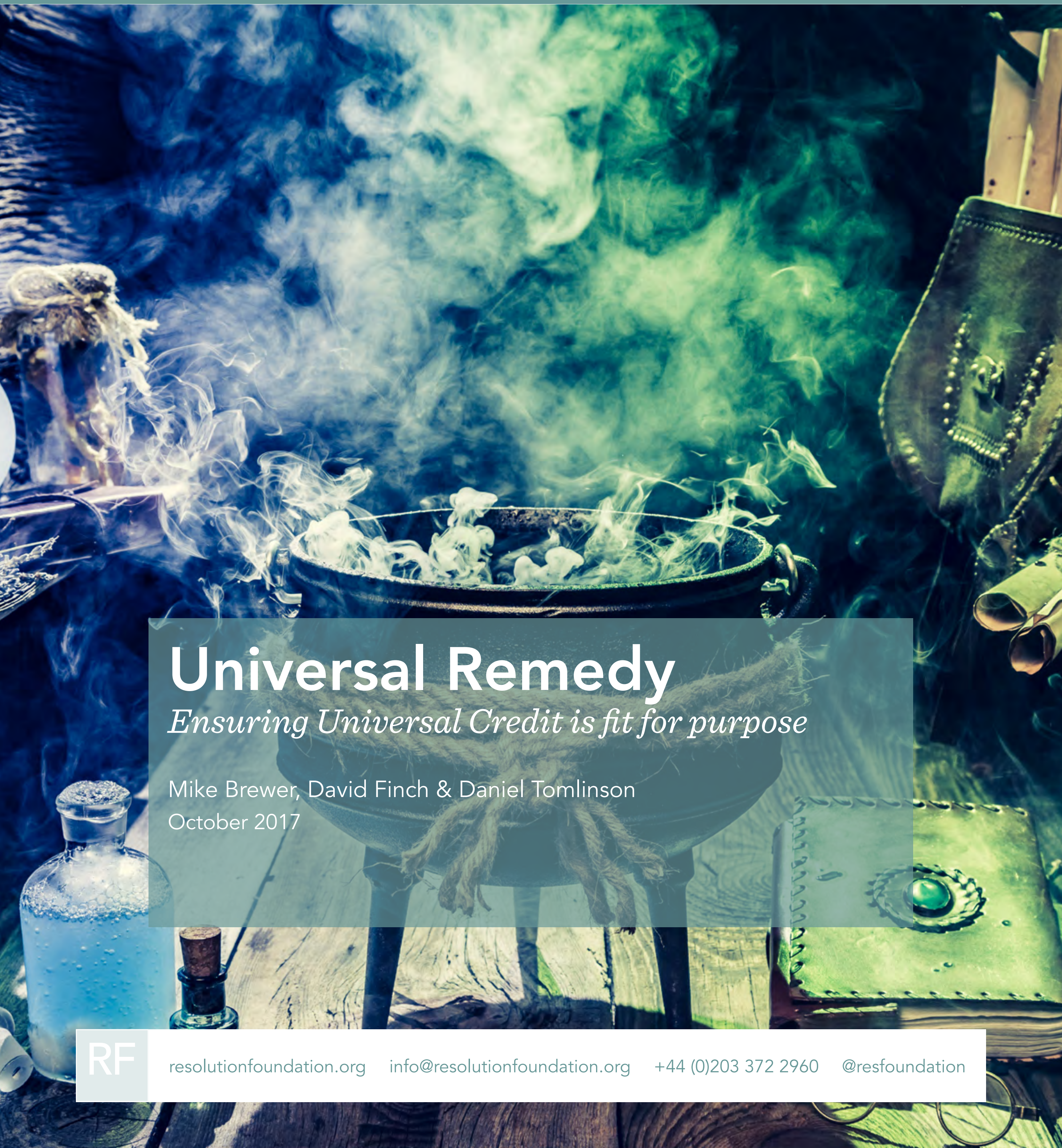
REPORT



Universal Remedy

Ensuring Universal Credit is fit for purpose

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Executive Summary

Making Universal Credit fit for 21st Century Britain

For most of its 7 year life, discussion of the implementation of Universal Credit (UC) has largely been limited to welfare experts and largely focused on one thing: the IT and wider technical challenges of merging six benefits into one and making payments that reflect the varying lives of an expected 7 million families. Over the last six months however that conversation has both grown in volume and broadened far beyond IT.

This important switch reflects two trends. First the good news of the Department for Work and Pension's increasing confidence in an IT system that is now being put into place at an increased rate of around 50 Jobcentres a month. But second, the reality that as the roll-out of UC speeds up to affect hundreds of thousands of people, the flaws in some elements of its design will move from being warnings from organisations like the Resolution Foundation to posing very real major challenges to the very low and middle income families UC was created to help. The six week wait for an initial UC payment is the current focus of debate, but it is only one symptom of a number of inherited flaws that risk UC failing to match the needs of 21st Century Britain.

In recent years the overall impact and policy intent of UC, and in particular its fit with our nation's labour market and families' lives, has taken a back seat to an understandable focus on delivery in the DWP and a less defensible HM Treasury goal of realising significant savings. The aims of simplifying working age benefits, strengthening incentives to work and supporting low to middle income household incomes too often feel like they have been forgotten, being last formally assessed by government as far back as 2012.

The scheme has since undergone significant change, driven by a post-election spree of working-age welfare cuts in summer 2015, rather than by considered design. Moreover, the challenges of the UK labour market have also changed since the years immediately after the financial crisis, when UC was first conceived and designed. Strong employment growth has rendered the scheme's excessive focus on reducing worklessness even further out of date. Today the challenges facing us are building on record employment by reducing endemic low pay, boosting chances of progression, and restarting income growth for low and middle income families.

The prize of a far simpler social security system is certainly a big one that is well worth holding onto, despite the prospect of opposition from some quarters that would arise regardless of whether implementation is going well or not. But making a success of UC means facing up to the problems with its current design.

That includes dealing with design flaws causing problems for families receiving the benefit already, and getting ahead of the curve on those that will cause such problems in the months and years ahead as UC is rolled out to include not just many more families but also more complex cases. Identifying those problems and urging their fixing as part of a relaunch of UC that ensures it is truly a welfare system fit for 21st Century Britain is the purpose of this report.

The benefits and challenges of a single system for working-age families

There is one huge advantage that UC delivers representing a big prize worth the long implementation wait: the unification of key working-age benefits into a single system. The complexity of the old system meant that some, especially renters, were not always clear that almost everyone was better off in work. The practicalities of having to re-claim support upon moving into work created additional uncertainty. Beyond easing the transition into work, having one benefit rather than six should also help boost take-up and ensure that people receive all the money to which they are entitled.

Yet clearly the first step for families is to actually receive those entitlements, especially so when multiple streams of support stem from a single source. In that context it is not surprising that the big issue currently attracting political and media attention is the initial six week wait between making an new claim and receiving money in a bank account.

The wait itself consists of a seven day waiting period before a claim is accepted, a month to assess entitlement, and a further week to process the payment. It is the result of the coming together of a decision to cut spend (the seven waiting days) with the strict imposition of a design rule (payments made monthly in arrears) that may work fine for some already working families, but simply doesn't suit the financial circumstances of many UC recipients.

The insistence on monthly payments in arrears is not inherent to UC, but has been justified as reflecting the pattern of working life. Using new data based on bank transactions, we are able to assess just how well a monthly payment system matches the pay frequency of those moving out-of-work and onto UC. This shows that the majority (58 per cent) of new claimants moving onto UC as a result of moving from employment were paid either fortnightly or weekly in their previous job. This unnecessarily rigid restriction therefore also does a poor job of reflecting how many people actually live their lives.

The seven day waiting period would have some justification for a benefit like JSA, where entitlement is assessed daily and a wait can help reduce the number of very short-term claims where people quickly find work. But because UC has been designed to take a month to assess someone's circumstances, an initial waiting period is unjustifiable.

Scrapping the seven waiting days at the start of a claim, at a cost of up to £200 million a year, should be the first step in reducing the six week waiting period. The government should also look to compress the payment processing days. Announcing these measures together at the forthcoming Budget could reduce the wait for a first payment by at least a week and a half.

That would leave a reduced, but still significant, wait for new claimants to receive a first payment. The government's answer to this is the wide promotion of advances. This may help address short-term need but institutionalising six months of advance repayments at the start of the claim should not be core to a new system. Such a move would be a short-term fix, not a lasting solution. Instead, DWP should look to pay housing support in particular much sooner, during the first few weeks of a claim. It would reduce arrears and the reliance on large upfront advances. **Looking further ahead benefit claimants should have the right to opt for fortnightly rather than monthly payments.**

Getting ahead of the curve

While the issue of the six week wait is already being recognised, other challenges lie in wait. With the accelerating pace of rollout, not only will a greater of volume of families be on UC but the number of more complex claims is set to increase rapidly. This is likely to turn other design flaws into real world cases of claimants suffering hardship. While testing and learning has delivered real benefits in improving UC's IT, the DWP can get ahead of the curve by relaunching and fixing these policy problems before they materialise at scale and affect many low income families.

The self-employed, a now larger share of the lower paid workforce, will face much stricter reporting requirements, leading to inequitable treatment compared to employees with similar levels of earnings. The Minimum Income Floor (MIF) is set to save £1.5 billion a year, in part purely because of how it interacts with the varying pattern of income of self-employed workers. **DWP should align the method of assessment for the MIF with the tax system (currently annual) to remove this inequity and allow the MIF to become the mix of fraud prevention and provision of support for struggling businesses it is meant to be.**

The requirement to report childcare costs in arrears (to match how earnings are assessed via real-time PAYE data) has led to the design of a complex system of advances. Although the system is yet to be tested to any great degree – indeed the digital element of the process is yet to even be put into place – it has all the markings of a design flaw, with scope for fraud, error and overpayments. **DWP should review childcare reporting requirements and move them in line with more flexible Tax Free Childcare arrangements** before they drive future negative headlines.

Other areas are simply unresolved, perhaps because there simply is no straightforward solution. Determining eligibility to free school meals is one large, £0.6 billion, unanswered question. And it is one where any quick-fix solution risks undermining the aim of always making work pay. A planned earnings threshold for eligibility is likely to create an effective drop in income at whatever earnings level is chosen. And the now reduced generosity of UC work allowances makes any resolution harder. **The government would ideally set the threshold for free school meal eligibility below the level of (restored) work allowances to strengthen incentives to progress in work.**

UC will, overall, make working families worse off than the current system

With few working families currently on UC, the cuts to in-work support may be harder to spot than the six-week lack of income, yet this issue will be the one that determines the long term impact of UC on the country's labour market and living standards.

On the latter, such a big reform was always going to lead to a mix of gainers and losers. Eventually covering the equivalent of what will be £60 billion of spend on working-age benefits in 2020-21, the steady accumulation of cuts to UC mean that it will now, overall, be almost £3 billion a year less generous than the system it replaces. This poses a major drag on the living standards of families on low and middle incomes over the next few years. Even accounting for the boost to UC via a taper reduction in the 2016 Autumn Statement, we estimate that compared to the existing tax credit system:

» 2.2 million working families are expected to gain, with an average increase in income of £41 a week.

» 3.2 million working families are expected to be worse off, with an average loss of £48 a week. 600,000 of those losers, mostly couple parent families, will no longer be entitled at all.

While the overall net impact on couple parent families is broadly neutral, significant variation lies behind the headline. Almost the same number will gain (1.0 million) an average £54 a week, as lose (1.1 million) an average of £53 a week. But that is not the case for one of the hardest affected groups: single parents, who will overall lose an average of £26 a week. However, nearly twice as many are expected to lose (0.7 million) as gain (0.4 million). And those gains (average £31 a week) are around half the scale of the losses (average of £57 a week).

Restoring parity with the tax credit system by re-investing £3 billion a year into UC is essential, not only to protect living standards but also to prevent UC's brand becoming synonymous with such major cuts resulting in significant opposition to roll-out. The large number of losers makes the gradual geographical roll-out of UC a postcode lottery for the incomes of many working families. The 'transitional protection' scheme seems set to offer little compensation, with less than a fifth of losing families expected to receive support. The long list of conditions that are deemed to reflect a change in circumstance, bringing such support to an end is likely to mean relatively short durations of protection.

Making it pay to work

For the labour market as a whole, the biggest strengthening of incentives to enter work since the financial crisis comes not from UC but as a result of a higher wage floor (the National Living Wage), lower tax and less generous benefit system (not least as a result of the freezing of all working age benefits). Yet UC *does* matter for incentives to enter work. The purpose of the new scheme was rightly to build and improve on the incentives created by the tax credit system: encouraging more people into work and to boost their incomes by earning more.

A key plank of that strategy is to simplify the system, make the positive financial returns to working much clearer and removing the uncertainty of moving between systems when entering work. The other key plank is, or at least was, to boost the financial return to working.

UC undoubtedly improves the incentive to enter work at very low levels of hours or earnings, because of the work allowance. Set at a level of earnings equivalent to either 5 or 10 hours at the National Living Wage, no entitlement is withdrawn below the level of the allowance, leading to a big boost in take home pay for people for who want to work but for whom making the jump to 16 hours work a week – the target in Working Tax Credit – can be too great, such as disabled people or parents of very young children.

However, as a result of the successive series of cuts to in-work support provided by UC, it now does little to improve financial incentives overall. Most importantly it risks weakening work incentives among those most likely to respond, such as single parents and second earners in couples with children. For them, the size and shape of incentives are important, not just for the decision to work but the pattern of work chosen.

For example, not only does the combination of a low work allowance and relatively high taper rate of 63 per cent mean most single parents will be worse off than under the current system, but it also increases the risk that single parents may choose not to work or move into work at shorter hours.

The work allowance for single parents should at a minimum be set at the equivalent of 15 hours a week at the National Living Wage. The £1.2 billion a year cost would prevent the erosion of the big rise in employment supported by the tax credit system, one of the biggest policy success stories of the last 20 years.

Second earners, who have no work allowance and have all their initial earnings subject to the taper will keep only 37p in the pound of their pay from a part-time role. Some, as a result, may choose not to work at all: indeed the DWP *expect* some not to. Such a move goes against the grain of the growing number of dual earning households, a key trend in helping to boost family incomes. A new second earner work allowance set at the £2,200 a year 5 hours of work at the wage floor, at a cost of £1 billion, would help support more second earners into or to remain in work.

Members of a further group are also set to see a change in their incentives – low paid workers without children. UC will mean an extension of in-work support to under-25s for the first time and take-up of housing support for workers is expected to be higher. Precisely how they respond is difficult to judge given a lack of historical evidence. But an increasing trend for men to work part-time suggests a new sensitivity to the returns to work on offer. The big question is whether the incentives created by UC for this group reinforce this worrying trend. With such uncertainty, **how workers without children respond to incentives in UC must be closely monitored, and any concerns quickly acted upon.**

Getting on in work

UC was largely designed to help eradicate a problem of the 1980s and 1990s, and a cause for concern immediately after the financial crisis: worklessness. Today however, the UK's impressive employment performance has already helped the share of households in which nobody works reach record lows. Instead, with over two-thirds (68 per cent) of children in poverty living in working households, a refocus of UC is required to ensure that it can tackle the problems of our 21st Century labour market: low pay and in work progression.

And the UK definitely has a low pay problem. One-in-five workers are in low pay, and only one-in-six of those manage to progress to a higher level of pay within a decade. The minimum wage and National Living Wage have helped to eradicate the lowest rates of pay, but do nothing to help lift people off that floor, while increasing the number of people on those rates of pay.

The UC taper of 63 per cent has helped to improve the reward from earning more for some by eradicating the very highest marginal withdrawal rates of the current benefit and tax credit system, which historically left some with less than 10p of every additional pound they earned. By withdrawing the equivalent of tax credits and Housing Benefit under a single taper, taxpayers will under UC now keep 25p of each additional pound earned.

Although a significant improvement on the current system for some, keeping only a quarter of what you earn is still a poor return, and a little worse than that which currently applies to taxpayers on tax credits and no other benefits, who keep 27p in the pound. And if we include the cost of childcare, the return to earning more under UC falls again, to as little as 6p in the pound for example if paying for two pre-school aged children.

If UC is to truly support progression for those already in work, it is time for a re-think. Of the groups entitled to UC, those likely to require and respond to much stronger incentives to progress are mothers, especially with younger children. Intervening when children are young makes particular sense, and long periods out of the labour market have significant long-term impacts of women's future incomes.

Big reductions in the taper would seem the obvious place to start, but they are expensive (because they benefit all on UC) and ultimately the 'right' rate to maximise progression is unknown. More creative thinking is required. **Targeted solutions should focus on where incentives are weakest and improvements likely to have the greatest effect by exploring lower taper rates for single parents and second earners. More innovative plans should also explore the use of conditional, time-limited, 'progression payments' for those who manage a sustained move onto a higher level of earnings (through hours or pay).** Previous research has shown these to have had a significant effect on the work behaviour of single parents, moving them to full-time work. **Either way, the government should commit to extensive trialling of new progression approaches, and start soon.**

Ultimately the government must take a far more radical and far-reaching approach to progression. As a partial response to all of these concerns, the government plans an extension of conditionality – the requirement to undertake work search activity – to people in low paid work. The policy has the potential to provide much needed support for some to secure full-time work. But reduced financial incentives risk it becoming a stick to enforce a minimum number of hours of work in a less generous system. With work allowances restored and financial incentives strengthened where they are needed the most, **in-work conditionality within Jobcentre Plus should be focused on providing practical support to find continuous employment.**

Looking more broadly, it makes sense to offer help with progression for those stuck in low pay and on UC, but a true system of support would have to go beyond the boundaries of UC. Support to progress for all workers, not just those on UC, is needed but is best delivered via a wider national progression service rather than Job Centre Plus.

Getting ahead of the curve and relaunching Universal Credit

Rolling out any reform of the welfare state on the scale of UC was always going to be hard. Until recently one of the biggest strengths of the new benefit was the near universal support for the principle underpinning it of a simpler scheme that would improve work incentives and outcomes for low income families. That consensus is now looking seriously strained.

Re-establishing it requires the government to continue making the case for UC, while recognising and addressing its problems – be they already-visible or likely to materialise as the roll-out spreads. These problems cover both the process of UC payments but also, more fundamentally, the size and design of support for working families. The planned break in roll-out in January and upcoming Autumn Budget provide the government with the opportunity to take stock, resolve the design flaws in UC and relaunch the benefit in a way that is unequivocally fit for the challenges of the 21st Century.

This will unavoidably cost money. Some changes require relatively little additional spend, compared to the £60 billion a year set to be spent on UC. For example, investment of £0.2 billion a year would strike seven days off the six week wait. Other necessary changes, for example, matching current system generosity and strengthening the financial incentives to work, will require significantly more but could be done without additional borrowing. The £3 billion needed to restore parity with the current benefit system could be provided **by delaying a range of tax cuts that disproportionality affect the richest.**

Box 1: Recommendations

Implementation

1. Remove the seven day wait for UC entitlement and strip down processing days to significantly reduce the six week wait for an initial payment.
2. Introduce faster payment, or at least faster assurance of payment of housing support, for out-of-work families beginning a UC claim.
3. Allow recipients to opt for fortnightly payments and readily provide an advance of standard allowances in the first three weeks, in line with the suggested Northern Irish approach.
4. Allow tenants the freedom to choose direct payment of housing support to landlords, accelerate the implementation of the landlord's portal and trusted partner status including facilitating access of private landlords to the landlord's portal.
5. Allow self-employed workers to report their income in line with the tax system, at present annually in arrears, and apply the MIF on the same basis.
6. Rethink the design of support with childcare costs to reduce the compliance burden and provide government support when parents pay providers, rather than requring them to recoup their costs.
7. End uncertainty around free school meal eligibility and introduce an earnings threshold at a low level of earnings, or supplemented with a lower work allowance for those with free school meal entitlement.

Generosity of support

8. Re-invest £3 billion a year into in-work support to ensure at a minimum parity of overall generosity with the tax credit system, with the exact form of that support maximising work incentives for those most likely to respond and in need of support.

