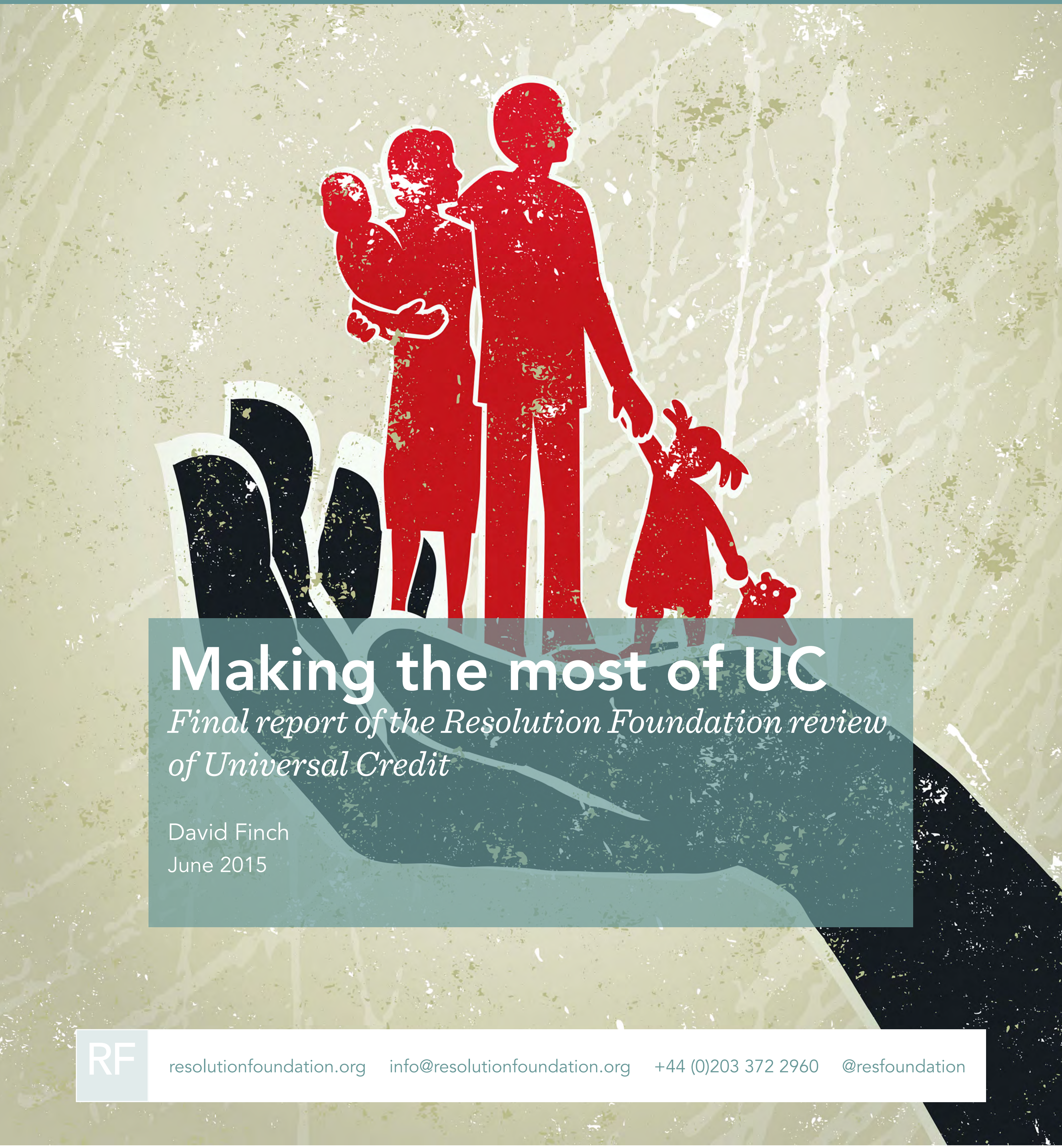
RF

Resolution Foundation
REPORT



Making the most of UC

Final report of the Resolution Foundation review of Universal Credit

David Finch

June 2015

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

Acknowledgements

The panel would like to thank the wide range of experts who have shared their expertise at various times throughout the project, including Sir John Hills, Sue Royston, Lindsay Judge, Caroline Davey, Tony Wilson, Rowan Foster, Katie Schmuecker, Fran Bennett and Susan Himmelweit and Ellen Broome, Adam Butler and Jill Rutter.

We are grateful for conversations with officials at HM Treasury, the Department for Work and Pensions, the Greater London Authority and National Audit Office, representatives from Equity, seminars held by LITRG and the Social Security Committee and the opportunity to visit Newham Workplace. We would also like to like to thank all of those who attended a roundtable to discuss our early ideas in September 2014.

Contents

Expert Panel

Vidhya Alakeson (co-chair), Chief Executive of The Power to Change, formerly Deputy Chief Executive of Resolution Foundation

Professor Mike Brewer, Professor of Economics and Director of the ESRC Research Centre on Micro-social Change at the University of Essex

Professor Paul Gregg, Professor of Economic and Social Policy, and Director of the Centre for Analysis and Social Policy at the University of Bath

Grainia Long, Chief Executive at the Irish Society for the Prevention of Cruelty to Children and formerly Chief Executive of the Chartered Institute of Housing

Gavin Smart, Deputy Chief Executive of the Chartered Institute of Housing

Dr Jim McCormick, Scotland adviser to the Joseph Rowntree Foundation, member of the Social Security Advisory Committee

Ian Mulheirn, Director of Consulting for Oxford Economics

Emma Stewart MBE, Director of Timewise Foundation

Nick Timmins (chair), public policy expert and historian of the welfare state

Giles Wilkes, Financial Times leader writer and former adviser to Vince Cable

Chairs' Foreword

Universal Credit is one of the biggest, boldest and riskiest of the changes that the last coalition government undertook. For much of its life it has looked like a rudderless tanker heading for the rocks. It remains a monumental challenge for the newly-elected government.