Financial incentives to enter work

9. Boost work allowances for single parents to at least £6,800 a year (the equivalent of working 15 hours on the wage floor) at an annual cost of £1.3 billion
10. Introduce an initial work allowance for second earners of £3,200 a year at an annual cost of £1 billion, with a long term goal of this reaching a level equivalent to 15 hours a week.
11. Closely monitor the situation of workers without children or disability, particularly those working part time, and the impact that UC has on their working patterns.

Financial incentives to progress

12. Commit to trialling different forms of financial incentive to encourage progression with stronger financial incentives and more forms of practical support including:
    - ~ lower tapers for second earners and single parents
    - ~ time-limited conditional payments for achieving progression
    - ~ providing additional support with the cost of childcare for pre-school aged children
13. In the short term, gradually reduce the UC taper once work allowances have been strengthened.
14. Build progression conversations into UC work search discussions and use UC administrative data to identify those at risk of low pay to signpost them to progression support.
15. Focus in-work conditionality on helping those with the greatest barriers to work to find continuous employment.
16. More widely: dramatically improve the career guidance information available; create a national body to oversee progression trials and work with employers at a sectoral level; ensure that progression is a core part of ongoing government policy, in the same way that employment underpins the actions of departments beyond the DWP.

Section 1

Introduction

Universal Credit (UC) is a radical transformation of the welfare state, combining six key working age benefits into a single system. Its original aims were to simplify the benefits system, reduce poverty and make work pay. But those aims are at significant risk of not being achieved.

Successive rollout delays have caused the government some embarrassment, with all-too familiar issues arising in relation to the system's IT infrastructure. But more recent implementation challenges have tended to reflect more fundamental policy design flaws, following significant improvements with the IT underpinning UC, with the six week wait for new claims causing high profile material problems for some claimants.

Stepping back from these specific design questions, it looks increasingly likely that the very policy focus of UC needs to be reviewed. Since UC was first mooted, the UK's labour market has undergone significant change but the policy has failed to adjust. This report assesses the extent to which UC will deliver on its original aims and sets out suggested solutions for both easing the immediate pain of roll-out and ensuring UC is fit for the 21st Century.

A radical reform of working age welfare

The ambition of UC is impressive. The scheme combines six existing working age benefits: income-related Jobseekers Allowance, income-related Employment Support Allowance, Income Support, Child Tax Credit, Working Tax Credit and Housing Benefit. Altogether these benefits account for around £60 billion of government spend, or 62 per cent of the working age benefit budget.[1]

The new approach not only rationalises the welfare system, it also restructures the support offered to working families. The current system of in-work support hangs eligibility on the need to work a minimum number of hours (16 for single parents, 24 for a couple), and then withdraws entitlement for tax credits and Housing Benefit at different rates as earnings rise. UC replaces these 'hours rules' with a 'work allowance' that acts as an income disregard. Entitlement is not withdrawn until a (low) level of earnings is reached, subsequently all entitlement is withdrawn at a single 'taper' rate as net earnings rise.

UC's extension into the lives of over 9 million individuals in 7 million families, in any given period highlights the importance of getting the new system right. That means delivering on the three key objectives of UC:

» easing the accessibility and usability of the system;

» providing financial support for low to middle income households; and

» strengthening financial incentives to work and progress.

This Autumn marks the point at which the full UC system – serving all types of cases, rather than just the simplest ones that have dominated to date (the early rollout of UC focussed on the unemployed but not the more complex cases involving children, housing or disability) – is finally being put into place at scale. Given the delays that have beset the implementation process

[1] DWP (2017) *Benefit Expenditure and Caseload tables 2017*, March 2017

so far, this is an important milestone. However, it is even more important that the system that is introduced is fit for the 21st Century. With that in mind, the New Year brings with it a break in implementation to allow for an evaluation of the ramped up roll-out. It provides a perfect moment in which to re-assess and review both how the system is working and the sustainability of the underlying policy design.

This report builds on the work of Resolution Foundation's 2015 expert panel-led review of UC, chaired by Nick Timmins. Where relevant, we update the analysis that fed into the conclusions of that review.[2] Even in just a few years, there have been significant changes – both in terms of the economic backdrop and the budget in place for working age welfare. The future is always uncertain, but it's clear that the nature of the challenge facing the UK's welfare system has shifted somewhat over time. It's less apparent, though, that UC has adapted to match this evolving environment.

21st Century welfare

The UC concept was originally developed in the late-2000s by the Centre for Social Justice,[3] with the coalition government swiftly setting out a more detailed White Paper following its election in 2010.[4] At the heart of its attempt to simultaneously streamline welfare, lower poverty and boost work incentives, the policy focused on ending the separation of support for in- and out-of-work people. Having to reclaim entitlement when moving into work was rightly seen as a disincentive for taking on employment and a barrier to the take-up of some forms of support.

This aim attracted widespread – and cross-party – support. But implementation has, perhaps not surprisingly, been dogged by delays. And the commencement of wider UC roll-out in recent weeks has coinicded with a focus on a number of more serious design flaws that appear to be putting the prize of a single, easier to use system of support in which work always pays at risk. The problem is threefold.

First there are straightforward concerns about the way in which UC is designed to work in practice. We look at a number of such issues in detail in **Section 2**, highlighting the extent to which unnecessarily poor policy choices are not inherent to UC but instead appear to have flowed from attempts to make short-term savings or from misguided attempts at concentrating on altering human behaviour rather than supporting people in need.

Second there is the very significant reduction in funding UC has faced since it was first announced. Once set to be more generous than the system it replaces,[5] UC is now expected be nearly £3 billion a year less generous by 2021-22. Of the eventual over £14 billion a year of cuts to working age welfare set out at the Summer Budget 2015, it is the £4 billion a year reduction in the generosity of the in-work support provided by UC that this report focuses on. In **Section 3** we assess how these cuts – partially offset by a lowering of the taper rate in Autumn 2016 at the cost of £0.7 billion a year – have altered the shape of support on offer for low to middle income working families.

Third is the failure of UC to adapt to meet the changing realities of the 21st Century labour market. The aim of ensuring that moving into work always pays is commendable and uncontroversial. However, in **Section 4** we show that the emphasis on this aspect of UC – in combination with significant budget cuts which limit the ability to provide broad-based support – risks driving a perverse outcome in which some recipients choose to work *fewer* hours than they do under the current system.

[2] See: V Alakeson, M Brewer & D Finch, (2016) *Credit where its due? Assessing the benefits and risks of Universal Credit*, Resolution Foundation & D Finch (2016) *Making the most of UC: Final report of the Resolution Foundation review of Universal Credit*, Resolution Foundation

[3] CSJ (2009) *Dynamic Benefits: Towards welfare that works*, September 2009. One of the authors of this report (Brewer) provided technical advice to the CSJ at the time, but was not involved in the writing of their full report.

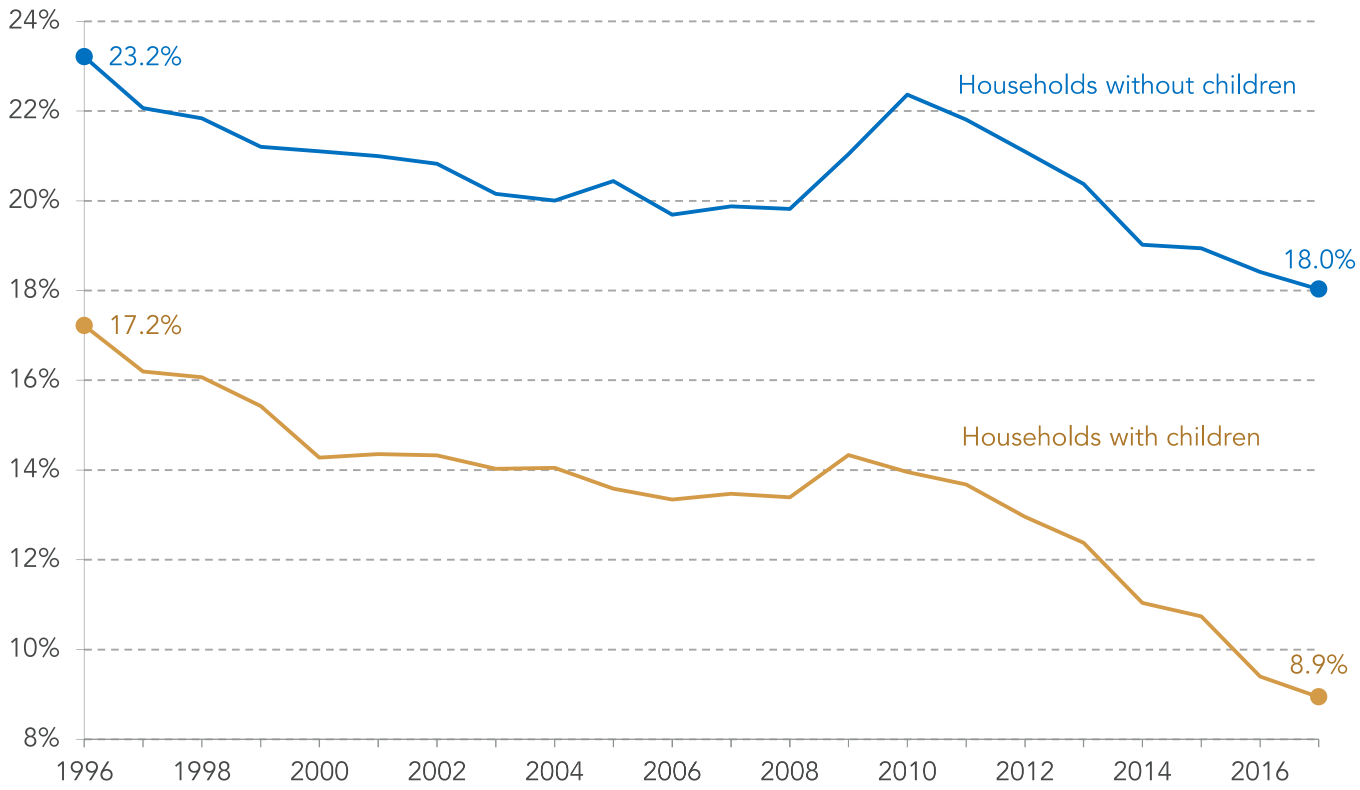
[4] DWP, *Universal Credit: Welfare that works*, Cm 7957, November 2010

[5] DWP, Universal Credit impact assessment, October 2011

This focus on tackling worklessness – that is, the condition where no one in a household is in employment – that underpins this central aim of UC seems now outdated. After all, employment is at a record high and the share of households where no-one is in work currently sits at a record low, as Figure 1 shows. The share of households with children in which nobody works has fallen by almost half from 17.2 per cent in 1996 to 8.9 per cent in 2017. As we explore in **Section 5**, the challenge which UC must rise to is not worklessness but rather the low pay, insecurity and lack of progression experienced by too many employees.

Figure 1: The falling share of workless households over the last two decades

Proportion of working-age households



Source: ONS, *Working and workless households in the UK: April to June 2017*

Notes: Working age is defined as a household containing an individual aged 16 to 64; April to June quarters shown only

Each section of this report contains not just an assessment of UC's flaws, but recommendations for a way forward too. We present policy suggestions that both deal with near-term practicalities and refocus the system to better match the realities of life in 21st Century Britain. We offer concluding thoughts in **Section 6**.

Section 2

Implementing the system

To date the tale of UC has been one of protracted implementation, with a number of false dawns for delivery. With the roll-out now starting to accelerate, there are tentative but very welcome signs the IT may finally be working. But in many ways, this is when the real challenge for the new system begins. Stories about delayed payments and building rent arrears have hogged the headlines in recent weeks, but the consequences of other design issues are likely to emerge in the coming months as more complex cases move onto the scheme.

At the heart of these various problems is a combination of a drive for short-term savings and the unnecessarily rigid nature of the design of the UC system. Building more flexibility into the scheme in order to better meet the inevitably differing needs of users may require a relatively small upfront investment. But such an approach could boost longer-term efficiency and so generate further savings down the line.

Implementation may, finally, be on track but policy choices risk derailing the system

By Autumn 2017, the original timetable for UC foresaw 7 million families receiving support. Instead there are just 610,000 families claiming.[6] However, that caseload – and the complexity of those cases (until now, most cases have covered unemployment but no children, childcare support or disability) – are now set to build rapidly.

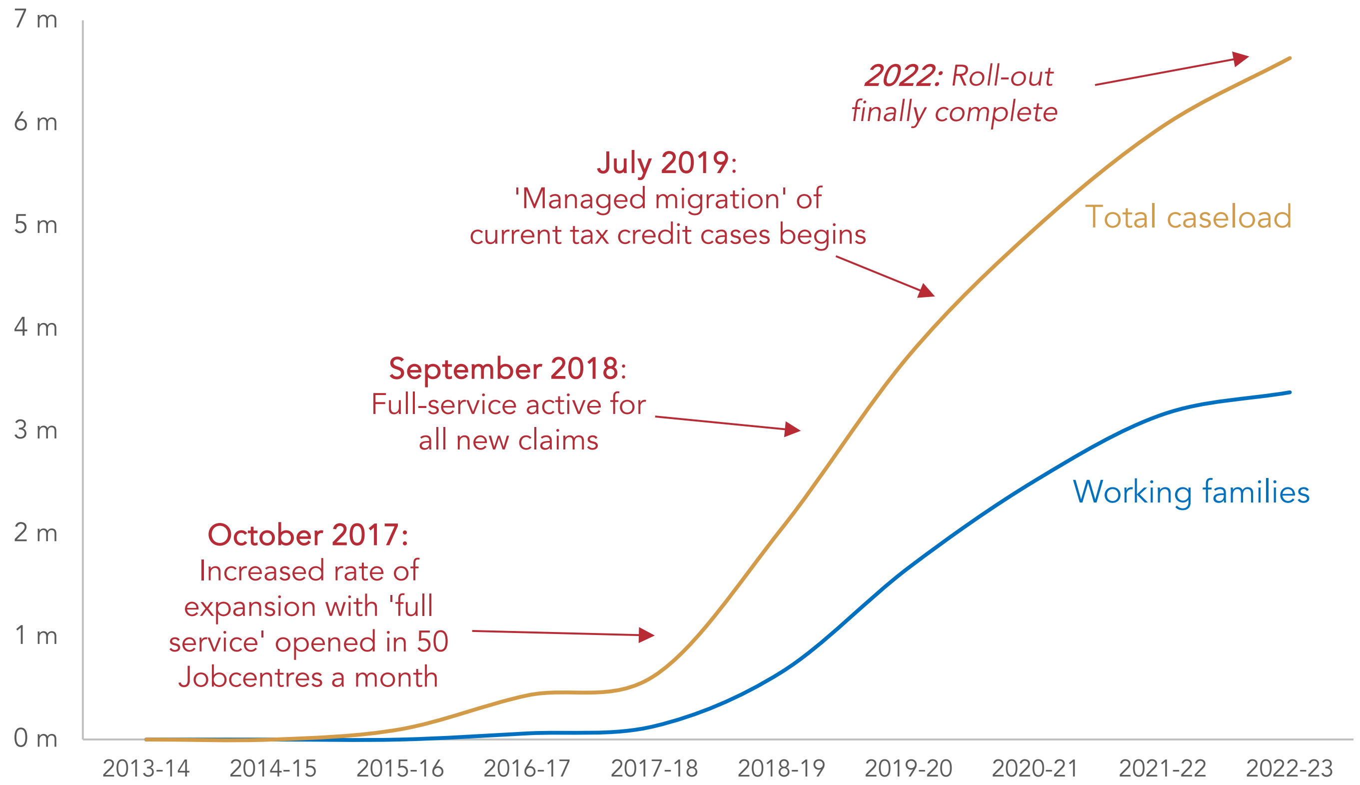
Following significant improvements in the operation of the IT underpinning UC, the full version of the benefit– open to all types of new claims (bar large families that the system cannot yet cope with) – is now coming to around 50 Jobcentres a month across the UK. A short break is planned in January 2018 but, unless significant problems appear, the pace of roll-out should mean it reaches all Jobcentres by July 2018. Shortly after it is expected that the current benefit system will be closed to new claims.

At present it is only new claims for support or people on the current system experiencing a 'natural' change in their circumstances, such as having a child, moving home or moving out-of-work that will move onto UC, and then only in the areas to which it has been rolled out from summer 2019. The plan is for existing claims, mostly working families with tax credit entitlement, to have a 'managed move' instigated by DWP to the new scheme.

Figure 2 sets out the key implementation dates and our best estimate of how the caseload is set to build until 2022 (incorporating an OBR-assumed six month delay in DWP's plans). The growth of working families is highlighted given these are most likely to have a different entitlement (higher or lower) compared to the current system.

[6] DWP (2017) *Universal Credit Statistics, 29 April 2013 to 14 September 2017*, October 2017

Figure 2: UC roll-out schedule and key milestones



Source: RF analysis using OBR *Economic and Fiscal Outlook, March 2017*, HMRC, *Tax Credit statistics*, DWP, *WPLS* and ippr tax-benefit model

Despite this apparently positive news on roll-out, the delivery of UC is coming under a more fundamental threat. It's one that stems not so much from IT problems, but instead from a series of flaws in the policy design.

These flaws appear to reflect both cost-cutting measures imposed on UC since its announcement and original policy choices that simply fail to account for how people live their lives. Simplicity has clear merits, but the emphasis in UC tends to be on avoiding complexity in its internal workings at the cost of placing a greater compliance burden on recipients. In this regard, the desired simplicity of the system crashes into the inevitable diversity of people's circumstances.

Waiting six weeks to get paid

Turning first to the headline grabbing six week wait for payment faced by new claimants (excluding recipients already in the current system who move to UC following a 'natural' change in circumstances facing a five week wait, and others with certain limited exceptions)[7] we find a clear example of how the design of UC fails to meet the needs of its recipients. Those affected are essentially people who fall out-of-work, accounting for roughly two-thirds (64 per cent) of all new claims to UC made in May and June 2017.[8]

The delay constitutes three different elements. The first is a period of seven waiting days in which recipients have no entitlement to benefits. Waiting days were imposed in the JSA and ESA system

[7] Claimants exempted from the waiting period include those who are terminally ill, recent victims of domestic violence, care leavers, 16-17 year olds without parental support, and those who have left prison.

[8] DWP, *Universal Credit Waiting Days: May and June 2017*, September 2017

to both save money and reduce very short term claims from those who moved quickly back into work. The second part is due to the month taken to assess UC entitlement from the first point of claim, reflecting the goal of paying UC monthly in arrears. The third element is the seven days it takes to process a payment.

Much of the recent focus on this area relates to stories of delays lasting much longer than six weeks.[9] Currently, one-in-five do not get their full entitlement paid within six weeks, and one-in-ten get *nothing* in that time frame.[10] These delays mostly arise in claims that involve additional elements, such as housing or childcare, or claims from the self-employed. That is, it is the 'complex' claims that UC is starting to absorb which are driving the issue up the agenda. As wider roll-out continues, we might expect more headlines in this area.

More encouragingly, the speed and accuracy of payments *have* been improving. Extreme delays are, thankfully, now the exception, and the DWP appears very confident that its IT system is now on track.[11] Precisely how and why these improvements have occurred is unclear: the lack of more detailed information makes it difficult to properly judge. A new National Audit Office review of UC implementation should shed some light.

Yet even if the extreme delays are eradicated in the coming months, it remains the case that the fully-intended wait of six weeks from claiming to receiving support is too long for a scheme that is the safety-net part of our social security system, meant to support those who need help the most.

Paying support monthly in arrears does reduce the risk of overpayments (something which bedevilled the tax credits system, and led to high levels of over- and under-payments each year). And monthly payments in arrears might be acceptable in cases where recipients have steady jobs, but it has obvious, and all too visible, limitations when it comes to supporting the poorest in society. As our previous research has shown, only 14 per cent of working age households for whom income from benefits is the main source of income have savings that exceed a month of income to fall back on.[12]

Using new data based on bank transactions,[13] we are able to assess just how well a monthly payment system matches the pay frequency of those moving out-of-work and onto UC. Figure 3 shows that the majority (58%) of new claimants moving onto UC as a result of leaving employment in the last tax year were paid either fortnightly or weekly in their previous job. This is a far higher fraction than the economy-wide average, where less than one-in-four of all jobs are paid fortnightly or weekly. But we should not design a payment system for the most vulnerable in society around the financial arrangements of the typical British household.

[9] See for example: https://www.theguardian.com/society/2017/sep/16/universal-credit-rent-arrears-soar

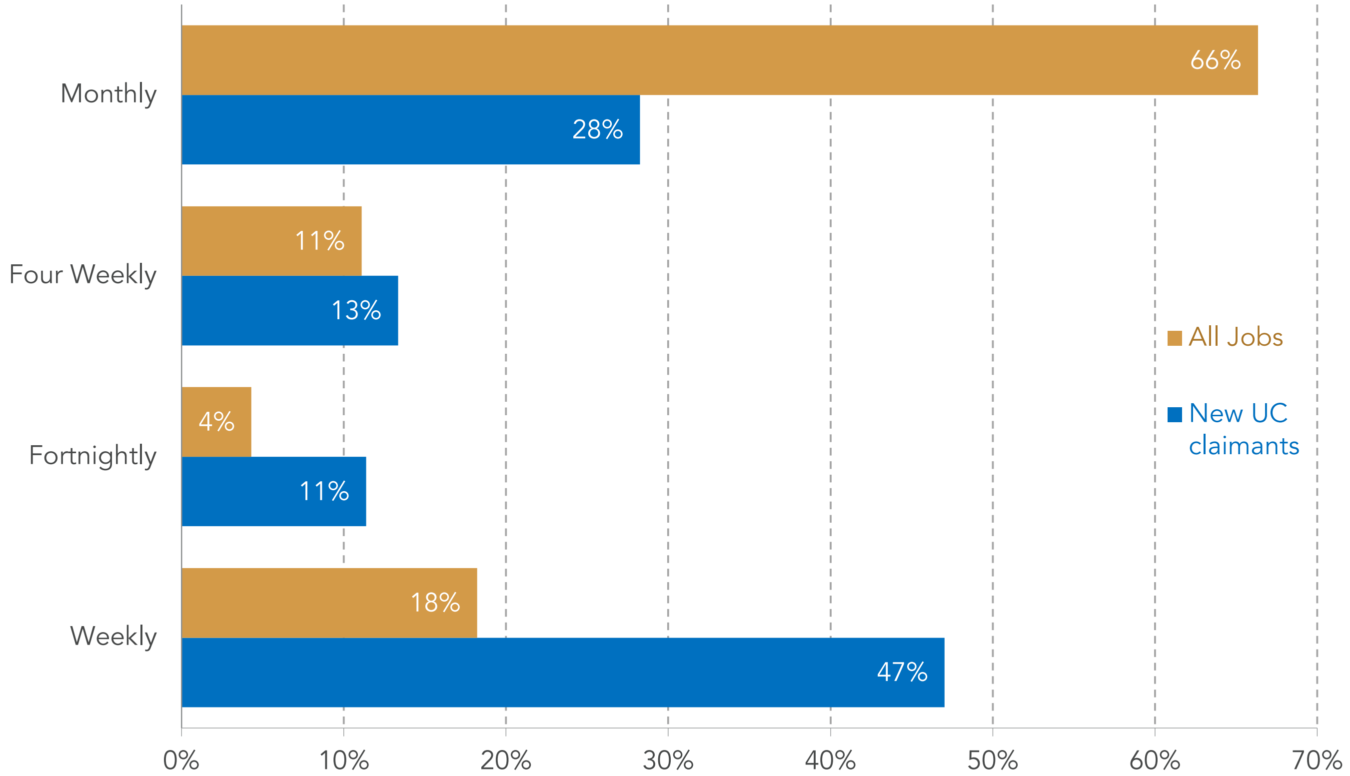
[10] DWP, *Universal Credit payment timeliness: Jan 2017 to June 2017*, October 2017

[11] Work and Pensions Committee, Oral evidence: Universal Credit rollout, HC 336

[12] A Corlett & S Clarke, *Living Standards 2017: The past, present and possible future of UK incomes*, January 2017

[13] This data is an early finding from a new joint research project between Resolution Foundation and Lloyds Banking Group into trends in earnings volatility in the UK. A full report will be published in the coming months.

Figure 3: Payment frequency for new UC claimants in their previous job, 2016-17



Source: Analysis of bank account transactions, Lloyds Banking Group

Notes: New UC claimants are those who left employment up to two months before starting to claim UC and whose claim began in the 2016-17 financial year. All jobs refers to all active jobs in March 2017. Pay frequency measured in jobs held for at least three months in which payroll transaction data was identifiable.

Recommendation one: *reducing the waiting period*

The government needs to remember that UC is more than just a top-up to wages for lower-income families. It is also the critical safety net in our social security system that prevents those without a job from falling into debt, hunger or destitution. Timeliness of an initial payment is therefore crucial.

And certainly the six week wait can be reduced. The presence of the month long processing period renders the initial seven day wait no more than a cost saving exercise (that is, it can no longer be argued that the seven day wait will help reduce short-term claims when claimants in any case face a month's delay) and means that it should be removed. The cost to the government would be small. Latest estimates suggests it saves £150 million to £200 million a year, or around 0.2 per cent of the working-age social security budget.[14] Removing it will reduce hardship amongst many families who have the most need for immediate cash.

The seven day payment processing period at the end of the six weeks can also be shortened. Bacs payments typically take three working days to process, and Faster Payments can be instant, or take up to as little two hours. When making the first payment, the soonest possible day should be chosen, even if that means the first payment is made on a different day of the month to future payments.

[14] Social Security Advisory Committee, *Report on the Universal Credit (Waiting Days) (Amendment) regulations 2015 (S.I. 2015 No. 1362)*, June 2015

Removing the initial seven waiting days and compressing payment timescales at the end of the process should and could be done. Reducing the overall wait by at least 11 days would represent progress, but it would still leave recipients facing more than a month with no financial support. Other approaches might therefore also be needed.

Recommendation two: *Advancing to fortnightly payments*

The role of advance payments is becoming more widespread in UC. Indeed knowledge of their availability appears to have been low until recent months, but now almost *half* of new claims to the full service receive an advance.[15] That might mean people are getting some cash quicker, but it is hard to think it a success for a new streamlined and simple system to bake in arrears for those who need help the most from day one.

Dealing with this issue without dismantling the monthly entitlement period at the heart of UC is difficult to envisage. Adopting the Scottish approach to fortnightly payments provides a more frequent flow of funds, but does nothing to alter the initial six week wait, simply paying fortnightly payments from that point in arrears. The Northern Irish model has more advantages in this regard. It provides an advance three weeks into the first entitlement period, mimicking an initial fortnightly payment, which is then clawed back over the following six months.

Recommendation three: *faster payments for housing*

While the Northern Irish model is perhaps preferable to the Scottish proposal, it is no panacea. A more radical approach would instead tread on what has historically been considered sacred ground and treat different elements of the UC payment differently depending on what they are intended to pay for.

For many, the greatest problem with waiting six weeks for any support will be the threat of rent arrears. A faster commitment from DWP to pay housing costs (as in the current Housing Benefit system where payments are usually made within two weeks) would reassure landlords and go a long way to easing the broader six week issue. Smaller cash advances could simultaneously be available for the remaining elements of the UC claim, with their subsequent clawback creating fewer potential problems than might be the case with larger advances.

Making the rent

A connected, and similarly high profile, issue has been the build-up of rent arrears reported by social landlords. In large part, this problem reflects the six week wait, and in particular the extended delays beyond the six weeks discussed above, especially where recipients are moving into short-term accommodation. A mismatch in how quickly tenants have their claims processed and the length of time a tenant can fall behind in rental payments before being deemed as being in arrears (currently set to six weeks) has not helped.[16]

The process has been complicated in part by the higher level of evidence demanded from the DWP under UC to process support with housing costs. That stems from a move away from established relationships between local authorities (who deliver Housing Benefit) and social landlords towards a new interaction between the DWP and tenants. Given that the DWP has long known that UC would disturb past relationships, its failure to develop solutions to these problems any earlier is disappointing. But things do at least appear to be gradually improving. The DWP have been developing a landlords' portal that can be used to verify tenancy arrangements and speed up the processing of claims for social landlords. The plan is for more social landlords to join the portal as the roll-out of UC continues to build.

[15] DWP, *Universal Credit payment advances: May 2016 to July 2017*, October 2017

[16] See *Work and Pensions Select Committee Universal Credit Inquiry*

A further change in relation to housing support under UC comes in the form of the default position of making payments direct to tenants rather than landlords. Only where a tenant has fallen into arrears will housing support be paid to the landlord, but many would argue that this is akin to closing the stable door after the horse has bolted. There is no obvious reason – other than administrative efficiency – to pay rent direct to a landlord, and the absence of choice has sparked criticism. The DWP's trusted landlord scheme offers one way forward, with certain 'trusted' landlords given discretion to opt for direct payments if they believe their tenants to be at risk of arrears. That should help, but the simplest solution would be to allow tenants a free choice.

Recommendation four: *laying the foundations for efficient treatment of private renters*

To date, there has been very little interaction between UC and the private rented sector. But as increasing numbers of working families join UC, the number of PRS tenants will increase. 28 per cent of low to middle income families privately rent, more than double the proportion (around 11 per cent) in 2000-01.

Private renters are already more likely than renters in the social sector to deal with their rent payments themselves, and this means that they might find the production of evidence of their tenancy agreement and rental rates more straightforward. But the ease with which the system deals with these claims is yet to be tested at scale. It is important that the UC system makes provision for this group before they move on in quantity, and the DWP should widen the coverage of the landlord's portal to include private landlords too.

There are more implementation challenges around the corner

It is disapointing to see entirely predictable issues with the design of UC flare up when those issues were pointed out by many in the early years of UC policy design.[17] Yet the problems that have so far been profiled are likely to be just the tip of the iceberg. Coverage is after all still at less than 10 per cent of the eventual caseload. The system seems to be improving, but it still deals primarily with relatively simple cases. Only 15 per cent of claims between May and June 2017 were from families with children, their share of the overall UC caseload will be much larger.[18]

For some of these cases, other elements of the design of UC are likely to come to the fore in the coming months. Once more, it is the rigid application of monthly assessment periods that looks set to place a compliance burden on recipients and so create the potential for some new groups to find themselves struggling with the system.

Recommendation five: *reporting flexibility for the self-employed*

How the self-employed interact with UC represents another large break with the past. Under the current system, such workers report their income on an annual-and-in-arrears basis – in line with how the tax system treats them. Under UC, they are instead expected to report their income on a monthly real-time basis. Once again, the burden of fitting in with the monthly operation of the UC system rests with the claimant. In truth, there is a good case for reform of the tax system for self-employed people. But until that happens it is illogical to treat their income differently under UC.

The problem of this approach extends beyond mere hassle. That's due to its interaction with the new Minimum Income Floor (MIF) policy that self-employed claimants will also be subject to. The MIF acts as a cap on UC entitlement in months when an individual's reported

[17] For example see various responses to regulations from the Social Security Advisory Committee; evidence submitted to the Work and Pension Select Committee; research by the Women's budget Group, Citizens Advice and Child Poverty Action Group.

[18] DWP, *Universal Credit Waiting Days: May and June 2017*, September 2017

self-employment income drops below the equivalent of a full-time employee job on the minimum wage. It is designed to prevent deliberate underreporting of income to boost UC entitlement.

Yet, as we've set out before,[19] the interaction of monthly reporting and the MIF can lead to a self-employed person being worse off than an employee with precisely the same annual earnings, simply because of the pattern of their earnings. While an employee is likely to have a relatively stable level of earnings from month to month, the self-employed can have large variation depending on when they invest in new stock or on seasonal demand for their goods and services. They might therefore fall foul of the MIF in some lean months, without ever receiving any corresponding 'overpayment' in months when their incomes are higher.

As currently structured, the MIF is more than a fraud reducing device; it is an inequitable measure for making savings too. The DWP estimates that the MIF will save £1.5 billion a year in 2021-22. Yet our best estimate is that of the 600,000 self-employed entitled to UC, 60 per cent report that their self-employed income in the last week are below the MIF. However, this takes no account of how their income will vary *across the year*. Recent DWP research shows that the vast majority of self-employed on tax credits have varying monthly income.[20] That means a portion of those savings come from monthly variation rather than consistently low earnings. The current design of the MIF therefore leads to an outcome that goes against the original aim of equity between employees and the self-employed.

To overcome the problem, the DWP should simplify the system by allowing the self-employed to report their income based on an annual projection of their income for the coming year (in line with the tax system). As and when wider tax reform for the self-employed is introduced, the UC system can change to reflect it.

The MIF should also be applied on an annual basis. Such an approach would better target people seeking to consistently underreport income, remove inherent unfairness in its operation and provide a trigger to ensure poorly performing businesses are offered practical support and direction.

Recommendation six: *rethinking the design of childcare support*

A further area of complexity looming on the horizon is how UC provides support with childcare costs. While the level of support with these costs is in large part more generous than the tax credit system (85 per cent of costs will be covered instead of 70 per cent in Working Tax Credit), accessing that support is harder.

Once more, the issue revolves around a rigid adherence to the monthly process, this time requiring parents to claim childcare costs monthly and in respect of childcare already paid for. This raises two issues.

First, there is the familiar problem of matching monthly reporting to real life. The weekly cap of support that can be claimed under UC is equivalent to the tax credit system (£175 for one child, £300 for two), but there is reduced flexibility. Under the current system, parents can make claims based on an annual average (reflecting the volatility of childcare needs over the course of a year). Under UC, that support is limited to the month of claim. Moreover, if parents fail to register costs in a month they lose that entitlement.

The second issue relates to the fact that parents are expected to find the funds to pay for their childcare *before* claiming back the 85 per cent UC will cover. A typical week of part-time childcare costs for a two year old is £112, representing a sizeable outlay when we note that a month's income

[19] D Finch, *Making the most of UC: Final report of the Resolution Foundation review of Universal Credit*, Resolution Foundation, June 2015

[20] T TU, A Bollen & S Pannell, *Self-employment Working Tax Credits Claimant Survey and Qualitative Follow-up Research*, DWP, September 2017

for a single parent working full-time on the minimum wage is just £255 per week after tax.

To try and address this challenge DWP allows advance payments of childcare. This is a welcome option within the current approach but relies on accurate forecasting of the parents' work patterns in subsequent months – a potential recipe for user and system error.

This set of rules stand in stark contrast to the compliance regime of Tax Free Childcare (TFC), the new scheme offering support for all parents other than those on tax credits or UC. Under TFC, a parent simply needs to show every quarter that they are earning above £50 a week on average. The matched support provided by the government is made at the time that parents make their own payment so, although TFC is less generous than to UC, by providing only a 20 per cent top up, the support is received immediately. Payments are then only released to registered childcare providers to avoid the risk of fraud.

To truly meet the needs of parents, UC could learn much from the TFC scheme. Fortuitously, this is also a part of the UC IT system that remains to be implemented. So, before large numbers start using this part of UC, compliance requirements should be reduced, and payments should be matched with government support, then made direct to providers, rather than in arrears with parents paying out first.

Recommendation seven: *ending uncertainty around free school meal eligibility*

The final large scale outstanding policy issue yet to bite relates to free school meal (FSM) entitlement. Historically, FSMs have been pegged to the receipt of out-of-work benefits, raising a clear challenge for a new welfare system which deliberately tries to blur the distinction between being in- and out-of-work. As well as this clear trigger point for entitlement, the current system also provides an opportunity to account for the loss of the value of FSMs at the existing 'cliff-edge'. Once the Working Tax Credit hours requirement (16 for a single parent, 24 for a couple) is met, recipients receive additional entitlement. That income boost is enough to compensate parents for the loss of FSMs (worth around £11 a week per school-aged child in term-time).

No such mechanism exists in UC. Indeed, by wanting to ensure that every additional hour of work pays, UC can't countenance any cliff-edges in support. So far, no clear policy has emerged on how entitlement to FSM will be determined in the long term. PQ responses have suggested that an earnings threshold will, at some point, be announced, with parents needing to earn below this in order to be entitled. As an interim measure, all families with children receiving UC are currently entitled to receive FSMs. If the situation does not change, the cost to government of this extension of FSMs could reach around £0.6 billion a year.[21]

That may be an acceptable cost for avoiding the introduction of additional complexity. But given the constrained budgets UC finds itself operating under, it is worth pointing out that such resources could be better targeted at the lowest income working families on UC. As we cover in the next section for instance, extra spend could instead be channelled to single parent work allowances.

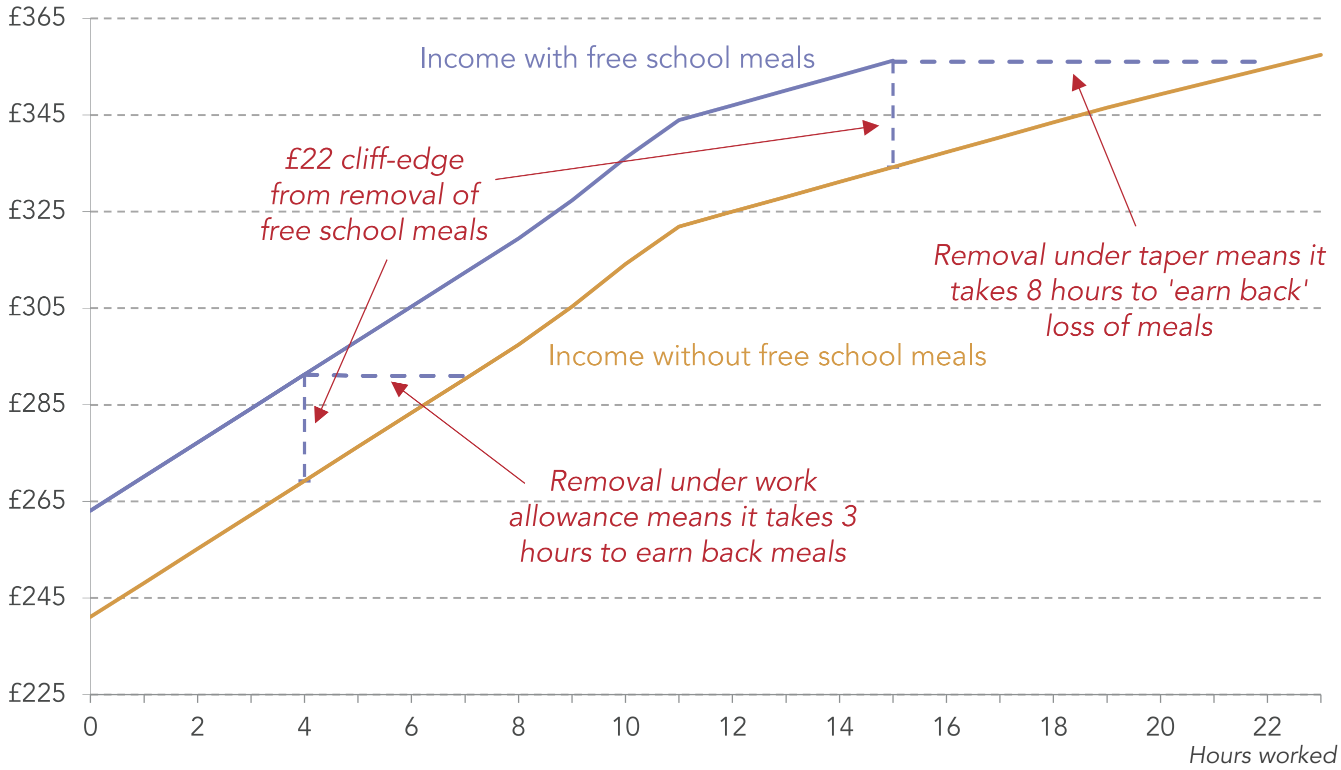
It's also the case that picking an earnings threshold is not as simple as it may sound. For example, if FSM eligibility were removed when families are earning the equivalent of 16 hours at the wage floor, then families would need to earn £30 a week more (per child) to compensate for the financial loss. That's because the 63 per cent taper applies at those hours. Alternatively, lowering the threshold to where the work allowance (and therefore no taper) applies would mean it takes a third of the additional pay to offset losses. In practice these losers may be little more

[21] We estimate a total 1.7 million children would be additionally entitled to Free school meals based on RF analysis using the ippr tax-benefit model and DFE, 2017, Schools, Pupils and their Characteristics: January 2017 - National Tables. Given a per meal cost of £2.30, a 38 week school term and a take-up rate of almost 90 per cent suggests the estimated additional cost of provision to be £0.6 billion a year.

than theoretical, because very few people with children work less than 16 hours, but it would represent a clear breach of the aim of making it always pay to work. Figure 4 sets out this dilemma, highlighting the cliff-edges that removing entitlement could create.