Its intentions are, however, entirely honourable. In principle it should attract support from across the political spectrum. The honourable intentions are both to simplify a horrendously complicated benefit system and to ensure that, in almost all conceivable circumstances, entering work, and getting on once in a job, pays. UC is non-partisan in the sense that what used to be termed the UK's 'three main political parties' are, at least at a headline level, signed up to that agenda. Indeed the last Labour government repeatedly explored, with an enthusiasm that varied over time, the idea of a single working-age benefit. At its core, that is what UC is.

That doesn't mean that there aren't fundamental policy choices involved in its design – with the choices having major distributional consequences. Cross-party support doesn't mean an absence of small 'p' political issues.

As in any benefit system, UC must balance key trade-offs between the total cost of the system, the level of support for families with the lowest incomes and the strength of incentives to start, and then progress, in work. There are also questions of scope – both in terms of coverage and ambition. Should this single working-age benefit be literally what it sounds like on the tin – a credit that embraces all or almost all benefits, both in and out of work – or are some payments better left outside the system? And how far can it, or should it, seek to address emerging trends in the labour market and wider pressures on the cost of living, such as housing and childcare?

The 2010 coalition provided answers to these and other questions. But the answers were formed in the early part of last parliament (and indeed by thinking done in the previous one), with government focused on recovery after the downturn.

In setting up this expert panel, the Resolution Foundation took the view that – by the time of its publication, five years on – changing economic conditions warranted a fresh look at UC. There is an opportunity, with a new government, to pause and consider how well placed it is to meet the challenges that the UK's working-age welfare system will face over the coming decade.

At the time the panel was established, there was a real risk that UC would founder on the rocks. Indeed there remains a risk that could still happen – that, at scale, it will prove to be un-implementable. The chances of that, however, appear to be diminishing, even if the timetable for full implementation is likely to extend beyond the end of this decade.

To review where UC has got to, and how its course might be altered, the Foundation assembled an impressive panel of independent-minded experts that the two of us have chaired. Outside the Department for Work and Pensions (DWP) and the Treasury, few people can know more about the issues – in terms of both the macro questions as well as some of the more granular challenges associated with welfare reform and the micro practicalities of benefit design and delivery.

The pages that follow do not set out a utopian UC, designed in academic isolation. Nor do they start from a blank-sheet of paper in terms of the long-term future of our social security system. Rather, they take as their starting point the proposals put forward by the last government on UC. And they are grounded in an acknowledgement of the realities of today's public finances (though they don't wed themselves to any one party's views of necessary fiscal consolidation).

Nonetheless, in our view they represent a package of reforms that:

» strike a better balance between inevitably competing objectives,
» speak to the reality of the UK's evolving jobs market and the changing nature of household working patterns, and
» are more likely to fulfil the underlying goals that lay behind UC in the first place.

In coming up with its recommendations the panel has identified savings, prioritised, proposed experimentation where necessary and made some difficult trade-offs between competing objectives. None of the recommendations are likely to be entirely uncontroversial – few benefit changes are.

But we hope and believe they chart a course to a better version of welfare reform. They also seek to elevate the crucial policy choices that underpin UC – choices which all too often have been lost to sight amid the media focus on missed deadlines and troublesome IT contracts.

Our aim has been to produce – within the constraints that exist – the best outcome for those who really matter: the millions who are set to depend upon UC and the taxpayers who fund it. Many of them, of course, being the same people.

Nick Timmins and Vidhya Alakeson

Executive Summary

At some point in their lives, almost everyone in the UK will receive financial support, often referred to as 'welfare', from government. In addition to benefits offered universally, like those provided to older people or most parents, specific support is targeted at people who are out of work and to those or who are in work but need extra help to get by. In offering this assistance, **governments must strike a delicate balance between making work pay, providing adequate support to families and containing the overall cost to the taxpayer**.

Because the way we live and work is always changing, **the way these trade-offs are dealt with will evolve**. In Britain, gender roles and family employment dynamics have shifted in recent decades, creating new pressures around, for instance, childcare provision. Improved life expectancy and inadequate pension saving mean that older workers are staying in the labour market for longer. Falling levels of homeownership, inadequate supply and rapid rent increases mean that the welfare system is doing more to support families with the cost of housing.

How the labour market functions and develops is a vital consideration. **Tackling worklessness across households is central to any welfare system and the UK has performed well on that front. In contrast, low pay and working poverty have risen up the agenda**. With close to two-thirds of poor families with children already having someone in work, the nature of poverty has fundamentally altered. And while the six-year squeeze on pay has ended, there is no sign of the UK shedding its long-held position near the top of the international low pay league.

With both the previous and current governments proposing reductions in the working-age benefit bill as part of their wider fiscal consolidation, **responding effectively to these shifts puts an ever greater emphasis on getting the design of Britain's welfare system right**. It is against this backdrop that Universal Credit (UC) – the most far-reaching transformation of the benefits system in generations – is being rolled out. **Making the most of the reform, both in terms of its design and implementation, is a defining challenge of this parliament.**

This report is the culmination of a nine-month review of UC, led by a panel of economists and welfare and employment experts. It provides an independent assessment of both the pros and cons of UC and how the current proposals need to be improved so they meet the realities of our jobs market.

Making the most of Universal Credit

UC combines six in- and out-of-work benefits into one monthly payment. At its heart, it is **designed to ensure that benefit recipients are *always* better off in work**. It sweeps away a raft of rules which meant people became eligible for support once they had worked a specific number of hours. It enables those in work to keep all of their benefits as they begin to earn. By simplifying recipients' interactions with the system and applying a single rate of withdrawal for those in work, it is hoped UC will reduce some of the complexities that have dogged the current system. Improvements in reliability and transparency should, in theory, **reduce the financial risks associated with entering work. People should be better able to understand the financial return from starting work. Benefit take-up should rise**.

UC is a highly ambitious undertaking and one that – in principle – we support. It is not, however, without its problems, some of them very significant. The most immediate concern, and the one that has dominated media attention, is ensuring UC is implemented effectively, with a sensible plan for its roll-out over the course of this parliament.

This focus on the problems with the delivery timetable and IT contracting have meant that key underlying policy choices that will help shape the future of the jobs market, working patterns (including between the genders) and pay and progression have all received far less attention. Our report seeks to address this.

A starting point is that **multiple changes to UC since its conception – some policy-related, some reflecting a lower than originally anticipated budget – have altered both its design and expected impact**.

The improvements necessary to enable UC to, at a minimum, make work pay and smooth the transition into work must be made *before* millions of families are moved onto the new system. The start of the new parliament provides a natural opportunity to review the potential impact of UC and set out plans for its near- and medium-term development. **Our proposals span two phases:**

- The first phase – covering **the period when UC is fully rolled out, largely over this parliament** – seeks to focus incentives to work on the groups most likely to respond, in order to maximise its potential impact. **Our recommendations in this phase are cost-neutral, recognising a backdrop of ongoing fiscal constraint.**
- The second phase – in the next parliament, **following UC's full roll-out – incorporates ambitious proposals designed to ensure UC is fit for purpose over the next decade and maximises its impact on employment**. Our recommendations here are no longer bound by our short-term cost-neutral constraint but continue to fit within official projections of the expected long-term level of spending on working-age benefits.

Throughout, **we take no account of any potential savings from the improved employment outcomes we expect our proposals to achieve**. We identify structural problems and propose solutions – both short and longer term – across four broad themes: **incentives to start working; progression in work; the benefits covered by UC; and the ease of interaction with the system**.

Theme 1: Getting into work – incentives to enter work under UC

One of the main drawbacks of the current system of in- and out-of-work benefits is that people who enter work at relatively low hours or take on more hours can find themselves little or no better off as a result. Working tax credit provides a strong incentive to work at least a certain number of hours.[1] However, out-of-work benefits are withdrawn on a pound-for-pound basis at fewer hours: for every extra pound earned from employment, a pound of benefits is taken away. Once in work, the gradual or tapered withdrawal of in-work support and Housing Benefit means that individuals can lose up to 91 pence in every extra pound they earn (assuming they pay income tax and National Insurance). **This represents a major disincentive to work or earn more.**

[1] 16 hours for single parents, 24 hours for couples with children and 30 hours for individuals in families without children.

Rebalancing work allowances

Guaranteeing that work always pays must therefore be a central plank of welfare reform. The primary tool to achieve this in UC is the introduction of a 'work allowance' – an amount a person can earn before their benefits begin to be removed. We support the introduction of work allowances because they will encourage people to enter work at a low level of earnings, helping those who previously would not have found it worthwhile to do so, and may not have worked at all.

Beyond the work allowance limit, all benefits within UC are taken away at a single rate – referred to as the taper – of 65 per cent. This means a person keeps no more than 35 pence of every additional pound they earn above their work allowance, until UC is entirely removed. **If paying income tax and National Insurance, individuals keep only 24 pence of an extra pound earned** or even less if they also receive Council Tax Support. But the **worst examples of punitively high** withdrawal rates caused by withdrawing Housing Benefit and tax credits at the same time, **leaving people with less than 10p of an extra pound earned, are eliminated**. This should help to further reduce the number of households where no one works.

Despite these gains, the proposed combination of work allowances and the taper creates significant risks among some groups. For example, while work allowances are expected to increase the absolute number of people entering work, they are likely to incentivise *low-hours* working – a danger that has grown due to budget cutbacks since UC was first proposed. **For some groups, therefore, UC could make reducing the number of hours they work more attractive**, because the fall in their employment earnings is largely cushioned by UC and, ultimately, the taxpayer.

Given scarce resources, we must also look at **whether the improvements in incentives in UC are targeted at the right groups**. We consider whether work allowances might be distributed where they are likely to have the biggest impact:

» ***Non-disabled workers without children***: In the current system, working non-parents have little entitlement to in-work support. But under UC, members of the group who rent or who have low earnings are treated significantly more generously. They remain entitled to out-of-work support until their earnings exceed their work allowance, with the 65 per cent taper only applying above this threshold. As such, the **penalty associated with working fewer hours is reduced**.

» ***Main earners in couples***: Research suggests that primary earners in couples tend to be relatively unresponsive to financial incentives, working full time even if they face high withdrawal rates. Given that both partners are out of work in just one-in-ten couples, **a large work allowance for this group may not be the best use of scarce resources** when funding is being cut from other parts of the UC budget.

» ***Single-parent renters (i.e. those who receive help with housing costs)***: In the current system, single parents who work at least 16 hours a week can become entitled to working tax credit. Many work precisely these hours, indicating a strong tendency to respond to financial incentives. **UC will provide support at lower hours of work, which could boost employment among those who want to work shorter hours. However, it may also increase the risk that some in this group opt to reduce their hours towards the 'sweet spot' at which their work allowance is exhausted, or that employers offer roles for these hours of work**. A single-parent renter's work allowance will run out after just nine hours of work at the minimum wage (fewer if their hourly rate is higher).

» ***Second earners in couples***: Currently, tax credit entitlement is calculated on the basis of household income. As a result, **second earners in couples already lose 41 pence of every pound on earnings below £8,060**.[2] **This jumps to 65 per cent in UC, further weakening the incentive to work and progress**. A second earner with a salary of £10,600 would see their net household income rise by £6,000 under the existing tax credit system. This falls to just £3,600 under UC – a 65 per cent reduction.[3]

To help insure against these risks while maintaining the advantages of a system in which all individuals moving into work would find it worthwhile to take on at least part-time hours, we make the following recommendations. Taken together, they represent a significant rebalancing of incentives within UC.

[2] The primary threshold for National Insurance.

[3] In each case, £300 of National Insurance contributions are made – 12 per cent of gross earnings above £8,060.

i Recommendations – work allowances

- **Increase the work allowance for single parents with housing costs** from £3,100 a year to £5,100 a year, at *a cost of £600 million*.
- **Introduce a work allowance for second earners in families with children** of £1,500, at *a cost of £600 million*.
- **Remove the work allowance for non-disabled families without children**, creating *savings of £600 million*.
- **Reduce the work allowance for couples with children** by the equivalent of two hours at the minimum wage, *saving £200 million*.
- **Abolish the Married Couple's Allowance** to reinvest in a second earner work allowance, *saving £900 million*.