Figure 4: The impact of free school meal entitlement on net income

Net weekly income by hours of work



Source: Resolution Foundation analysis using RF microsimulation model

The importance of this very tangible benefit should not be underestimated – either in relation to work decisions or politically. Although no perfect solution exists, and in the absence of a consistent government policy towards free school meals in general, we believe it would be most sensible to remove entitlement at a low level of earnings where we would not expect anyone to be working in the first place, and where parents are still benefitting from the work allowance.

That would mean families can rapidly recoup the loss, and very few would be affected. Continued support for some exceptions, such as where disabled parents work short hours should also apply. Restoring work allowances (a topic we turn to in Section 4) would, though, greatly ease this situation.

A recommended approach to easing implementation

As the government plans to accelerate the pace of its roll-out of UC, so the risk of system processes and compliance requirements raising challenges looks set to increase. Such an outcome is neither desirable nor necessary.

There is still considerable development to go, with important parts of the new IT system yet to be built, but that is a situation that brings with it opportunity. The government should take the current faster roll-out period as a test of UC at scale, while taking the opportunity to review system design and outstanding policy issues so that it can get ahead of the curve in solving design flaws before they hit, rather than defending them after they have negatively affected UC recipients' lives.

The government can take relatively simple action in the case of the most pressing issue – the six week wait – while having time to put into place a system that better meets the needs of users. And it should do so before public demand for changes reaches a point at which the entire system is at threat or hasty reactive decisions bake in further complexity. A summary of our recommendations to ease the implementation and improve user interaction are set out in the box below.

i Box 2: Implementation recommendations

1. Remove the seven day wait for UC entitlement and strip down processing days to the minimum possible following the first month of entitlement.
2. Introduce faster payment, or at least faster assurance of payment of support with housing costs to landlords, for out-of-work families beginning a UC claim.
3. Allow recipients to opt for fortnightly payments and readily provide an advance of standard allowances in the first three weeks, in line with the suggested Northern Irish approach.
4. Allow tenants the freedom to choose direct payment of housing support to landlords, accelerate the implementation of the landlord's portal and trusted partner status and facilitate access to the private landlords to the landlord's portal.
5. Allow self-employed workers to report their income as a monthly average of their annual income and apply the MIF on annual basis.
6. Rethink the design of support with childcare costs to reduce the compliance burden, and match government support when parents pay providers, rather than them having to recouping out-of-pocket expenses.
7. End uncertainty around free school meal eligibility and introduce an earnings threshold at a low level of earnings.

The next section turns from issues affecting day-to-day interactions with the scheme and the ability of recipients to access their entitlements to consider the generosity of the new system for working families in comparison with the current tax credit system.

Section 3

A less generous system of support

The 'iron triangle' of welfare highlights how any system of support has to contend with three fundamental trade-offs: the adequacy of support for the lowest-income out-of-work families; the financial return from entering work or working more; and the overall cost of the system. In the absence of any significant increase in total funding, the rationalising and simplifying of the welfare system introduced under UC was therefore always likely to create a mix of gainers and losers.

However, a series of cuts to the generosity of support for working families since UC was first designed means that the number of losers is now set to be substantially higher than was originally anticipated. In steady state, UC will be around £3 billion a year less generous than the current tax credit system and will lead to an average loss of £625 a year for working families. Immediate cash losses may be prevented by the appliance of 'transitional protection' for existing cases that move directly from the current system onto UC. But such protection and how big losses for some families will be handled is yet to be enshrined in legislation, and gaining approval could prove to be the greatest challenge for implementation in the medium-term. A lack of political consensus means significant government concessions may be necessary.

Re-investing in support for working families could prevent such issues from arising. Alongside better meeting the needs of low to middle income families, such an approach would therefore make it more likely that full UC roll-out actually happens.

UC is now less generous than the system it replaces

The alignment of six different benefits and underlying eligibility rules in UC was almost certain to lead to a mix of gainers and losers. Complexity in a system often exists by way of preventing some hard cases falling through the cracks, so simplicity generally comes at a cost. Minimising losses from such major systemic change means either making the system much more generous or extensive forms of 'transitional protection' (guaranteeing continued access to existing, more generous, entitlement for those families already in the current system). Either approach requires additional funding.

However, UC is expected to cost £1.9 billion less a year by 2021-22 than the current tax credit system. That saving is predominantly driven by less generous support for working families and would be higher still – roughly £2.7 billion – if we also accounted for the £0.8 billion of transitional protection due to be paid that year. We can expect total steady state savings to be greater still, given not all cases will have been moved onto the new scheme by that point. Although the extent of gains or losses vary across family types and their precise circumstances, once in steady state we expect working families to be, on average, £625 a year worse off.

That's especially worrying given the weak performance of pay recorded in recent years – and set to persist for some time yet. The UK is on course to experience the worst decade of real pay growth since Napoleonic times,[22] and the Office for Budget Responsibility looks likely to significantly

[22] M Whittaker, et al, *Are we nearly there yet? Spring Budget 2017 and the 15 year squeeze on family and public finances*, Resolution Foundation, March 2017

downgrade its medium-term wage growth assumptions at next month's Budget.[23] Reducing support for lower paid families when their other key source of income is under pressure will only deepen the squeeze on their living standards. Indeed, taking a wider view, we anticipate the combination of weak pay growth and the total £14 billion a year of cuts to working age benefits to lead, by 2020-21, to an increase in inequality not seen since Margaret Thatcher was in power.[24]

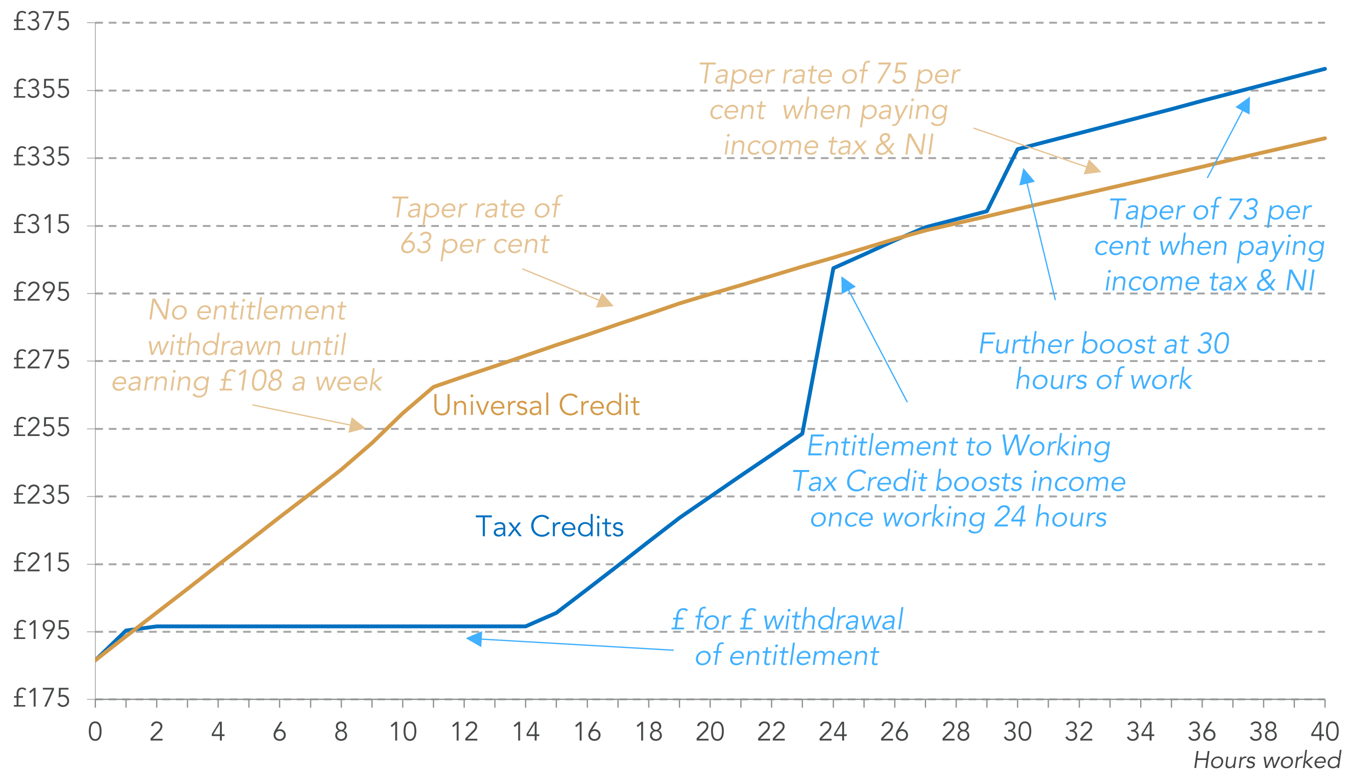
This all flies in the face of one original aim of UC: reducing poverty. Already two-thirds (68 per cent) of children in poverty live in households in which at least one adult works.[25] By reducing support for working families with children, UC is likely to drive rising, not falling, child poverty.

The pattern of gains and losses varies by family circumstance

At the family level, the precise impact of UC depends of course on the exact circumstances of the household. In this section, unless otherwise mentioned, we consider only the differences in support offered by the current tax credit system and UC. We *do not* assess the impact of the benefit freeze or the limiting of support to families with more than two children. To help explain the pattern of gains and losses, Figure 5 sets out the net income for a couple with one child as the sole earner in the couple increases their hours of work.

Figure 5: Simplification of in-work support and the impact on net income

Weekly net income for couple with one child, based on a single earner receiving the minimum wage: 2020, £ cash



Source: Resolution Foundation analysis using the RF microsimulation model

[23] OBR, *Forecast evaluation report - October 2017*

[24] A Corlett & S Clarke, *Living Standards 2017: The past, present and possible future of UK incomes*, Resolution Foundation, February 2017

[25] DWP, *Households Below Average Income: 1994-95 to 2015-16*, March 2017

There are a number of factors worth highlighting:

- First, the level of support when out-of-work is very similar (there are some small differences due to UC allowances being on a monthly basis and uprated under different rounding rules). This would not be the case if the parents were under-25, with support for younger parents being £15 per week lower in UC whether working or not.
- Second, UC is more generous at low hours of work. The current system withdraws entitlement on a pound-for-pound basis at very low levels of earnings (after a small disregard) and then provides a boost once working 16 hours. In UC the work allowance acts as a more generous disregard, with entitlement only withdrawn beyond a given earnings level. In this example that equates to around 10 hours a week of work.
- Third, UC can be more or less generous than the current system beyond 16 hours of work. This is due to different taper rates. UC is withdrawn at 63 per cent on net earnings, rising to an effective tax rate of 75 per cent once tax and NI are paid. Not shown here is that under the current system tax credits and Housing Benefit are withdrawn at a combined rate of 79 percent on gross earnings, rising to an overall 91 per cent when also paying income tax.
- Finally, Working Tax Credit provides an additional boost when the sole earner in the couple works at least 30 hours.[26]

It is also worth pointing out that, of course, UC does not cover all forms of support available to working age families. In particular Council Tax Support was localised rather than brought into a single system. In a further policy twist, local areas have been given freedom to vary the eligibility rules of their schemes at the same time as UC seeks to align and apply one set of entitlement rules across different benefits. How those schemes interact with UC will also affect the pattern of gains and losses, and we try to account for this in the analysis below.[27]

We can consider the number and type of gainers and losers, as well as the size of those shifts in income, by using a microsimulation model applying different tax and benefit systems to household survey data, identifying the key characteristics that determine entitlement. We model a baseline scenario that corresponds to the world in 2017-18 in which the current tax credit system is fully in place, and compare that to a scenario in which UC is fully in place. In both scenarios, we assume that cuts to family support (the removal of the family element and limiting of support for two children) have been fully implemented: this is to isolate the impact of the change in support for working families in the steady state system.

Table 1 sets out in detail the impact of UC as currently designed compared to the current tax credit system on working families. It shows that:

- 2.2 million families are expected to gain under UC, with an average increase in income of £41 a week.
- 3.2 million families are expected to be worse off under UC, with an average loss of £48 a week. 600,000 of those losers, mostly couple parent families, will no longer be entitled to benefits under UC.
- The net impact on couple parent families is broadly neutral. Slightly fewer couple parent families will gain (1.0 million) than lose (1.1 million). The average gain of £54 a week compares to an average loss of £53 a week.
- That is not the case for single parents. They will overall lose by an average of £26 a week but almost twice as will lose (0.7 million) as gain (0.4 million), and lose by almost twice as much on average (many losing £57 a week compared to gains of £31 a week).

[26] Further differences exist if we also account for support with childcare costs, which we consider in more detail in the final section of this report.

[27] There are various different rules and tapers now applied in local areas. For means of simplicity and because CTS is not the focus of this report we assume a 20% taper applies in both CTS and CTB systems. For more detailed information see www.counciltaxsupport.org.

Table 1: Change in income for different working family types for families entitled to the current system or UC, 2017-18

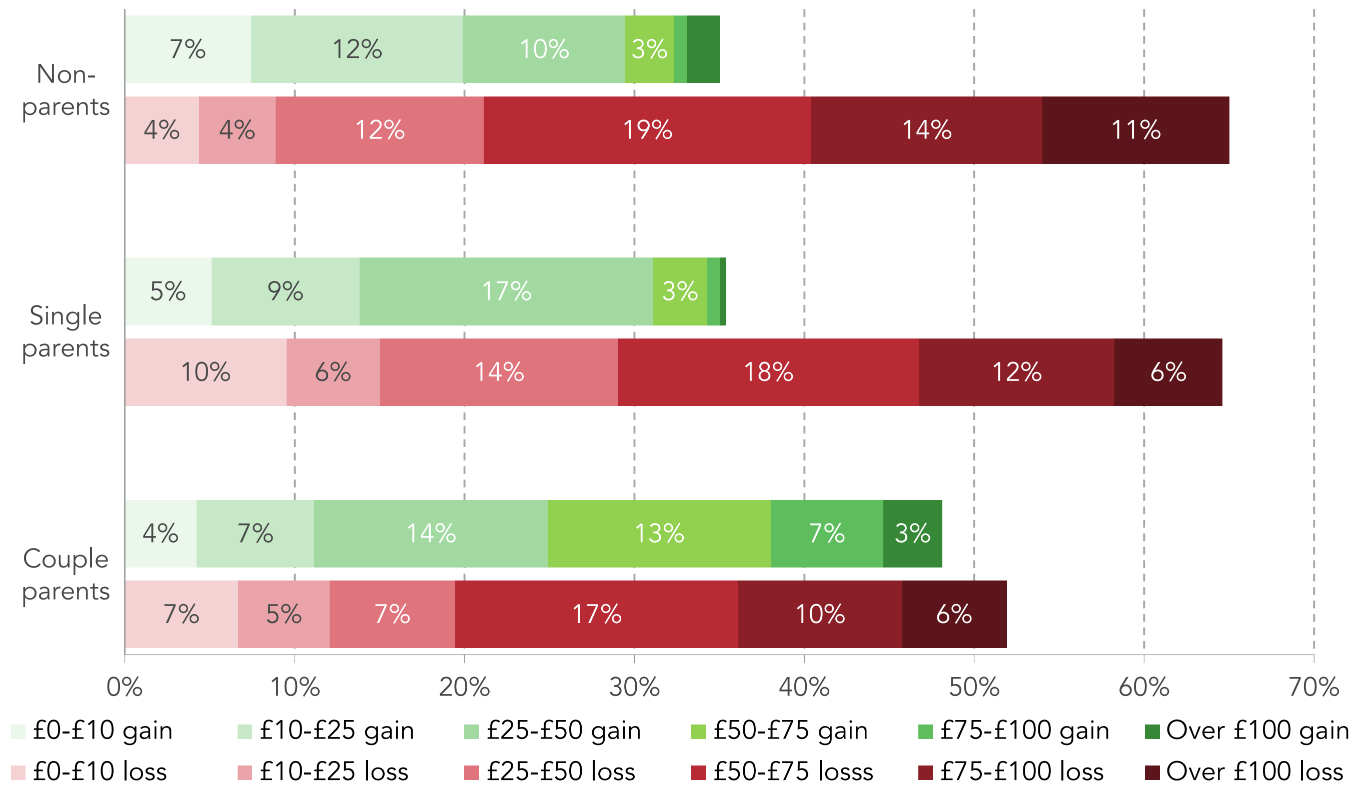
	Couple parents	Single parents	Non-parents	All
Change in generosity for population entitled in either the current system or UC (millions)				
Gainers	1.0 m	0.4 m	0.8 m	2.2 m
Losers	1.1 m	0.7 m	1.4 m	3.2 m
of which:				
receive UC	0.6 m	0.6 m	0.4 m	1.6 m
do not receive UC	0.4 m	0.1 m	1.0 m	1.6 m
Total population entitled to UC	1.6 m	0.9 m	1.2 m	3.7 m
Change in entitlement (£ per week)				
Mean Gain	£54	£31	£30	£41
Mean Loss	-£53	-£57	-£40	-£48
of which:				
receive UC	-£55	-£57	-£49	-£54
do not receive UC	-£50	-£56	-£37	-£42
Net change in income	-£2	-£26	-£14	-£12

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

Notes Estimates are on an entitlement basis, there is no adjustment for take-up. We would broadly expect take-up assumptions to have a significant effect only on the number of working families without children gaining or losing with the entitled population of 1.2 million falling to around 0.7 million recipients.

Even within the different groups of gainers and losers, there are a wide range of outcomes. Figure 6 sets out the distribution of gains and losses across couple parents, single parents and families without children. It is not the case that change will be relatively small for most with a few big gainers or losers distorting the average. The most common gains and losses for families will fall somewhere between a sizeable £25 and £75 a week. For some, the gains or losses will exceed £100 a week.

Figure 6: Distribution of gains and losses for different family types entitled to the current system or UC, 2017-18



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

UC provides welcome additional support to renters but the shift appears to have little to do with long term strategy

A further lens through which to consider the difference in entitlement between UC and the current system of benefits and tax credits is whether households rent or not. Their work allowances are different (lower for renters than homeowners), but the taper rate applied to renters in UC is significantly lower than that which arises from the combination of Housing Benefit and Tax Credits in the current system. Together, that means that withdrawal of entitlement from renters starts sooner than in the tax credit system but it is withdrawn more slowly.

Table 2 sets out the average gains and losses by family type and tenure. It shows that, as we might expect, renters are far more likely than home owners to gain. Of the total 3.2 million losers, 2.5 million are homeowners. Of the 2.2 million gainers, 1.6 million are renters.

Table 2: Change in income for different family types by tenure for families entitled to the current system or UC, 2017-18

	Couple parents	Single parents	Non-parents	All
Change in generosity for population entitled in either the current system or UC (millions)				
Gainers				
renters	0.8 m	0.3 m	0.4 m	1.6 m
home-owners	0.2 m	0.0 m	0.4 m	0.6 m
Losers				
renters	0.2 m	0.2 m	0.2 m	0.7 m
home-owners	0.8 m	0.5 m	1.2 m	2.5 m
Change in entitlement (£ per week)				
Mean Gain				
renters	£57	£30	£32	£45
home-owners	£35	£37	£28	£30
Mean Loss				
renters	-£63	-£53	-£54	-£56
home-owners	-£51	-£59	-£6	-£31

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

The number of home owning low to middle income families has been falling steadily, and private renters have faced higher housing costs as a share of their income than owners have on average in recent decades. With that in mind, the fact that renters are more likely than home owners to gain under UC might be considered a positive development. However, it would appear that this change in part is the consequence of making significant savings from UC, with cuts in generosity that hit home owners in particular, rather than any strategic policy design. Indeed earlier more generous versions of the policy produced the opposite result with greater gains for homeowners.

There is a potential long term issue raised by this shifting balance of resources towards renters. If private rents rise as they have historically, or the balance of the caseload moves further owards renters, overall working age welfare spend could come under pressure. Alternatively if government reacts by maintaining the long term link between the level of rent support with CPI, or further restricting the extent to which a person's rent is covered as it has done in recent year with the LHA freeze, it will simply make those families facing faster rent increases poorer.

The growing cost of Housing Benefit has placed significant pressure on working-age welfare spend over the last two decades, growing from £10.7 billion in 1997-98 to £17.9 billion in 2017-18. It is a consequence of continued policy failure to provide affordable housing. Future policy design must make clear and strategic decisions to deal with the cost of housing in a way that, first, does not compromise other goals of the benefit system and, second, links to wider policy to provide affordable housing.

Transitional protection

The DWP's gradual approach to UC roll-out is much more sensible than a big bang approach that could risk leaving millions with no or reduced income if the new scheme fails, as happened to many in the first months of the current tax credits in 2003. But a slow roll-out brings its own challenges. UC is going live Jobcentre by Jobcentre. Each has its own district, which does not necessarily align with other local boundaries such as local authorities or parliamentary constituencies. Under our almost entirely UK-wide social security system, families with very similar characteristics living either side of such a boundary could find themselves in a different financial situation purely due to the benefit system they are entitled to.

This postcode lottery of gainers and losers was always somewhat inevitable but has become a much bigger risk as cuts mean UC will be much less generous than the current tax credit system. There will be a greater number of losers, losing more from the postcode lottery.

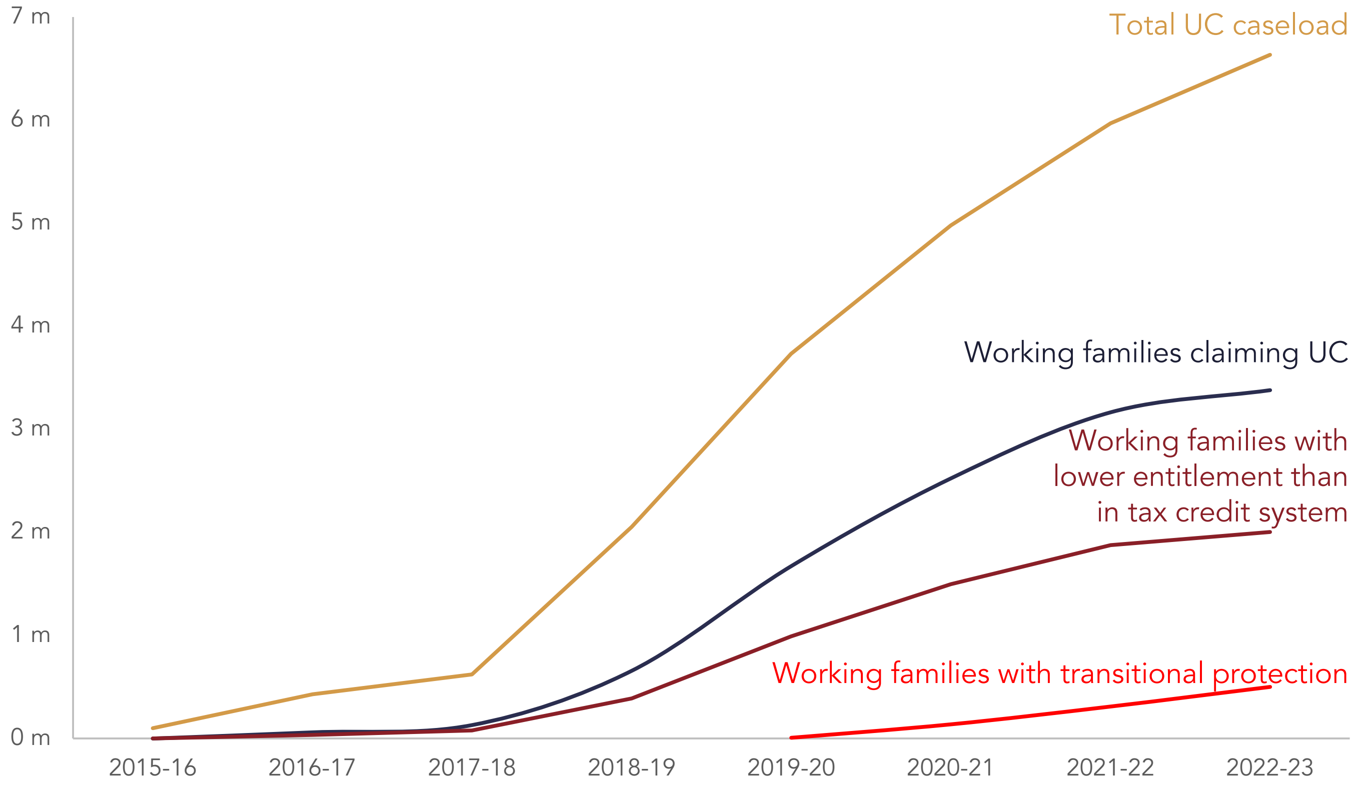
To tackle the problem of creating actual cash losers, a system of Transitional Protection has been planned since the time of the Welfare Reform Act 2012. This is a standard policy response when governments look to avoid losers from a benefit reform.

Transitional Protection will apply when existing tax credit cases are actively moved to UC (the "managed migration" of existing cases currently planned for Autumn 2019). It excludes those who may experience a natural change in circumstance, because of the birth of a new child, a change in household composition, or a change in address.

If these migrated cases have lower entitlement under UC than they currently enjoy they will be paid a cash top-up to account for the difference. That top-up will subsequently reduce if UC entitlement declines in reaction to, for example, a rise in the family's net earnings. A significant change in circumstances would mean they lose the cash top-up entirely. Figure 7 provides our best estimate of the number of working families set to have lower entitlement under UC than in the current tax credit system, and the share expected to receive transitional protection. We anticipate that less than a fifth of families with lower entitlement will be in receipt of such compensation.

Figure 7: Families benefiting from Transitional Protection during UC roll-out

Millions of families



Source: RF analysis using OBR *Economic and Fiscal Outlook, March 2017*, HMRC, *Tax Credit statistics*, DWP, *WPLS* and ippr tax-benefit model

So far so complicated, but there is also a hidden issue that is likely to become a centre of debate in Westminster. Those precise changes in circumstance that will apply to determine whether Transitional Protection ends – such as having a new child, moving home, separation or new family formation, or losing a job – have not been formally set out. At some point, they will need to be agreed by both Houses of Parliament through new secondary regulations that can be subject to a vote. Because those rules will need to be in place before the managed migration begins in Summer 2019, agreement will be needed by the end of Spring 2019.

The Government's small effective majority means agreeeing the nature of this transitional protection may not be straightforward. There is still time before this controversy erupts to tackle the issue by restoring parity of in-work support with the tax credit system as part of an urgent review of the design of UC.

Restoring parity with the tax credit system

UC has always had the goal of reducing poverty at its heart, and the Prime Minister has repeatedly set out her intentions to provide greater support for low and middle income working families – the 'just about managing' – who are struggling to get by. Yet it is precisely those families set to bear the brunt of cuts to UC.

The government should make increasing the generosity of UC for working families a priority in the upcoming Autumn Budget. With an imminent need to have legislation dealing with potential cash losers approved, acting now to boost overall generosity – and so reduce the number of losers and the scale of their loss – could prevent a future parliamentary stand-off.

Alongside the Budget, the upcoming January break in the roll-out of UC provides an opportunity for re-launch that goes beyond fixing the design of system processes, as discussed in the previous section. The government must ensure the system provides the support needed by lower income working families to face ongoing challenges to living standards.

UC is set to be less generous than the current system, but the new scheme is not just about the generosity of cash transfers. The shape of support also matters for the strength of financial incentive to work it creates. Re-investment in the support UC provides to working families is essential, but it must be targeted effectively at those who are in most need of support and those who are most responsive to such financial incentives. We discuss how that re-investment should take place in Sections 4 and 5, beginning next with a focus on the financial incentives created for people moving into work in the first instance.

i Box 3: Funding recommendations

8. Re-invest in in-work support to ensure a minimum of parity of overall generosity with the tax credit system, the exact form of that support should maximise work incentives for those most likely to respond and in need of support.

Section 4

Moving into work

A key aim in designing UC was to strengthen incentives to work, with a core focus on eradicating worklessness. We discuss the need for a shift in design to tackling low pay and progression in the next section, but UC must first ensure that it at a minimum maintains the improved incentives to enter work created by the tax credit system. Incentives that have supported a significant rise in single parent employment.

Work allowances will improve incentives to work at short hours, helpful for people unable to meet the current minimum demand of working 16 hours a week. But the £3 billion of cuts to work allowances risk single parents having a reduced incentive to work. The lack of a work allowance at all means second earners – who keep only 37 per cent of their initial earnings – may find it no longer makes financial sense to work. To build a strong platform for people to enter work before they look to progress, in-work support needs reinvestment. That means boosting work allowances for single parents and introducing them for second earners with children.

Supporting the modern labour market

UC was explicitly designed to strengthen financial incentives to work, for people both moving into work and those progressing when already in work. Encouraging more people into work and enabling people to earn more to boost their incomes, not simply increasing transfers to low paid parents, was also part of the overall poverty reduction strategy.

Part of that strengthening of financial incentives to work or earn more is meant to come from having a single, simpler to understand system, making it easier for people to understand the pay-off from entering work, or from earning more. But although UC is simpler than the set of benefits and tax credits that it replaces, its interactions with the tax system and other parts of the working age benefit system (such as Council Tax Support) means calculating entitlement will still be by no means simple.

When initially designed, in the aftermath of the financial crisis, financial incentives were purposely focused on reducing worklessness: that is, the policy aim was to ensure at least one person in a household is in work. That imperative is reflected in the more generous treatment of couples with children, who are more likely to gain under UC, and are therefore better off in work than in the tax credit system.

Such an approach may have made some sense at the time, when unemployment was high in the wake of the financial crisis. But that is no longer the case. Employment has reached a record high, and the share of workless households has fallen to a record low.

The big challenge facing the labour market of the 21st Century is not worklessness, it is boosting the income of families already in work.

UC must meet the needs of the labour market of the future, not one of the past. That means recalibrating it to focus on improving pay progression. But first, the design of UC must ensure that it does not throw away the improvements brought about by the tax credits system, in helping to boost employment. As it stands, the large cuts to in-work support that are now a feature of UC will put even those gains at risk.

Making it pay to start work

Looking across the labour market as a whole, financial incentives to enter work have strengthened since the financial crisis. This is due to both a higher wage floor (via the National Living Wage and a less generous out-of-work benefit system (driven primarily by the four-year freeze in most working-age benefits).

However, some groups have proved to be particular responsive to the relative shape and size of financial incentives, in particular single parents and women in couples – often the primary carers of children. For them, the incentive structure created by UC matters not just for the decision to work at all, but the initial pattern of work chosen.

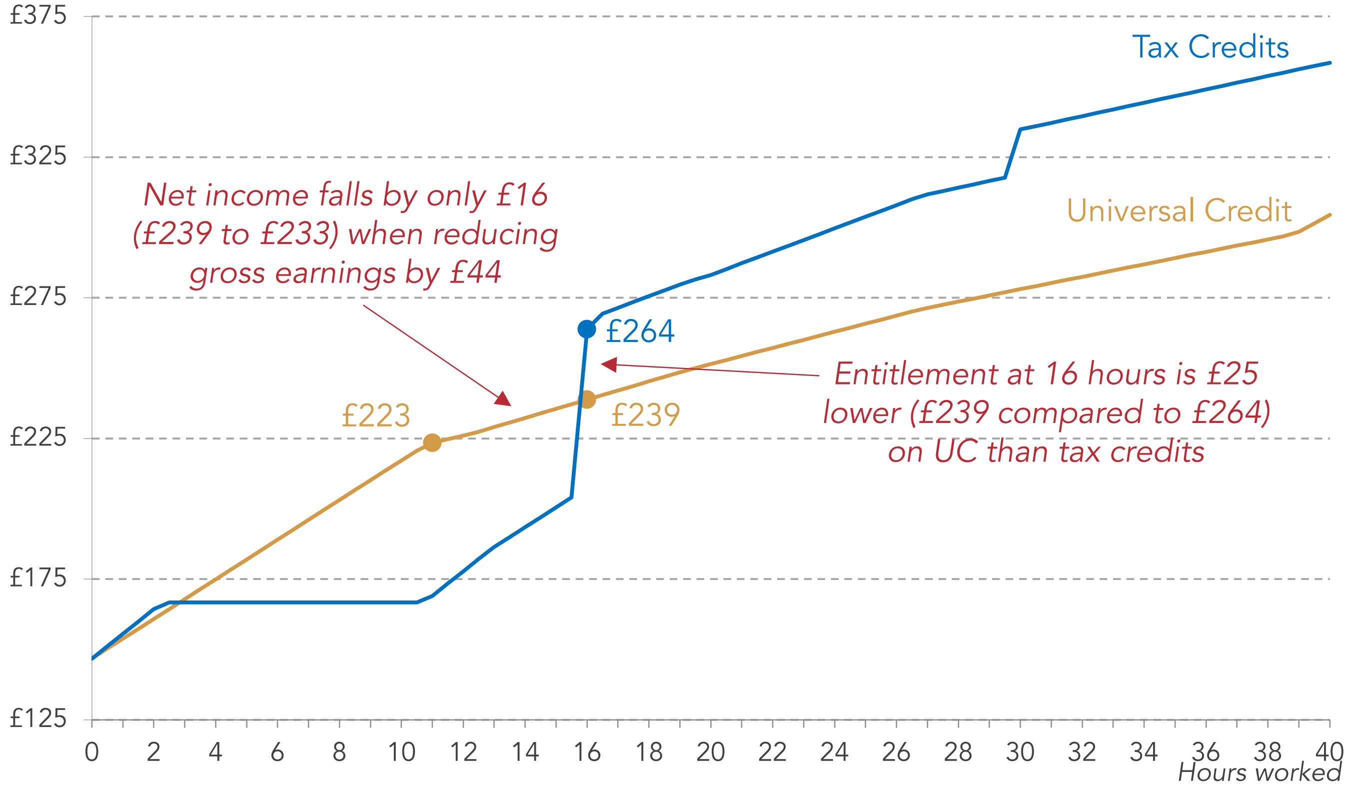
In UC, the tools that determine financial incentives are the work allowance and taper. The work allowance is effectively a disregard: UC entitlement for working families is reduced only once earnings exceed the level of the work allowance. The taper of 63 per cent is then applied: UC entitlement is reduced by 63p for every £1 of net earnings above the threshold. Once income tax is paid, that withdrawal rate increases to 75p in the £1, compared to 73p in the £1 in the current tax credit system or 91p with Housing Benefit.

Although the taper can primarily be thought of as the incentive to progress or earn more, how it interacts with the work allowance is also important. Together, they determine the size of the financial return from entering work, and the pattern of work that is most appealing.

Figure 8 helps to illustrate how the design of UC shapes the decision to enter work. It shows the net income at different hours worked for a single parent homeowner earning at the wage floor.

Figure 8: Incentives to move into work for a single parent homeowner

Net income with increasing hours of work: Single parent, homeowner, one child; £ per week, 2017-18



Source: Resolution Foundation analysis using the RF microsimulation model

Three broad conclusions stand out:

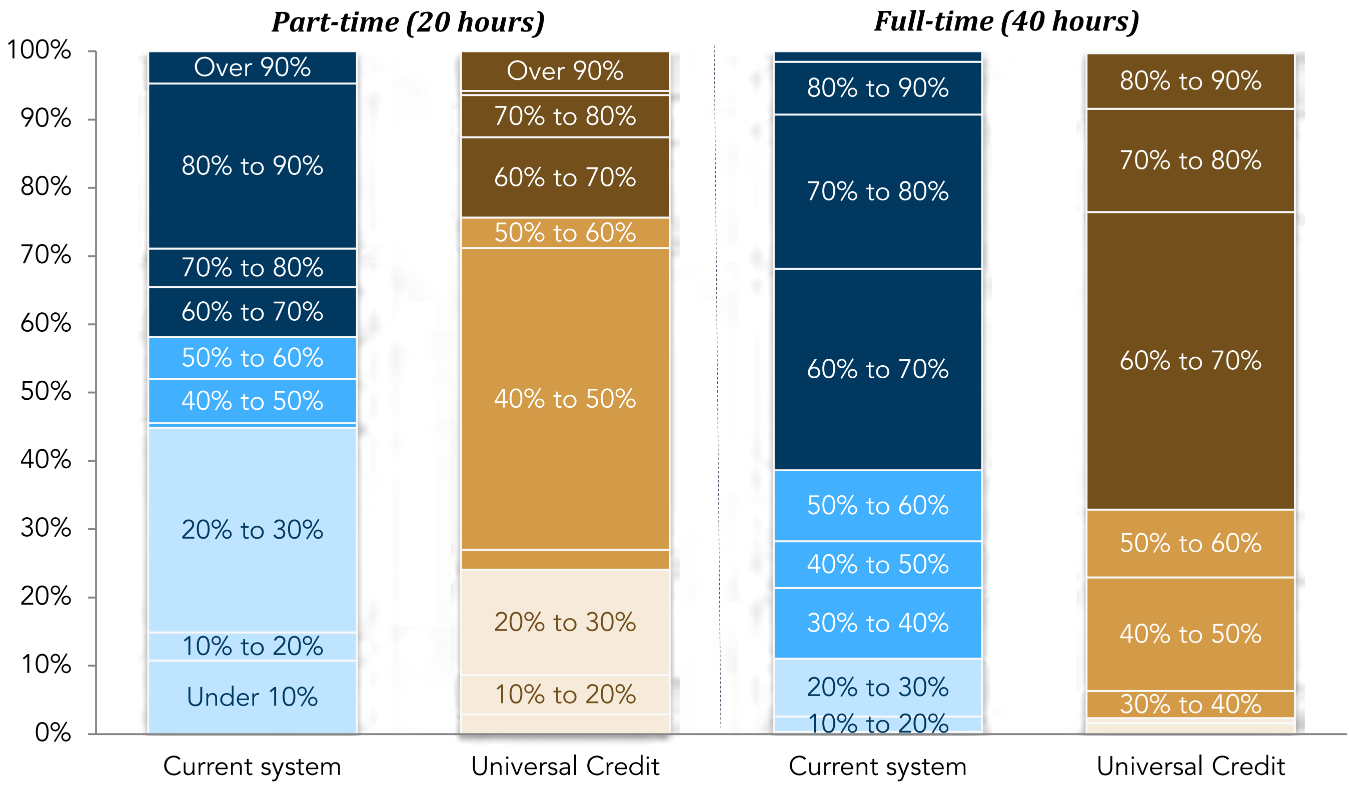
- First, the work allowance improves the incentive to enter work at very low levels of hours or earnings. While few people actually work such low hours currently, this shift in support could be of particular help to people with the greatest barriers to working. For these groups, such as disabled people or parents of very young children, making the jump to 16 hours work a week – the target in Working Tax Credit – may be too great.
- Second, once an individual moves beyond 16 hours of work a week UC is less generous than the tax credit system. The financial return from entering work at beyond low hours of work is therefore reduced.
- Finally, the combination of a low work allowance a and relatively high taper rate of 63 per cent runs the risk of encouraging single parents to reduce their working patterns towards a range of 5 to 10 hours a week at the wage floor. This is the 'sweet spot' before their earnings start to eat into their UC entitlement and could mean they become trapped at low levels of pay.

The analysis above considers a single hypothetical example. We can instead quantify the change in incentives for a population who are currently out of work, by calculating the Participation Tax Rate (PTR) for members of that group. The PTR measures the increase in net income (accounting for tax and benefits) as a share of gross earnings as somebody enters work. A PTR of 100 per cent would mean a person is financially no better off from working, whereas a PTR of 0 per cent means their income increases by the entirety of what they earn – they have paid no tax and had no benefits withdrawn. We use household survey data to estimate the PTR by family type for people moving into work under either the current tax credit system or UC.