Building on our short-term recommendations, we set the longer-term aim of realigning work allowances to provide, and over time maintain, a strong incentive to work at least a half-time job for all individuals in UC:

- **Increase work allowances** to a minimum value of 15 hours of work at the minimum wage **for single parents and second earners in couples**.
- **Uprate work allowances with a 'triple-lock'** – the higher of average earnings growth, minimum wage growth or CPI inflation.
- **Maintain a gap between work allowances for homeowners and renters** to recognise the extra help to which renters are entitled.

Improving interaction with income tax and National Insurance

In the current tax credit system, gross earnings (before income tax and National Insurance (NI) are paid) are used to calculate entitlement.[4] This means that any gains arising from a tax cut make no difference to the tax credit award.

In contrast, entitlement to UC is calculated from *net* earnings (*after* income tax and NI).[5] This approach means that – unlike under tax credits – **changes in the amount of income tax someone pays feed directly into their UC award, making any policy of income tax cuts dramatically less generous to UC recipients than would otherwise be the case**. This is an important distinction given the new government's pledge to raise the income tax personal allowance to £12,500 by the end of the parliament. **While a £100 increase in the allowance would increase net earnings by £20 for basic rate taxpayers, those workers on UC would be just £7 better off**.

[4] For each additional pound of gross earnings, 41 pence is withdrawn from tax credits and 32 pence is paid in income tax and NI, leading to an overall withdrawal rate of 73 per cent (41p plus 32p).

[5] Each additional pound of earnings is reduced first by 32 pence paid in income tax and NI. Then 65 per cent of the remaining 68 pence is withdrawn from UC, leaving only 24 pence and creating an overall withdrawal rate of 76.2 per cent (68 pence – (68 pence* 0.65)=23.8 pence. We refer to this as 76 per cent throughout.

i Recommendation – interaction with income tax and National Insurance

Pass on cuts in direct tax in full to families in receipt of UC via an equivalent adjustment in the appropriate work allowance. By convention, the cost of this measure should not come from the UC budget but should instead be part of the overall Exchequer cost of the tax cut.

Theme 2: Getting on at work – progression under UC

One in five (22 per cent of) workers is low paid, with the UK ranking among the worst performers in the OECD. For most, low pay is a persistent problem; only one-quarter of those with low hourly wages in 2001 had managed to permanently escape onto higher pay a decade later. **Among some groups – particularly single parents and second earners in couples (overwhelmingly women) – their prospects are held back by the penalties associated with part-time working**.

As well as providing an incentive to work a reasonable number of hours (Theme 1), **the financial incentives created by UC must also provide a path to *progress* – to increase earnings through either more hours of work or higher hourly pay**. UC succeeds in capping the most extreme withdrawal rates that can exist under the current system. But it also **makes progression less financially rewarding for many families**.

Adjusting the UC taper rate

Given the constrained fiscal environment, it is perhaps not totally surprising that the taper – the rate at which tax credits or UC are withdrawn as earnings rise – has increased to limit government spending on in-work support. **Before the downturn, workers paying income tax and NI kept 30 pence of each pound they earned after tax credits were withdrawn; policy changes since then have reduced this to 27 pence. Under UC, it falls again to 24 pence**. However, restoring the previous level of 30 pence – hardly generous – would require cutting the UC taper rate from 65 per cent to 55 per cent, at a cost of £3 billion.

Today's high withdrawal rates mean that, for many UC recipients, increasing their earnings may not feel worthwhile. **A lower overall taper rate should, therefore, be a clear policy objective. However, there is little evidence as to what the most effective withdrawal rate should be**. In principle, we support a significant reduction in the taper rate over the medium term (for instance to 55 per cent or less) to improve incentives. Given the cost of this reduction, and uncertainty over the exact impact this would have on behaviour, we propose testing different lower rates to guide policy in this area.

Recommendations – adjusting the taper rate

- **Conduct extensive randomised control trials in this parliament to determine the most effective taper rate** for UC, in order to support people to progress out of low pay and maximise their earnings potential.
- **Informed by this, significantly reduce the taper rate over time (eg to 55 per cent or lower)**, as funds allow.

Providing support to progress

Financial incentives alone will not be enough to boost progression. Individuals must take the lead in identifying opportunities to increase their earnings and improving their skills. But employers share this responsibility. Setting out clear pathways along which employees can progress and offering appropriate support and training to enable staff to do so is vital. Yet while examples of good practice do exist, they are too-often focused on better-paid workers. **Government must take the initiative and move to encourage more employers to prioritise progression, with the aim of cutting persistent low pay**.

Under UC, the risks we have identified around the increased appeal of short-hours working for some make the provision of appropriate progression support all the more important. **Currently, the UC system aims to deal with this via the introduction of a new 'in-work conditionality'. This will mean that if claimants do not earn the equivalent of 35 hours at the minimum wage** (fewer for those with caring responsibilities), **they will be expected to increase their hours or hourly pay sufficiently in order to continue receiving UC**. If they fail, conditionality – including sanctions – may apply.

However, the proposed large-scale extension of conditionality to the working population on low incomes is completely untried and untested, with little international evidence to support its design. And even if – after much development, which is only now starting at a small scale with simple Job Seeker's Allowance-equivalent cases – it proves effective at stopping people working too few hours, **it makes no attempt to encourage or help people move beyond minimum wage jobs**. In our view, a different approach is required.

Recommendations – in-work conditionality and support for progression

- **Be far more ambitious in the trialling of practical forms of in-work support in order to boost earnings progression.**
- **Build on these trials, putting an effective system of in-work support in place over the longer term.**
- Revise UC's **approach to conditionality** to work alongside and **complement the new financial incentives and practical support** that we propose:
  - Retain the **current system of out-of-work conditionality** but take into account longer term earnings progression, not just an immediate goal of finding work.
  - **Do not pursue the proposed system of 'in-work conditionality'**
- Develop **a clear and simple 'backstop' rule held in reserve in case those with few employment barriers fail to move to progress in work after a given period of time. Effectively this would be a 'minimum income floor' rule.**

Theme 3: What's in and what's out – the coverage of UC

By integrating six benefits into one payment with a single measure of income and a single taper rate, **UC has a number of potentially major advantages over the current system: smoothing the transition into work; increasing benefit take-up**; and making it **easier to understand the financial return from working**.