Beginning with single parents, Figure 9 compares the distribution of PTRs when entering work at part-time hours (20 hours) or full-time hours (40 hours) on the wage floor under UC and the tax credit system.

Figure 9: Distribution of Participation Tax Rates for out-of-work single parents

Proportion of out-of-work single parents



Source: Resolution Foundation analysis using ippr tax-benefit model

At part-time hours, we see that:

» The very highest PTRs have been capped, with less than a quarter of single parents having a PTR above 60 per cent in UC, compared to two-fifths in the tax credit system.

» The share of single parents with a low PTR of under 30 per cent has fallen from almost half (45 per cent) to almost a quarter.

» The proportion of single parents keeping up to 55 per cent of their earnings has increased from just over half to almost three-quarters.

At full-time hours:

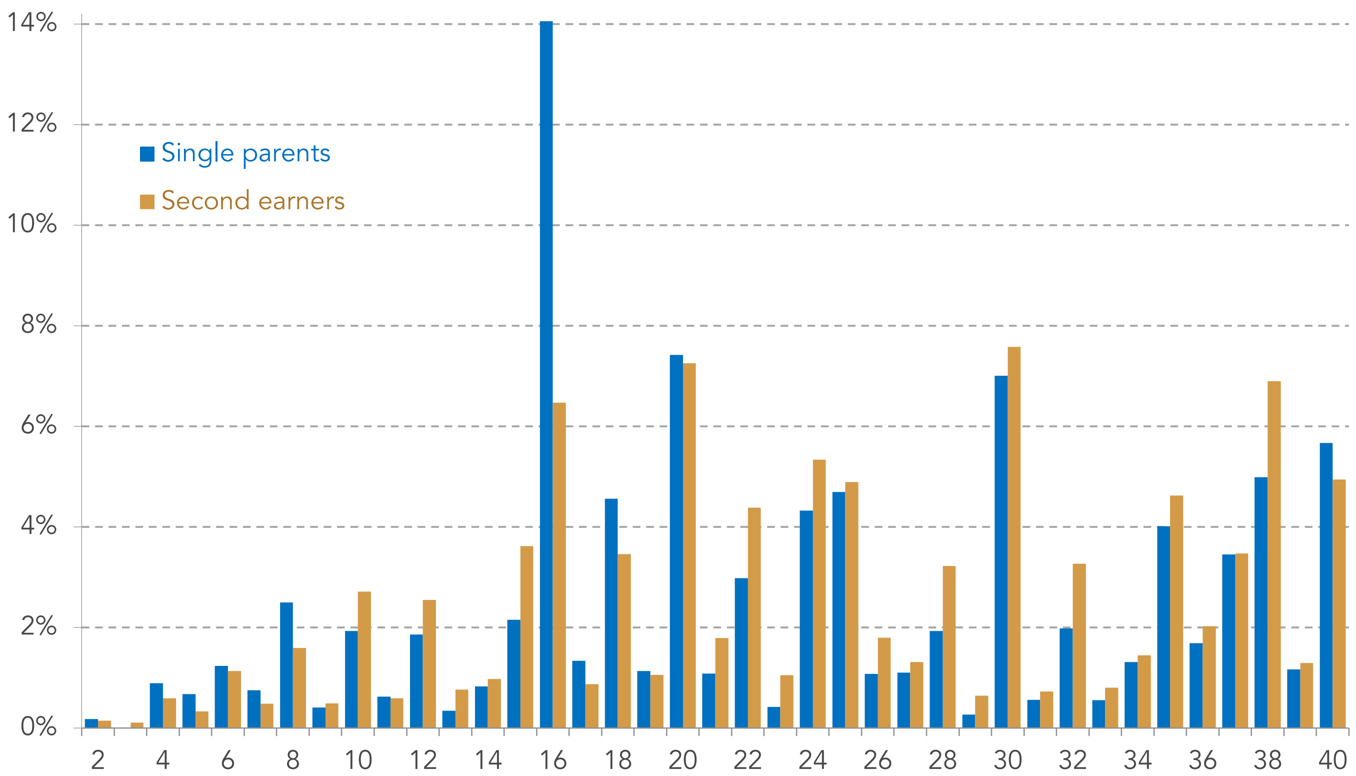
» Around the same proportion of single parents, over three-fifths, would keep less than 40 per cent of what they earn in either scheme – though fewer will keep only 30 per cent with the very highest PTRs being capped.

» The very lowest PTRs have all but been removed in UC, with a greater share having a PTR of between 40 to 50 per cent than under the current tax credit system.

The strength of these incentives matter. Single parents are perhaps the clearest example of a group which has altered its pattern of work in response to the financial incentives of the tax credit system. Figure 10 shows how currently the most prominent number of hours worked by single parents is precisely 16 hours a week – the minimum requirement of the tax credit system. This pattern of work stands in contrast to other primary carers of children – namely the lower earning member of a couple with children (second earners).

Figure 10: Pattern of hours worked by single parents and second earners with children, 2016-17

Distribution of hours worked by parents earning less than the median



Source: Resolution Foundation analysis using ONS, *Labour Force Survey*

Notes: Usual hours worked, excluding unpaid overtime. Those earning less than the median of the overall hourly pay distribution. Second earners defined as the individual in each couple working the fewest hours.

Recommendation nine: *boosting work allowances to avoid undoing the good work of the tax credits system*

Assuming the responsiveness of single parents to the tax credit system is replicated under UC, we might expect significant numbers to not work or to adjust their working patterns to match the new 'sweet spot' at which the work allowance ends. This would mean many individuals lowering their hours of work down to around 5 to 10 hours at the minimum wage, where the PTR would be far lower. Large numbers of single parents would thus achieve lower income and therefore be more dependent than before on support from the state.

These outcomes would clearly fail to meet the aims of UC, with recipients working less and having lower incomes. To prevent this, the government should use the re-investment in in-work support recommended in Section 3 to boost work allowances of single parents to the equivalent of a minimum 15 hours a week at the wage floor. Doing so would cost £1.3 billion a year in steady state, preserve the strong incentive of the current tax credit system and remove the role of a significant fall in income for this group.

Recommendation ten: *boosting incomes by supporting dual earning households*

The other group historically shown to be sensitive to financial incentives are the second earners (including those not in work at all) in a couple with children. A key route by which couple households can boost their income when pay growth is weak and state support being squeezed is through both adults working. This was a particularly important part of income growth in the mid-2000s. But the financial incentive to do so is set to weaken under UC.

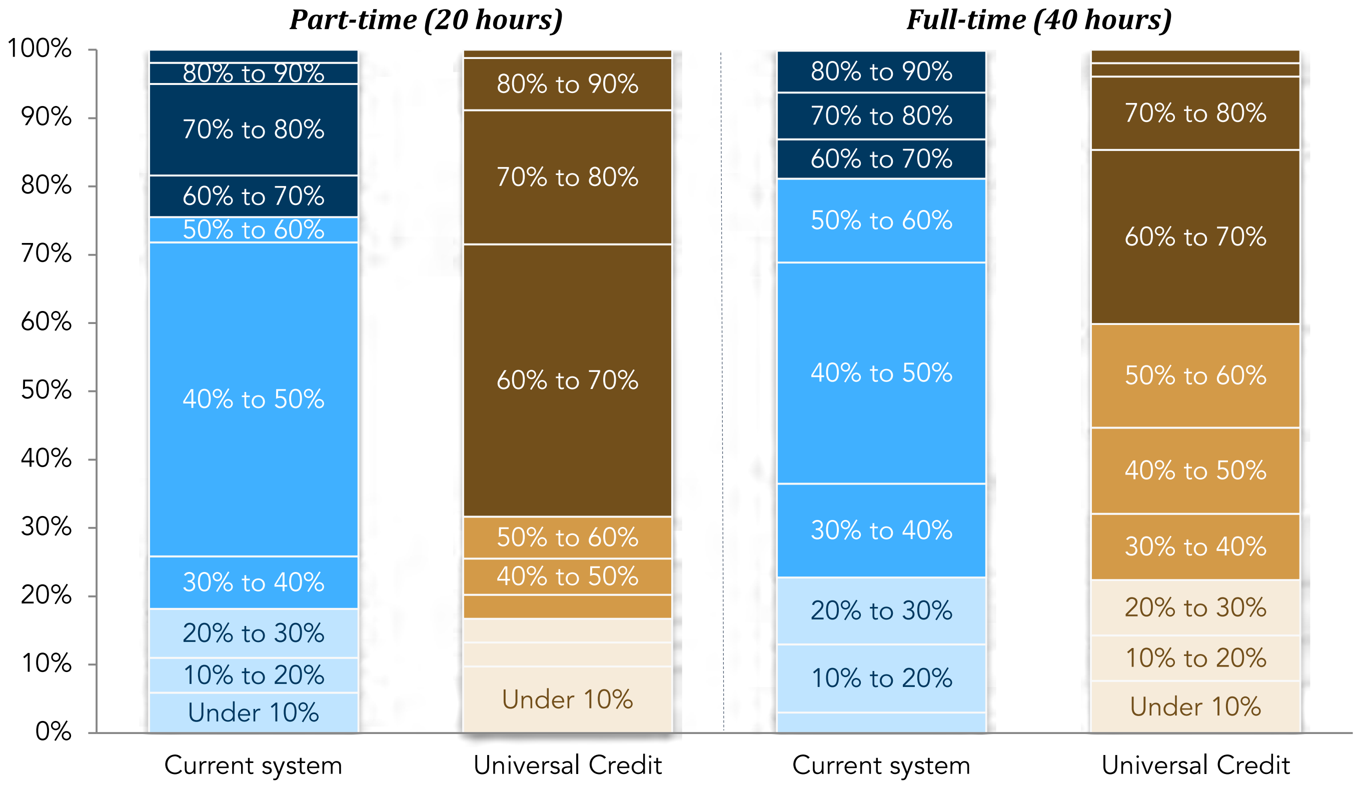
Traditionally, second earners primarily comprised mothers. However, an increasing number of fathers now work part-time: the number of low-paid men in couples with children working part-time has doubled, from 50,000-100,000, between 2002 and 2016. This is likely to reflect improved earnings outcomes for women before having children. Importantly, this provides a sign that financial constraints and trade-offs do have an effect on work decisions.

Unlike the primary earner, the pay of a second earner in a couple is almost always going to be immediately subject to the UC taper. The work allowance is offset against the first earner's pay, so of every gross £1 earned by the second earner they will be better off by only 37p (compared with 59p in the tax credit system). Under tax credits, the incentive of second earners was always weaker than that of the primary earner, but UC has made it weaker still.

We can quantify the extent to which this is the case by looking again, in Figure 10, at the distribution of PTRs but this time for second earners in families with children entering work at part-time or full-time hours.

Figure 11: Distribution of Participation Tax Rates for second earners in families with children

Percentage of out-of-work second earners in families with children



Source: RF analysis using the ippr tax-benefit model

Again we can draw multiple conclusions:

- If entering work at part-time hours, almost two-thirds would keep less than 40 per cent of their gross earnings under UC, compared to only a fifth of second earners in the current system.
- If entering work at full-time hours, the share keeping no more than 40 per cent of what they earn has increased from a fifth in the current system to almost two-fifths under UC. A similar share, around 20 per cent, would keep at least 70 per cent of their pay.

When they *do* work, second earners tend to be less likely to map their hours to parts of the tax or benefit system. As Figure 10 shows, they are more likely to have a wider spread of hours than single parents do. But then second earners are not under the same constraints as single parents. They face no hours rule in tax credits. The more pertinent question is whether they choose to work or not. That was a concern for government in relation to UC even back in 2012, when their impact assessment estimated that fewer would choose to work under the incentives created by the new system.

This outcome is a direct consequence of a benefit that prioritises having one person in a household in work, and it moves against long term trends in the rise of dual-earning households. Rather than supporting a route to boost incomes, as currently designed UC may restrict the work choices of couples with children.

To ensure that UC promotes the working patterns of the modern labour market, a second earner work allowance should be introduced to significantly boost the incentive to start work for this group of parents. Initially it should be set at £3,200 a year (equivalent to 7 hours a week at the

National Living Wage) at an annual cost of £1 billion. Ultimately it should be set at the equivalent of a part-time job, around 15 hours a week at the wage floor, providing a clear and much stronger financial incentive to work for second earners.

Once incentives to enter work have been strengthened remaining funding could be used to either further increase work allowances, or gradually reduce the taper to aid progression (see Section 5).

Recommendation eleven: *monitor the work patterns of those without children*

Members of a further group are also set to see a change in their incentives – low paid workers *without* children. People without children have little interaction with the working-age benefit system in the main, but that may change under UC.

Currently, Working Tax Credit offers some limited support for people aged 25 and over working at least 30 hours a week and earning less than the equivalent of £13,250 a year. This is a very narrow range of circumstances however, with the earnings threshold representing the equivalent of working 34 hours a week at the National Living Wage. The other area of interaction that non-parents might currently experience comes in relation to Housing Benefit. There has been a growing number of working households without children claiming support in recent years, but take-up rates for eligible families in work are low, around 55 per cent.[28]

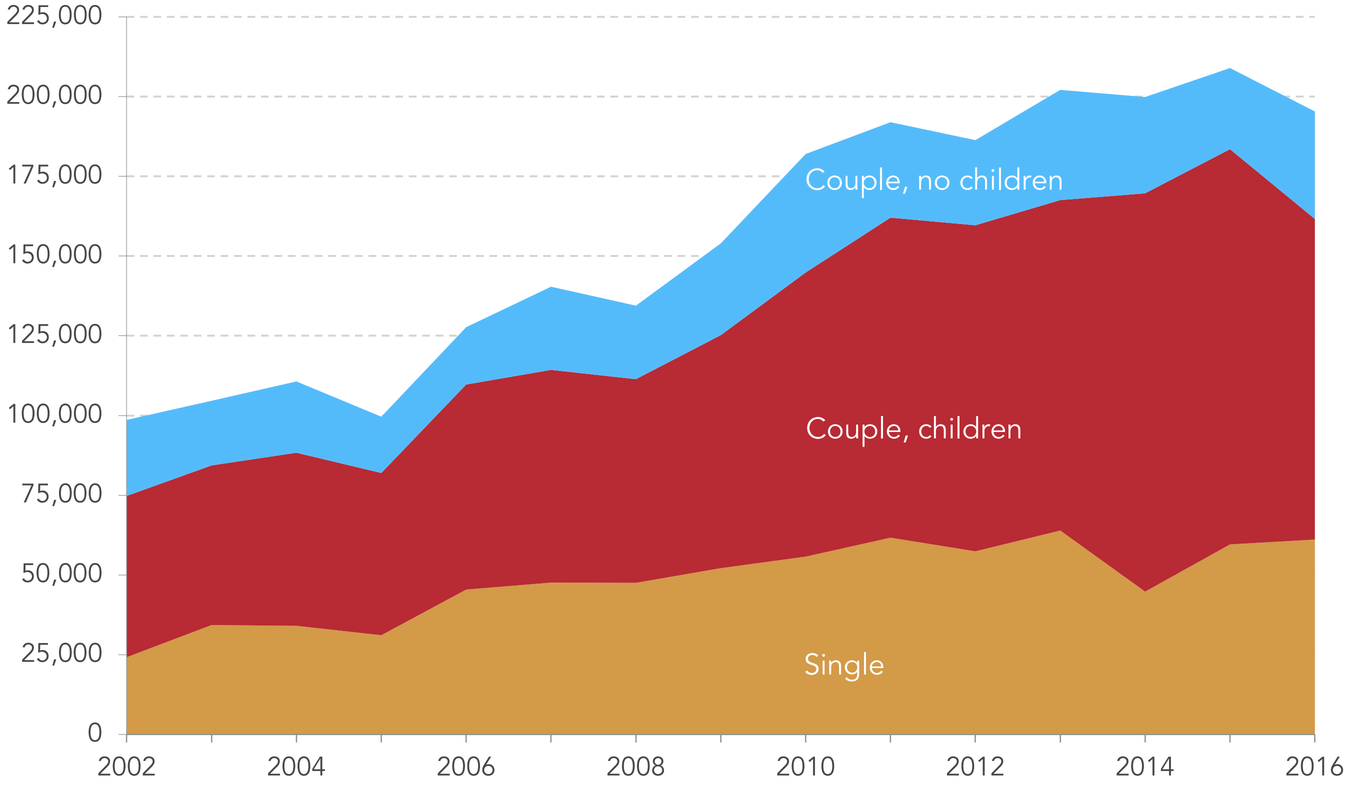
Under UC, especially for those moving into work when already on UC, benefit coverage within this group is set to increase for a number of reasons. First, they will no longer have support withdrawn pound for pound at the lowest levels of earnings. Second their entitlement will adjust automatically, so smaller payments people may not have bothered to claim in the current system would still be paid out. For those that do find themselves in work on UC, this would mean that, rather than being subject to the 32 per cent marginal effective tax rate associated with income tax and NI, this group would lose 75p of each additional £1 earned, significantly reducing their incentive to work.

Precisely how this group will respond to this changed interaction is difficult to judge; there is a lack of historical evidence. Previous expectations that low earning single adults – especially men – have little response to financial incentives may be changing however. Increasingly, more low paid, younger men are working part-time, suggesting a new sensitivity to the quality of and returns to work on offer. Figure 12 sets out the shifting trend of the last two decades.

[28] DWP, *Income-related benefits: estimates of take-up financial year 2015-16*, September 2017

Figure 12: The changing pattern of work among low paid men

Number of low-paid men aged 25 to 55 working fewer than 30 hours a week



Notes: Low-paid defined as those earning between the 5th and 20th percentiles of the male employee earnings distribution

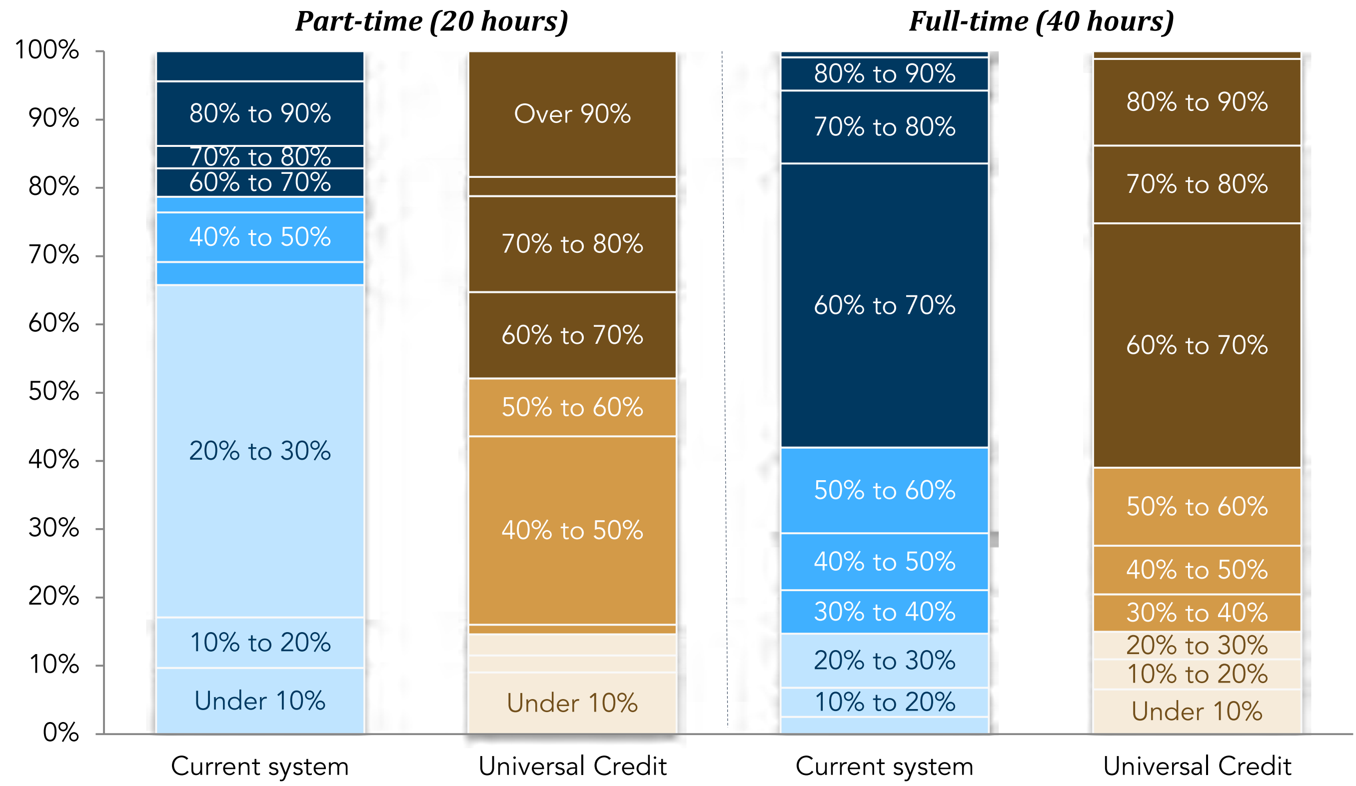
Source: RF analysis, *Labour Force Survey*

The phenomenon appears to be concentrated among men in couples. We have already discussed the shifting composition of the second earner population in families with children, but this is only around half all part-time, low paid men. As Figure 11 shows there has also been a substantial increase in the number of single men over the last two decades.