Crucially, however, several key working-age benefits remain outside of the system, potentially undermining these advantages. Our review considered the forms of working-age support that are most closely linked to the benefits UC replaces.

Integrating Council Tax Support and housing support

Most notable among the benefits excluded from UC is Council Tax Support (CTS). It is currently administered alongside Housing Benefit (which is incorporated into UC) and accounts for £2.4 billion of support to low-income working-age families. **The coalition government localised CTS in the last parliament and simultaneously cut its budget by around £500 million**. As a result, local authorities introduced their own schemes, many of which require a minimum payment towards council tax regardless of a family's income. This was a mistake. It has greatly complicated the system from the point of view of a UC claimant and may well undermine some of the anticipated key gains.

Integrating CTS inside UC would, of course, have cost implications. But savings are likely to be made by centralising its administration, with local authorities currently spending around £800 million delivering CTS. Our view is that CTS assessment should occur within UC, with the precise taper rate determined by the administrative savings released by this move.

The current design of UC allows for variations in the generosity of housing support across different areas. Further integration of Council Tax Support could take a similar approach, in line with the Smith Commission recommendations for the devolution of further powers to the Scottish Government.

i Recommendations – Council Tax Support and housing support

» **Integrate Council Tax Support (CTS) with UC but apply an additional taper to CTS in order to focus eligibility on lower income households**. CTS should be reduced at a taper of 20 pence for every pound of post-tax and post-UC income a household has, aligning it with the existing default CTS scheme. This will restore full support for council tax to out-of-work families *at a cost of £500 million*.

» **Meet the cost – and the administrative burden – of this change from the savings arising from centralising the assessment process.**

» **If responsibility to deliver housing support is devolved, payments should still be made through the UC system** following the approach of the Smith Commission. This will help strike a balance between maintaining a unified welfare system with clear work incentives, while providing localities with more flexibility over how they allocate government resources on housing.

'Passporting' to other forms of support for low-income families

In the current system, a variety of benefits – known as 'passported' benefits – are automatically made available to families who receive out-of-work support. For example, any child living in a family in which no one works enough hours to qualify for working tax credit becomes eligible for free school meals (FSMs). The risk that the loss of FSMs would discourage a person from working more hours is offset by the income boost when working tax credit begins to apply.

The deliberate blurring of the distinction between in- and out-of-work benefits in UC means this offsetting will be more difficult to achieve. The previous government indicated that it intended to introduce 'earnings thresholds' beyond which families would no longer be entitled to passported benefits. However, **with no equivalent in UC to the boost provided by working tax credit kicking in, the removal of passported benefits at specified thresholds is likely to act as a disincentive for an individual to increase their hours of (or indeed, enter) work**. As yet, this has not been resolved.

Overcoming this problem, without introducing prohibitively expensive universal entitlements (for example to FSMs) for all UC recipients, **will require some technical but important refinement of the work allowance**.

Recommendations – passported benefits

- **Keep passported benefits outside of UC, but determine entitlement to these benefits using a definition of income consistent with UC.** The point at which eligibility for such benefits ends should be pinpointed so as to minimise any negative impact on the incentives UC claimants have to work.
- **Allow families to retain their entitlement to free school meals, up to a specified earnings threshold**. To achieve this without damaging incentives will mean reducing work allowances for families receiving free school meals, so that their UC entitlement is withdrawn at lower hours of work. However, once families reach the free school meals earnings threshold, they should revert to the standard work allowance, boosting their income, and providing a clear incentive to increase their working hours.

Improving support for childcare costs

Support for childcare costs is included in UC. Similar to the support available in the tax credit system, **it covers a proportion of childcare costs (85 per cent) up to a given limit (£175 a month for one child; £300 a month for two or more children). Even this apparently generous level of coverage still leaves many families facing weak incentives to work more** (or at all). A parent (either single or in a couple) working an additional hour at the minimum wage and paying for childcare for two children could be better off by no more than 20 pence an hour.[6] A welcome further 15 hours of free entitlement is set to become available to 3 and 4 year olds in families where all parents work, but this will not help with the cost of childcare for younger children.

[6] 65 per cent of each £6.50 earned is deducted from UC after tax and NI is paid, making them £1.55 better off from working one more hour. They will need to pay £1.35 towards their childcare costs (15 per cent of two hours at £4.50 an hour). This leaves them with only 20 pence from an additional hour worked. If not paying tax and NI, they would be 93 pence better off from each hour worked.

At the same time as lower-income parents face these poor incentives to work, the government is set to invest £900 million in the new 'Tax-Free Childcare' scheme, available only to families with income levels high enough to mean they are not entitled to UC (but with combined pre-tax earnings of up to £300,000). In our view, **funds dedicated to some of the highest income families under this scheme should be redirected to improve the childcare support for those on UC with young children**.

i Recommendations – childcare costs

- **Increase the childcare support given to UC recipients with children under the age of three** (who face higher hourly costs and greater barriers to entering work) **to 95 per cent of their childcare costs**, *at a cost of around £150 million.*
- **Reduce the Tax-Free Childcare earnings cap to £65,000 per person (rather than the current £150,000 cap)** in order to cover the cost of the improved UC offer.

Complex reporting requirements for childcare costs may make it difficult for UC recipients to claim the support they are entitled to, leaving them worse off than in the current system. These problems stem from trying to fit the often *termly* pattern of childcare costs into a *monthly* system to match UC entitlement periods. Under UC, parents will also have to find the money upfront to pay for a childcare place, before claiming it back. Paying UC funds direct to providers could ease this problem.

i Recommendation – more practical childcare payments

- **Calculate entitlement to childcare support on a quarterly basis** – broadly aligned with the school term timetable – making it more flexible and easier to use.
- Explore the medium-term possibility of **paying childcare providers directly through the UC system**.
- Over the long term seek to **move to a single system of demand-side support alongside the move to a more universal supply-side system.**

More generally, powers look set to be further devolved, with increasingly fast-paced devolution to the Scottish Government and Welsh Assembly, as well as English cities. It is vital that UC provides the platform for an integrated system of working-age support that can enable appropriate flexibility to allow variation at a more local level.

Theme 4: A user-friendly system – interacting with UC

The benefits system has to deal with real people in real situations, which can often mean contending with complex family characteristics and rapidly changing circumstances. It would be impossible to develop a system that perfectly copes with every eventuality. However, steps can be taken to reduce the possibility that groups with specific differences – such as the self-employed – face unnecessarily complicated processes or unfair treatment. **Many of the potential benefits associated with UC could be undermined if significant numbers find the scheme difficult to use or struggle to understand how changes in circumstances will affect their income.**

Meeting the reporting needs of the self-employed

The income of many self-employed people will vary over the year. Reflecting this, HMRC has historically based its assessment – for both tax purposes and entitlement to tax credits – on an annual basis to account for the 'lumpiness' of income.

In contrast, **UC will require the self-employed to report their incomes on a *monthly* basis, placing a significant additional reporting burden on the group**. While there is no simple solution to match the monthly employee UC system with varying self-employed income, aligning UC reporting requirements with the tax system would be a helpful simplification.

Recommendation – self-employed reporting periods

» Allow the self-employed to report their income for the purposes of UC in line with the requirements of the tax system. At present this is usually on an annual basis in arrears.

While UC currently fails to account for the differing reporting needs of the self-employed, it does set them apart from employees in terms of how entitlement is determined. **A 'minimum income floor' (MIF) is applied to the self-employed, meaning the amount of UC they receive is calculated *as if* they earn at least the equivalent of a full-time worker (35 hours) on the minimum wage each month**. People earning less than this will receive a reduced UC award.

The aim of the MIF is to prevent underreporting of income and to discourage those who are likely to rely on state support indefinitely. **But applying the MIF on a monthly basis could leave self-employed workers much worse off than employees, despite having identical annual incomes**. This situation would arise as a result of a self-employed person's UC award being capped by the MIF when their income is low, without then being recovered in months when they earn more. As with requirements around reporting income, we believe an annual approach is more suitable.

Recommendation – minimum income floor

Apply the minimum income floor for the self-employed on an annual, rather than monthly, basis to prevent inequitable treatment compared to employees.

Taking a common sense approach to the administration of payments

In the current system, benefits and tax credits can be paid on a schedule that suits the recipient. In contrast, **UC imposes strict monthly payment periods for all recipients by default, making it difficult to alter the arrangement**. This monthly pattern will be inconvenient for some but **potentially creates budgeting difficulties for others**, particularly those just managing to cope on a week-to-week basis. Without a compelling argument for only paying UC monthly – which we are yet to hear – we favour greater flexibility.

Recommendation – timing of payments

Allow UC recipients to be able to request a more frequent payment period that best suits them.

UC amends the way in which housing support is delivered. Under the current system, Housing Benefit for social-sector tenants tends to be paid to landlords. The new regime will result in Housing Benefit being paid directly to the tenant. Our concern is that this could reduce the accuracy of payments and increase the risk of rent arrears. Again, greater flexibility appears to be a sensible approach.

i Recommendation – delivery of housing support

Allow recipients to request that housing support payments are made directly to their landlords rather than being made to the tenant as the default under UC.

Aligning eligibility rules fairly between the in-and out-of work systems

Entitlement to benefits – both in the current system and in UC – is withdrawn in line with household income. **In the existing system, the way in which elements of income other than earnings** (e.g., occupational pensions or payments to a former spouse) **are treated depends on whether the individual is in or out of work. Under UC, this distinction is removed, with the harsher out-of-work approach being applied in all cases**.

> The basic level of support that UC provides is less generous to younger parents, making single parents under-25 £12 a week worse off than they are in the current system

This means people with savings of more than £16,000 will be unable to claim UC, whereas under the current tax credit system only *income* from savings is taken into account. Other income sources, such as occupational pension income, maintenance payments to a spouse and contributory benefit income are either ignored entirely or subject to the standard 41 per cent taper under tax credits. In UC, all these income sources **will reduce entitlement pound for pound**.

These tighter eligibility criteria are likely to discourage working families from saving – even as wider policy has been moving in the opposite direction. Taking other sources of income fully into account in benefit withdrawal tends to reduce the incomes of single parents and the disabled more than any other group.

The basic level of support that UC provides is less generous to younger parents, making single parents under-25 £12 a week worse off than they are in the current system. Our view is **there is little justification for introducing a penalty that does not currently exist** on these claimants, relative to other parents.

i Recommendation – fairer treatment of groups and sources of income

Unfairness in the treatment of different forms of income and the level of support provided to different groups needs to be addressed. Under the continued fiscal constraint of this parliament, we would prioritise the following changes, using savings left over from our rebalancing of work incentives to fund them:

» **Exempt savings held in ISAs** against the UC savings limit, *at a cost of £200 million.*

» **Treat maternity allowance in the same way as earned income**, meaning that it is subject to the UC taper rather than resulting in a pound-for-pound reduction in entitlement, *at a cost of £100 million.*

» **Align the under-25 basic allowance for parents with the 25-plus rate**, *at a cost of £150 million.*

In the longer term, treat occupational pension income and spousal maintenance payments in the same way as earned income (and therefore subject to the taper).

The overall impact of our reforms

Our proposals seek to keep the benefits of small-hours working as people move into the labour market but mitigate some of the risks inherent in the current design of UC. This means improving financial incentives for those most likely to respond: single parents, who may find themselves trapped at low hours of work; and second earners, who may choose not to work at all. Together, this will help boost employment overall, and female employment in particular.

Our **short-term proposals** make working part-time hours more attractive for single parents and second earners. Improvements to work allowances reduce the proportion of income withdrawn by the state when entering work (known as the participation tax rate or PTR). For over 95 per cent of single parents, PTRs are capped at 20 per cent (compared with 40 per cent under the UC baseline). For second earners in a couple with children, PTRs are capped at 60 per cent (compared with 80 per cent under the UC baseline). **We estimate that as a result of our short-term proposals, an additional 150,000 to 290,000 people could enter work** compared with the current tax credit system. This represents an **improvement of around 30 to 50 per cent** on the number we expect to enter work under the government's version of UC.