The big question is whether the incentives created by UC for this group, brought into in-work support for the first time, will reinforce this trend by incentivising them to enter work at shorter hours. As Figure 12 shows, the incentive to work full-time has overall been little affected. But the incentive to work part-time has been weakened. The risk therefore is not that those who would curremtly choose full-time work may now go part-time, but rather that the increasing numbers going part-time are incentivised to do so at lower hours. For example, a worker on the wage floor could earn £60 less when dropping an eight hour shift, but lose only £15 of net income.

Figure 13: Distribution of Participation Tax Rates for people without children

Proportion of out-of-work second earners)



Source: RF analysis using the ippr tax-benefit model

Monitoring how this group responds should be a key focus of the DWP and Jobcentre Plus as UC rolls-out. After all, it is people without children on the scheme who are most likely to be moving into work.

So far the DWP has released some limited research assessing the impact of UC on the work decisions of such simple cases. It covers 27,000 new claims to UC in the period July 2014 and April 2015 in the North West. That research found that, compared to similar cases on JSA, unemployed people on UC were an additional 3 percentage points more likely to be in-work after six months, and an extra 4 percentage points more likely to have been in work at some point over the same period.[29] Worryingly though, evidence about earnings has so far suggested they did *not* increase to the same extent. If this is because they worked shorter hours it could be a cause for concern.

What isn't clear is the extent to which it is the financial incentives or practical actions of work coaches in those Jobcentres that are driving the changes. It is still too early to tell precisely what the effect will be, but at least this suggests the situation is being monitored. More detail of what part of the system is driving what change will be important to understand.

[29] DWP, *Universal Credit Employment Impact Analysis: update*, September 2017

Box 4: Incentive to enter work recommendations

9. Boost work allowances for single parents to at least £6,800 a year (the equivalent of working 15 hours on the wage floor) at an annual cost of £1.3 billion.
10. Introduce an initial work allowance for second earners of £3,200 a year at an annual cost of £1 billion, with a long term goal of this reaching a level equivalent to 15 hours a week.
11. Closely monitor the situation of workers without children, or disability, particularly young men and the impact that UC has on their working patterns.

Section 5

Progressing to the next level

Tackling low pay and supporting earnings progression is the key labour market challenge facing Britain in the 21st Century. One-in-five workers are low paid, and of those only one-in-six manage to sustainably progress to a higher rate of pay a decade later. Given already high employment rates, pushing forward on this issue is also central to boosting living standards. But it is a policy challenge on which precious little has been done to date.

The Tax Credit system has undoubtedly helped people into work but it does very little to support progression. Interaction between the tax system, tax credits and Housing Benefit mean that some people lose as much as 91p in every additional £1 they earn. UC marks a step forward, by capping marginal losses at 75p. But that's still a potential disincentive to earning more, especially once we account for childcare costs.

A lower taper would clearly help. But big improvements come with a significant price tag, and it is not clear what the optimum rate should be. In the immediate term that means trialling different tapers as well as more creative approaches in order to better understand how individuals respond to carrots as well as to sticks. Alongside financial incentives, there is scope for introducing improved practical forms of support too. Importantly though, such assistance should not be limited to people on UC alone: after all, the need for a pay rise extends well beyond the UC population.

The final frontier for labour market policy

Progression remains the untried frontier when it comes to the role of government and active labour market policy. Key to meeting the challenges represented by our modern labour market, it is an area where an effective approach must start to be built. For over 20 years, successive governments have steadily developed support – via a mix of financial incentives, practical help and regulation – to boost employment and reduce unemployment and inactivity. Minimum wage policy has also supported the earnings of the lowest paid workers. Yet over the same period of time there has been almost nothing to help those already in work move on.

One-in-five employees in the UK are 'low paid' (earning less than two-thirds of the median rate of hourly pay), and only one-in-six of those manage to move on to a sustained higher rate of pay a decade later.[30] Wage floor policy has certainly helped to prevent the least acceptable standards, with the National Minimum Wage eradicating extreme low pay and the new National Living Wage supplement for the over-24s producing the sharpest fall in the proportion falling below the low pay threshold in 40 years.

But lifting the wage floor off the bottom is very different from shifting the UK towards a high-value, high-pay economy. Indeed, a higher wage floor brings with it a risk: namely that a greater share of the workforce finds itself on the same 'going rate' of pay. If a higher wage floor produces significant compression on the bottom half of the earnings ladder, employees might find there are fewer opportunities to move up a rung.

[30] C D'Arcy & D Finch, *The Great Escape? Low pay and progression in the UK's labour market, Resolution Foundation*, October 2017

Improving the financial return from earning more

The original aim of UC was to not only improve the incentive to enter work, but to improve incentives to earn more once in work. The single taper of UC is the embodiment of the *making work pay* goal. Early designs of UC suggested a taper rate of 55 per cent, yet it now stands at 63 per cent. The lower version would have meant workers keeping 45p of each additional £1 earned, rather than the 37p that now prevails in UC but was deemed too expensive. It would also have resulted in UC entitlement stretching further up the household income distribution.

It is not just the *level* of the taper that acts as a barrier to progression in UC, but also its interaction with other aspects of the tax and benefit system. While the notion of a single taper was expected to provide greater simplicity, withdrawal rates continue to vary to some degree across different recipients and different earnings levels.

We can think of a benefit taper as a marginal effective tax rate (METR): it determines the proportion of additional earnings that remains as disposable income. The current tax credit system can lead to an overall METR of over 90 per cent, caused by the simultaneous withdrawal of Housing Benefit, tax credits and the payment of income tax and NI. An array of METRs can apply, depending on a recipient's level of earnings (in particular, whether a UC recipient earns enough to pay income tax or NI contributions) and various benefit entitlements. For example, a taxpayer with tax credit entitlement but without Housing Benefit currently has a METR of 73 per cent.

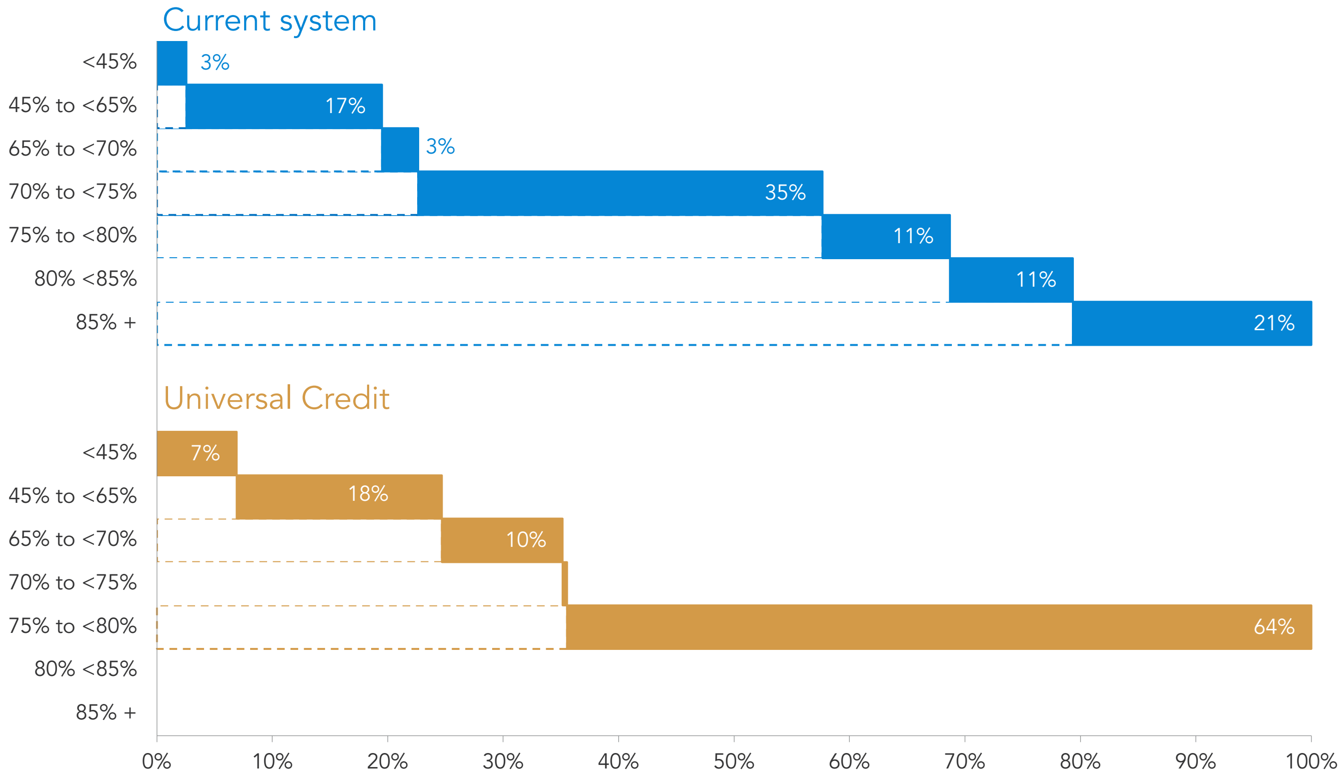
UC reduces the number of potential combinations by taking Housing Benefit out of the equation, but there are still three different METRs that can apply depending on whether a person pays NI or income tax. The possibilities double if Council Tax Support is also in payment.[31] A taxpayer with UC entitlement has a METR of 75 per cent.

Figure 15 sets out the distribution of METRs for people in work and entitled to UC under both the current tax credit system and under UC. The analysis assumes that entitled workers earn an additional pound, and calculates how much of that pound is added to their disposable income.

[31] At least within areas where the CTS taper is the same. The taper can vary by local area, but will also do so for people on tax credits.

Figure 14: The distribution of METRs for working families in different schemes

Proportion of workers with UC entitlement



Sources: Resolution Foundation analysis using the ippr tax-benefit model

The chart shows that:

- The very highest METRs of 85 per cent and above that exist in the tax credit system have been capped under UC. Nevertheless, 23 per cent of working UC recipients still have a METR of at least 80 per cent due to interactions with Council Tax Support.
- In both systems, around half have a METR of 70 per cent to 80 per cent largely reflecting the number of taxpayers in receipt of support.
- There is a greater share of workers in UC with a METR of at least 65 per cent, while both have bunching in the range of 45 to 60 per cent range;

Council Tax Support, withdrawn at 20 per cent in all cases, is also taken into account in the analysis. This increases the possible range of METRs but does not significantly change the overall picture. There is considerable churn in the METRs of workers across the two schemes, with some moving to a higher METRs and some moving to lower ones depending upon their precise circumstances. Table 3 sets out the number of workers with a lower or higher METR, by current band and the typical size of that change.

Table 3: Distribution of change in METRs by worker type and typical size of change

	Number of workers (millions)		Typical change in METR	
	Lower	Higher	Lower	Higher
Couples with children				
main earner	0.4 m	0.9 m	-16 ppts	+2 ppts
second earner	0.2 m	0.6 m	-16 ppts	+21 ppts
Single parent	0.3 m	0.5 m	-16 ppts	+2 ppts
Families without children	0.3 m	0.6 m	-16 ppts	+43 ppts
Total	1.3 m	2.6 m		

Sources: Resolution Foundation analysis using the ippr tax-benefit model

A number of conclusions stand out.

» Those with a fall in their METR are mostly in households that rent. This is due to the lower effective taper rate applied to housing support in UC; hence the typical 16 percentage point fall in the METR (from 91 per cent to 75 per cent for tax payers, or from to 79 per cent to 63 per cent for non-taxpayers).

» The 2 percentage point increase for 1.5 million workers reflects the increase in the METR for taxpayers in the tax credit system from 73 per cent to 75 per cent under UC.

» The fact that second earners face a 21 percentage point METR increase reflects the shift from the tax credit taper of 41 per cent to the UC taper of 63 per cent.

» For families without children, the typical 43 percentage point rise in METR reflects moving from paying tax and NI (32 per cent) to also receiving UC (75 per cent).

Whatever way you cut it, UC improves on the very highest METRs but still leaves the vast majority with a poor financial incentive to progress. A 75 per cent taper rate is still high – much higher than the 32 per cent and even the 47 per cent for basic and higher rate taxpayers outside of the benefit system.[32]

The optimum rate to encourage progression is, of course, unknown. As a starting point, we think it should be lower than 75 per cent, so recommend that the government should move to lower the UC taper. But doing so in a significant way is expensive: it would cost over £3 billion a year in steady state to reduce the UC taper by 10 percentage points.More targeted ways to boost progression shuold therefore also be explored.

Targeting progression

As with financial incentives to enter work discussed in the previous section, it tends to be single parents and second earners who are more responsive to incentives to progress. Members of these groups can also face much weaker incentives to increase their hours when childcare costs are taken into account. Paying for formal childcare to allow a primary carer of a child to work, even with the level of support on offer in UC (up to 85 per cent of costs are covered), takes a sizeable bite out of net income once tapers and tax are accounted for.

For example, a parent earning £8 an hour would keep only £2 after paying tax, NI and the UC taper. If they additionally faced average hourly childcare costs of £4.50,[33] they could have 85 per cent of their costs covered by UC and therefore need to the remaining pay 70p an hour. That would leave

[32] Although the METR does rise for parents entitled to Child Benefit where one earns between £50,000 and £60,000 a year.

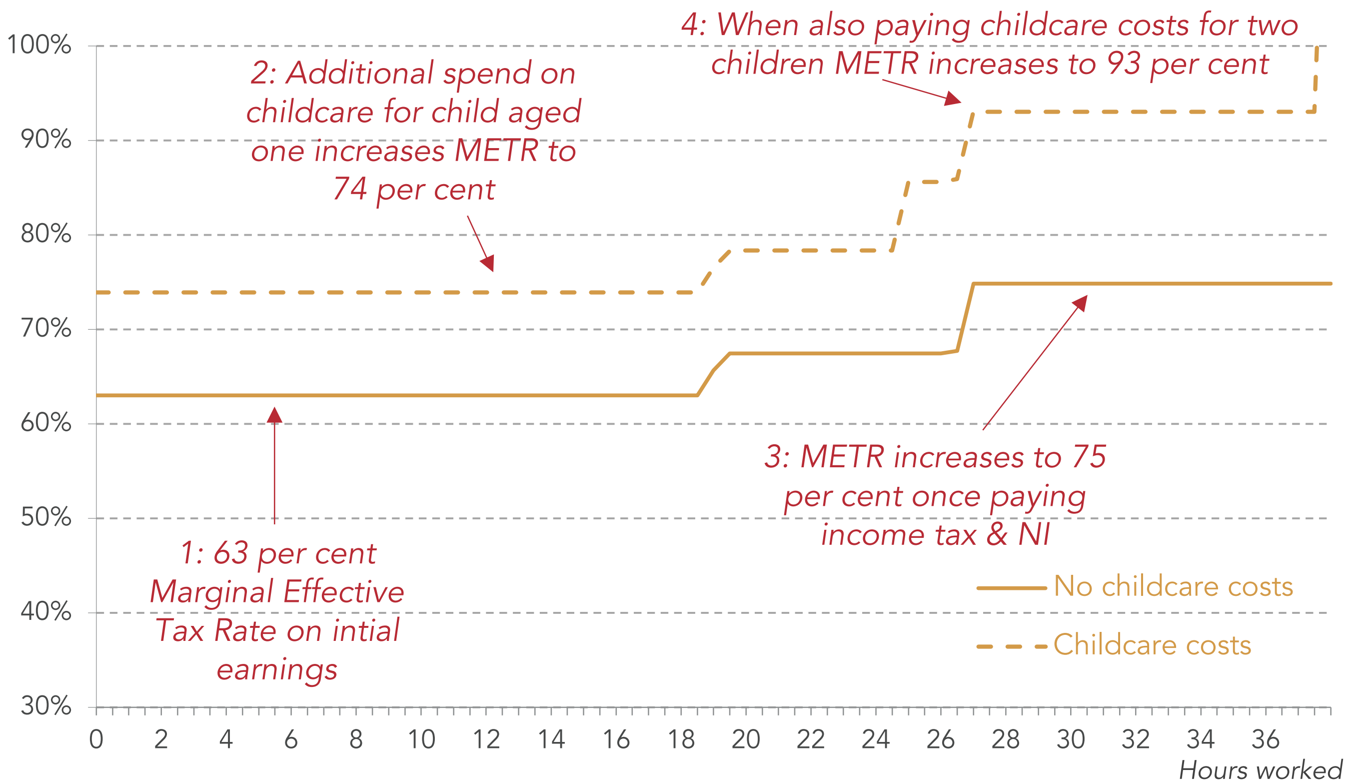
[33] C Harding, B Wheaton & A Butler, *Childcare Survey 2017*, Family and Childcare Trust

them with only £1.30 from an additional hour of work, or an METR of 84 per cent.

Figure 15 shows how the METR of a second earner changes under UC when increasing the hours that they work on the wage floor (in this example the couple has two children aged one and four). When working part-time hours and benefiting from free hours of childcare for their four year old, their METR is 74 per cent (higher than the usual 63 per cent taper of UC). Their incentive to earn more reduces significantly if they want to move to full-time hours. First they start to pay tax, increasing their underlying METR to 75 per cent. Second they also start paying for both children to use formal childcare, raising the METR to 93 per cent. For a National Living Wage earner today that would be equivalent to working for 52p an hour.