Our **longer-term proposals** go further, improving incentives to enter work at part-time and full-time hours, as well as providing better financial incentives to progress when in work. For a single parent working 40 hours a week, PTRs are capped at 50 per cent (compared with 60 per cent under the UC baseline); nine-in-ten second earners will have PTRs capped at 50 per cent (compared with eight-in-ten under the UC baseline). **We expect our**

longer-term proposals to encourage an additional 180,000 to 460,000 people to enter work, relative to the current tax credit system. This represents an **improvement of around 50 to 130 per cent** on the current UC baseline, potentially almost doubling the additional number of people who enter work.

Most groups gain from our proposals. In this parliament, **families with children gain between an extra £5 and £20 a week** compared to the UC baseline. Working single people and couples without children gain least: compared to the current design of UC they are worse off by an average of £7 a week, but they will still be better off than in the current system. Overall, **almost three-quarters (72 per cent) of all the gains from our short-term proposals go to those in the bottom half of the income distribution, increasing to four-fifths (80 per cent) under our longer-term proposals**.

A blueprint for reform

Once fully in place, UC will affect over 8 million working age families, containing half of all children in the UK. **This makes it imperative that we do everything possible to maximise the potential advantages of the new system. Our review has concentrated very deliberately on whether the proposed structure of UC will achieve its core goal of improving outcomes for families in our evolving jobs market. We conclude that significant reform of UC is needed if it is to meet the challenges of today and tomorrow rather than yesterday.**

To improve incentives – to both make it more likely that UC achieves its original purposes and copes with future obstacles – **we have set out a wide-ranging reform programme**. We have **also focused on making the system easier to navigate.**

There will be disagreement about which parts of UC we have included and excluded, and debate as to whether we have been too ambitious or not ambitious enough. But we believe that in setting out a two-phase approach – to first ensure that UC operates as effectively as possible given the tight fiscal backdrop of this parliament, before moving onto a more wide-ranging phase designed to meet the challenges of the next decade – **we have established a realistic but still far-reaching blueprint for reform**.

Part I

Opportunities and challenges: assessing UC's potential

Section 1

An overview of UC

This report concludes a nine-month review of Universal Credit (UC) conducted by the Resolution Foundation and led by a panel of welfare experts, practitioners and labour market economists. We have assessed the design of UC to ensure that, as it is rolled out over the course of this parliament, it achieves two core aims: first, of always making work pay; and secondly, of providing a simpler, easier to understand system for people to use. Looking beyond this roll-out phase, we have also considered how UC should evolve to maximise its potential benefits in the future. This section outlines UC itself – what it is and who will be affected – before discussing in more detail the scope and structure of the rest of this report.

Overhauling working-age welfare

The introduction of UC is an enormous undertaking. Replacing six in- and out-of-work benefits with one, underpinned by a single point of claim and set of eligibility criteria, marks a step into unknown territory. It is the most ambitious overhaul of working-age welfare since Beveridge. Over 8 million families, including half the children in the country, will be affected by the reforms at any one point in time. In addition, many more are expected to interact with the system at some point in their lifetime. (See Box 1 for more detail of the design of UC and how it compares to the current system; and Box 2 for a summary of the population entitled to UC.)

The sheer complexity of dealing with such a diverse and dynamic recipient group perhaps helps to explain the delays that have so far become almost synonymous with UC. Given the importance of the reform, it is absolutely right that the new system should be introduced, tested and assessed carefully rather than rushed in to meet an arbitrary deadline. However, it is also important to establish a viable timetable and show signs of progress, if only to restore faith that the system will eventually be in place.

What is clear is that the original aim of having a fully-functioning system by 2017 is no longer realistic. Instead, the most recent update suggested that UC would not be delivered nationwide, to all eligible family types, until some point early in the next decade.[7]

The delays to date have three important implications. First, there is still time to amend and improve the design of UC. Second, any significant changes to the size or structure of support for working-age families in UC – whether providing more or less generosity – will not influence government spending until the end of this decade. Third, if the new government wants to offer greater support to these low to middle income families within the current parliament, then they will have to do so through the existing tax credit system.

Our review is not about IT contracting, the precise delivery timetable or the finer points of the delivery mechanism. Instead, we have focused on ensuring that these major reforms meet Britain's welfare needs both today and in the future, striking the optimum balance between directly supporting family incomes, maximising work incentives and offering value for money for taxpayers.

[7] NAO, *Welfare reform – lessons learned*, May 2015 and OBR, *Economic and fiscal outlook*, December 2014

Box 1: What is UC?

UC merges six of the main in- and out-of-work income-related benefits into a single scheme, with the parameters detailed below. Not all working-age benefits will be included in UC, with Council Tax Support, contributory benefits (such as contributory Jobseeker's Allowance), Child Benefit and forms of in-kind provision (such as free school meals) remaining outside. Very broadly, outcomes for UC families will be similar to the current system if they are out of work or working beyond the hours requirements of working tax credit, and improved if they are working below these hours thresholds. However, tightening eligibility criteria, reducing support for under-25 parents and applying a single UC taper means that some families are either made better or worse off than in the current system (see Section 3 for a fuller assessment).