Figure 15: Incentives to progress for a second earner when paying for childcare

Marginal Effective Tax Rate for second earner in couple with two children, a full-time working partner and both parents earning at the wage floor



Source: Resolution Foundation analysis using the RF microsimulation model

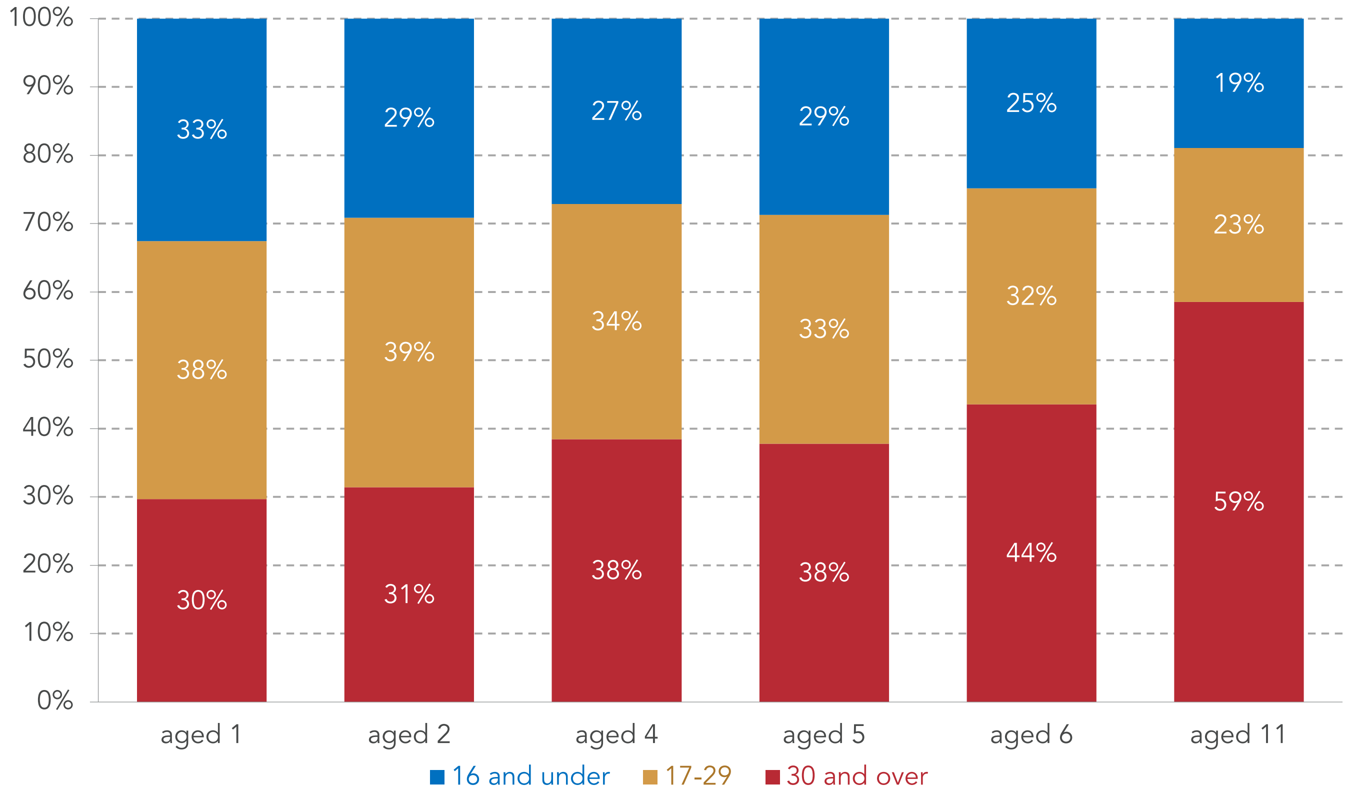
Notes: Childcare costs are based on average rates from FCT childcare survey 2017, increased with inflation to 2020-21. Estimates account for 30 hours of free childcare for working parents.

A second earner work allowance would help improve the return to working at part-time hours, but not deal with the incentive to progress to full-time hours. That's because while a work allowance would reduce the amount of support withdrawn at low hours of work, it will not improve the rates of withdrawal at higher levels of pay when the taper kicks in and people pay income tax. In designing better support with progression, it is also important to think about how people progress and when. For most, it is the early- to late-20s when progression is most rapid, as a burgeoning career establishes itself. But it is the progression of people most likely to be entitled to UC that we focus on here. In doing so we continue to consider the progression pathways of single parents and second earners when moving into work after having children – that is, later in life.

Figures 16 and 17 set out the hours worked of single parents and second earners by the age of their youngest child. This metric allows us to consider how the pattern of work changes as the greatest barrier to working (time to care for their child) diminishes. Hours worked are lowest during pre-school years and increase as the youngest child in a family ages. The greatest number of hours worked comes when children are of secondary school age.

Figure 16: Work patterns of single parents by age of youngest child, 2016-17

Proportion of single parents in work

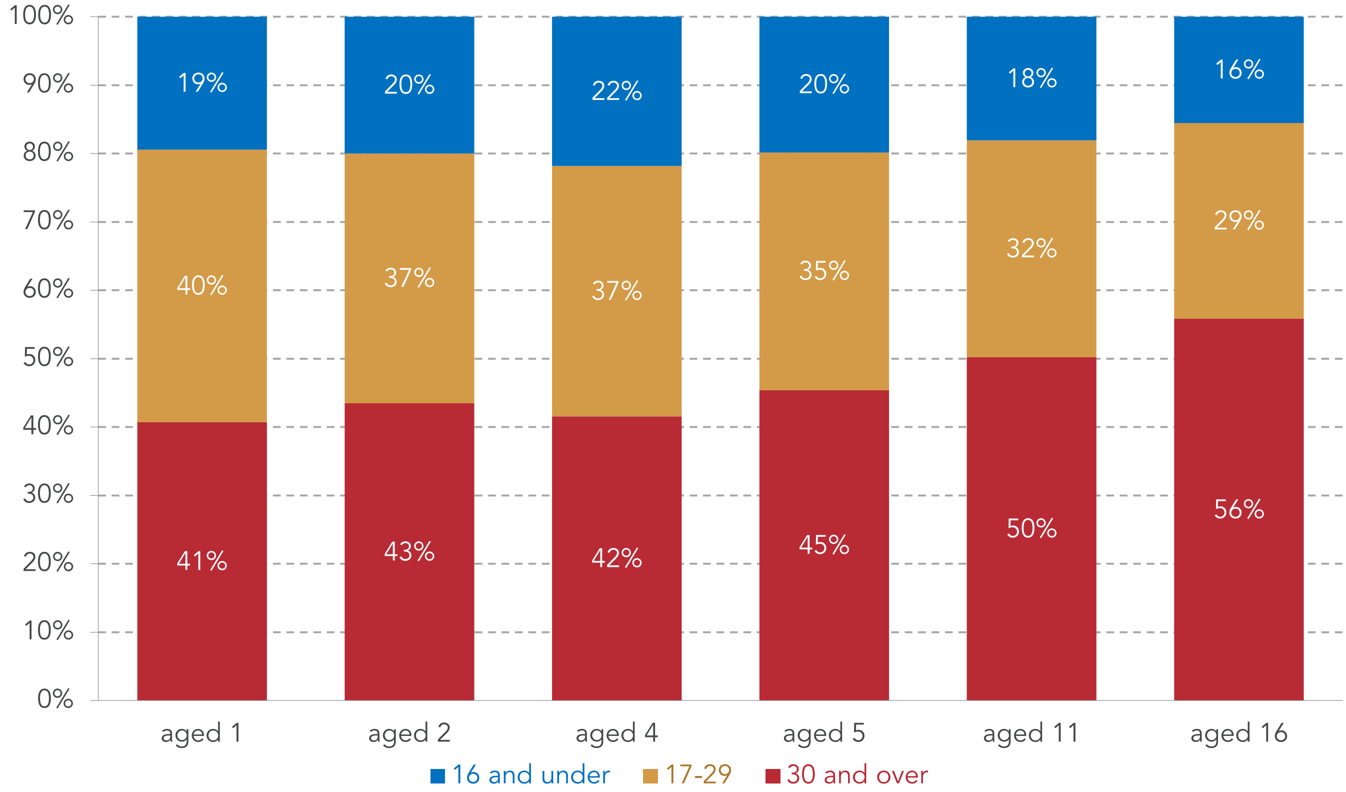


Notes: Second earners defined as the lower earning individual in each working couple. Paid hours worked.

Source: RF analysis, Labour Force Survey

Figure 17: Work patterns of second earners by age of youngest child, 2016-17

Proportion of second earners in work



Notes: Second earners defined as the lower earning individual in each working couple. Paid hours worked. Second earners defined as the individual in each couple working the fewest hours.

Source: RF analysis, Labour Force Survey

These patterns are not purely about the cost of childcare. They also relate to historical cultural norms where mothers often work part-time when children are young or not at all when children are of pre-school age. Although maternal employment rates in the UK have been improving, compared to other countries the UK has always had a high share of mothers working part-time. At the same time, while the gender pay gap has largely closed at younger ages, it opens up again once women have children. In part, the higher likelihood that mothers work part-time compared to fathers who work full-time means that women spend less time developing skills and experience necessary to progress.[34]

While working full-time is not going to be the best outcome for all, we know that working part-time is a key factor in failing to escape low pay. And that part-time work is also often of poor quality and poorly paid, but not working at all tends to have a bigger negative impact on long term earnings outcomes.

Parents can have different priorities. The work patterns of second earners with young children suggests that a group with fewer constraints than single parents choose to work shorter hours. It is important that all have the opportunity to both work the hours that suit their lives at a given point in time, while being able to boost their earnings through either higher rates of pay or more hours of work.

To an extent this is an issue that lies beyond financial incentives, and one that rests with employers to provide better paid and better quality part-time roles. By responding positively to various maternity regulations, firms have been vital in boosting maternal employment in recent decades. They have a key role to play in supporting progression chances too.

[34] M Dias, W Elming & R Joyce, *The Gender Wage Gap*, IFS, 2016

Recommendation twelve: *targeting financial support to aid progression*

If UC is to truly present a significant improvement on the current tax credit system and support progression for those already in work, then it is time for a re-think. Of the groups entitled to UC, it is clear that single parents and second earners in couples are most likely to both require additional support to progress and respond to improving financial incentives.

To better understand how much might be achieved via a lower taper rate, the DWP should experiment with lower rates for single parents or second earners, or even for those with pre-school aged children. By committing to extensive tests, the DWP can identify the most effective rate for these groups ahead of a potential wider roll-out. This approach would also open the door to more radical formulations. It is possible, for example, that a much lower taper would negate the need for a work allowance at all. Additionally support targeted at reducing the cost of childcare for pre-school age children should also be considered.

At the same time, the DWP should investigate conditional, time-limited, 'progression payments' for those who manage a sustained move onto a higher level of earnings (through hours or pay). Previous research has shown that such targeting had a greater effect than simply boosting the return from work at all hours. This might therefore better target support at the progression of lower earners than would be the case with an across the board taper rate reduction.[35] Given that real-life experiences tend to involve people progressing in jumps rather than at the margins, concerns of preserving single and simple tapers should not be over-prioritised.

Commitments to fund these improved incentives could be self-funding in the longer term, and should stem from the findings of a much expanded series of trials to assess the most effective forms of financial and practical support that considers more intensive and more radical interventions than those currently being piloted.

Recommendation thirteen: *reducing the taper in the short term*

Given the time it will take to trial and test the best approach to boost progression through financial incentives, and that we know the taper rate remains relatively high there is room to reduce the taper in the short term without extensive testing. The Chancellor should consider prioritising an across the board taper reduction in UC once work allowances have been boosted.

Beyond financial incentives

In-work conditionality (IWC), a new feature of UC, could well play a role in the shape of the financial incentives to progress. This is the extension of the same sort of job-search requirements currently placed on benefit recipients who are out-of-work to around one million UC recipients who are in-work. While this policy has often been combined with welcome discussion about pay progression, its current design implies a more limited role. The main aim of the policy will be to encourage people to earn at least the equivalent of a full time job at the wage floor (with exceptions for people with caring responsibilities).

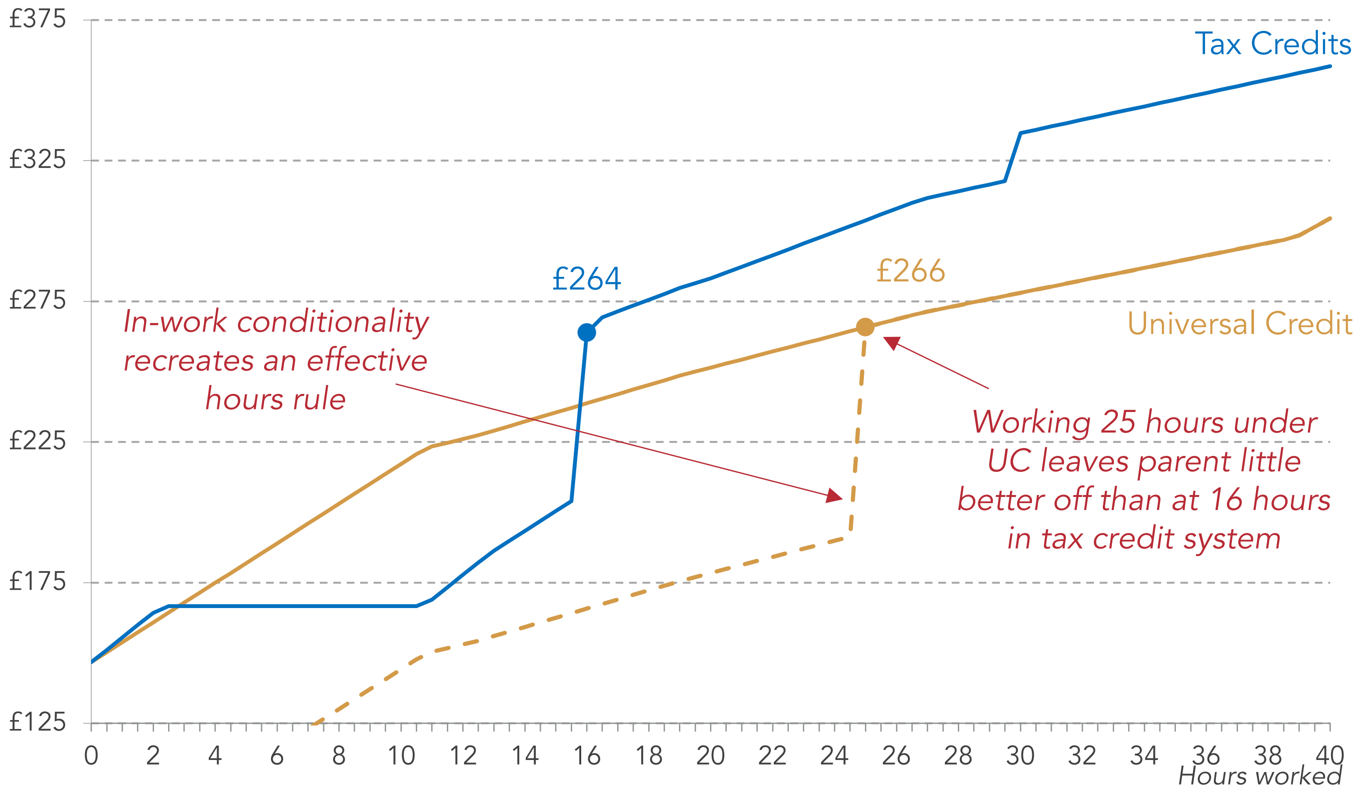
The precise extent to which government intend to enforce these rules is currently unclear. Taken in the strictest sense they imply a reduction in UC unless a certain earnings level is reached each month, not dissimilar to the MIF for self-employment. That may act as an effective counter to the effect of weakened financial incentives, but imposing such a rule could simply replicate a more stringent set of hours rules within UC – the very feature UC is meant to improve upon.

[35] M. Brewer and J. Cribb, *Progression and retention in the labour market: what have we learned from IWC and ERA?*, IFS, October 2017

To illustrate the potential effect Figure 18 sets out the net income of a single parent under the tax credit system, under UC and under a version of UC with IWC applied in the strictest sense. A single parent with a school-aged child would be expected to find work that fit around school hours; that could be as much as 25 hours a week. It is clear that a strict reading of IWC recreates the familiar tax credit-style shape of a boost to income once a certain level of earnings is reached. In this instance though the boost comes later, and overall income levels are lower.

Figure 18: Recreating hours rules in UC via in-work conditionality

Net income for a single parent home owner earning the minimum wage with one child



Source: Resolution Foundation analysis using the RF microsimulation model

Recommendation fourteen: *embedding progression into Jobcentre Plus*

As currently designed, IWC is focused on no more than full-time jobs at the wage floor. Truly tackling progression will require government to go much further than simply re-focusing Jobcentre plus advisers on encouraging people to earn a bit more.

There is clearly a role for UC given the interaction it provides with so many low earners, and thinking about progression should form a core part of the conversation held with people looking for work. UC also provides an opportunity for the state to identify and contact people who are stuck in low paid roles for significant periods of time. By the same token, administrative data can be used to target people at key transitions in their lifetime, such as when children start primary school. It is also important to ensure that access to practical support is tied to improved financial incentives.

Recommendation fifteen: *developing a system of genuine in-work support*

There are clear pros and cons to such an approach. While it may prevent people reducing their hours of work in response to weaker financial incentives, the method of implementation – via discussion with work coaches rather than simple hours rules – is far more complicated and open to error than the tax credit system. Sanctioning people who are already in work, and now expected to find more work in their downtime, will be tough to do on a personal and political level. It also, fundamentally, undermines the aim of UC to ensure people are always better off in work.

More importantly though, this discussion only arises because of the reduction in financial incentives to work. Providing a greater return to working part-time would mean the DWP has less reason to rely on potentially difficult to deliver sticks, than much simpler and clearer financial carrots. It would allow the focus of practical support to be remain on those who need help to overcome barriers to working or earning more and be a far more positive tool, rather than penalising those already in work. That makes restoring parity of support with the tax credit system even more important.

Recommendation sixteen: *a wider service for progression*

Yet the government should take a far more radical and far reaching approach to progression. After all, many low paid workers will *not* be entitled to UC.

We have previously set out a blueprint for boosting progression in the UK labour market. Drawing on work such as that undertaken by the Learning and Work Institute, it is clear that there is a role for a 'progression service' that significantly improves on the career guidance and job role information that is currently available. Government also has a key role to play in engaging with employers, encouraging them to place progression at the heart of workforce planning. Meeting the labour market challenge of the 21st Century means ensuring progression is core to cross-government policy, in the same way that employment concerns extend beyond the DWP.

Box 5: Progression recommendations

12. Commit to trialling different forms of financial incentive to encourage progression with stronger financial incentives and more forms of practical support including:

    ~ lower tapers for second earners and single parents

    ~ time-limited conditional payments for achieving progression

    ~ providing additional support with the cost of childcare for pre-school aged children

13. In the short term, gradually reduce the UC taper once work allowances have been strengthened.

14. Build progression conversations into UC work search discussions and use UC administrative data to identify those at risk of low pay to signpost them to progression support.

15. Focus in-work conditionality on helping those with the greatest barriers to work to find continuous employment.

16. More widely: dramatically improve the career guidance information available; create a national body to oversee progression trials and work with employers at a sectoral level; ensure that progression is a core part of ongoing government policy, in the same way that employment underpins the actions of departments beyond the DWP.

Section 6

Conclusion

Among those in the policy world who focus on such things, Universal Credit has become a watchword for delays and IT challenges in recent years. But wider roll-out and the introduction of more complex cases means it is now moving from being an issue primarily discussed and debated in the corridors of Whitehall to one that has a real and meaningful impact on the living standards of millions of families up and down the country.

The good news is that many of the IT hurdles appear to have been cleared: it remains some way off, but the end of implementation is at least in sight. Unfortunately though, there is plenty of bad news too. In many instances, this stems from the fact that the theoretical underpinnings of UC have started crashing into the reality of recipients' lives. Such an outcome was predicted by many, but its arrival means it can no longer be ignored by government. Indeed, to the extent that there are more problems to come as still more complex cases shift across to UC, the government must work hard to get ahead of the curve rather than simply reacting each time a new crisis hits the national media.

Most immediately, swift action needs to be taken on the six week wait that is causing hardship for numerous recipients. But the government should also be seeking to address issues around self-employment, childcare and free school meals that will shortly start to flare up in the absence of action.

But there is a bigger issue still for UC to tackle; and that is ensuring the support it offers for working families is appropriate in the modern labour market. There have been significant developments since UC was first designed, both in terms of underlying labour market conditions and in terms of the resources allocated to the reform. Strong employment performance in particular means that UC's over-riding focus on reducing worklessness looks even more outdated than it did when the policy was first designed. Against a backdrop of tighter budgets, the new system must instead prioritise tackling the new challenges Britain faces – namely in relation to supporting dual earning households and promoting progression.

Successive cuts to the generosity of UC have put much of the advantages it purports to bring at risk. Yet the prize of a single, simplified benefit system is one worth holding onto, and opposition can be addressed at the forthcoming Autumn Budget. A pause in the roll-out in January provides the ideal opportunity to re-launch UC, tackling outstanding policy issues and re-investing in the scheme. We have set a number of recommendations for a way forward in this report. Some deal with near-term process-driven difficulties; others are bigger picture and more long-term. We believe that taking on these recommendations and forging a consensus on how best to take UC forwards will ease implementation and support the delivery of what remains a very welcome major reform package into the next decade.

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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