	Current system	Universal Credit
Benefits covered	**Jobseeker's Allowance** is paid to the unemployed	Each award consists of a number of elements and allowances based on the circumstances of the household. These combine to form a maximum for those who are
	Income Support is paid to out-of-work parents	**Standard allowances** are broadly equivalent in magnitude to the existing out-of-work benefit rates
	Employment Support Allowance is paid to out-of-work disabled people	**Child element** is calculated on the basis of the number of children in the household (and is roughly the equivalent of Child Tax Credit)
	Child Tax Credit is paid to families with children (in-work and out-of-work)	**Housing element** is available to renters for support with their housing costs (equivalent to Housing Benefit)
	Working Tax Credit is paid to families working a minimum number of hours (16 for single parents, 24 hours for a couple with children and 30 hours for families	
	Housing Benefit is paid to in- and out-of-work families, providing support with rental costs	
Entitlement as income rises	Out-of-work benefits – an extra pound earned reduces benefit receipt by a pound	Work allowances will allow families to earn between £111 and £734 a month before any benefit is withdrawn. The limit varies by household type
	Tax Credits – an extra pound earned (above £6,240) reduces tax credit receipt by 41p	The UC taper reduces benefits by 65p of each additional pound of earnings after tax and NI are paid
	Housing Benefit – an extra pound of net income (post-tax and post-tax credit receipt) reduces HB by 65p	
Interaction with tax system	**Paying income tax and NI reduces each additional pound earned by 32p** (20p income tax; 12p NI)	**Paying income tax and NI reduces each additional pound earned by 32p** (20p income tax; 12p NI)
	When also receiving **tax credits each additional pound earned is reduced by 73p**	When also receiving **UC each additional pound earned is reduced by 76p**
	If receiving **Housing Benefit too, each additional pound earned is reduced by 91p**	There is **no additional withdrawal rate for families with housing costs**

Box 2: Who will get UC?

3.5 million families containing a disabled person or carer
- 69 per cent are workless families including
  - 0.4 single parents
  - 0.2 million couples with children
  - 1.8 million families without children

1.3 million working couples with children
- 29 per cent have only one parent in work
- 55 per cent rent their homes
- 38 per cent have one child, 40 per cent have two
- average award of £185 with rent, £105 without

1.2 million working families without children
- 36 per cent rent
- 18 per cent are in a couple
- average award of £95 with rent, £35 without

0.1 million out of work couples with children

1 million out-of-work people without children
- 22 per cent rent
- under 1 per cent in a couple
- average award of £165 with rent, £60 without

0.8 million single parents in work
- 53 per cent rent their homes
- 60 per cent have one child, 33 per cent have two
- average award of £220 with rent, £120 without
- 75 per cent work fewer than 35 hours a week

0.4 million out-of-work single parents
- 80 per cent rent their homes
- 46 per cent have one child, 31 per cent have two
- average award of £295 with rent, £150 without

The opportunities and challenges of UC

Our starting premise is to welcome, in principle, the introduction of UC. Creating a single, more integrated working-age benefit system has the potential to simplify recipients' interactions with the welfare state. In combination with the introduction of work allowances that let claimants retain their out-of-work benefits even as they start working, and a 'single' taper rate beyond a specified earnings threshold, the new regime should ease transitions into and out of employment and help to boost overall levels of working. The Department for Work and Pensions (DWP) estimates that the added simplicity from bringing together the six benefits will increase the number of people entering work by 60,000; new financial incentives are expected to add a further 145,000.[8]

However, we also recognise that the current design can be improved upon (and, as shown in Annex A, has been slowly changed since its initial conception). Indeed, we are clear that some of the existing policy choices risk seriously undermining the advantages that UC aims to deliver. For example:

- We identify **potential problems for different groups stemming from the interaction of work allowances and tapers**. These issues are inherent in the design of UC but have been exacerbated by repeated budget cuts (see Annex A). The risk is that, while UC will boost overall levels of employment, it will create new incentives for some (especially single parents and adults without children) to reduce their working hours. At the same time, it appears to prioritise the single-breadwinner approach among couples with children. As a result, the new system may help to reduce levels of outright worklessness but might prove less effective at raising living standards and cutting the welfare bill.

[8] National Audit Office, *Universal Credit: progress update*, November 2014. These are central estimates based on a range of between 50,000 to 100,000 due to 'simplicity and smoothing' and between 100,000 to 300,000 for the impact of financial incentives.

- We are concerned that the **system does too little to promote progression at work among those in low-paid jobs**. The new system of 'in-work conditionality' may help to mitigate some of the risks of short-hours working, though it is entirely untested and therefore may not be immediately effective. In any case, it will do nothing to help people move beyond minimum wage jobs. There is a danger that UC promotes a new form of 'welfare dependency' – not among the out-of-work, but among those trapped in low pay.
- In addition, the **failure to integrate all working-age benefits into UC** – with Council Tax Support being the most obvious omission – means that many recipients' experiences and incentives will not be as straightforward as is often claimed. In particular, the concept of a 'single taper' is misleading in many instances. This continued fragmentation of benefits overlooks an opportunity to improve user interactions with the welfare state and could therefore reduce the positive impact on employment associated with integration. Where multiple assessment and administration programmes remain in place, it also has cost implications.
- There are **question marks over how user-friendly the new system will be**. The focus on monthly claims and payments is set to create – in our view, unnecessary – difficulties for some groups. At the same time, the blurring of the distinction between in- and out-of-work support has been reconciled by settling on today's tighter out-of-work eligibility rules, for instance in relation to what constitutes 'income'. Difficult decisions remain about how the new system will deal with 'passported' benefits (such as free school meals) that currently accrue automatically to those who are out of work. Incorporating such benefits without altering the central principle of ensuring that people are always better off in work requires approaches that are either expensive or highly complex.

Navigating this report

This report is divided into three parts. The remainder of **Part I** follows this section.

- **Section 2** sets out our **approach to the review and the principles for reform** that have underpinned our work and recommendations.
- In **Section 3**, we provide a more **detailed assessment of the current design of UC** than the one set out above – outlining the four themes on which we have focused our attention.

In **Part II**, we revisit each of these four themes and **outline proposed solutions** to the problems we identify.

- **Section 4** covers **incentives to start working in UC**, looking particularly at the design and distribution of work allowances across different groups.
- **Section 5** looks at **incentives and support for progression at work**, with a focus on the UC taper rate and the role of in-work conditionality.
- In **Section 6**, we consider **which benefits should be included in UC** and make recommendations for integrating and incorporating more working-age benefits.
- **Section 7** explores a range of issues associated with **making UC easier to use** – from the timing of payments, to the treatment of the self-employed and eligibility criteria.

Part III concludes, providing an **assessment of the combined impact of our proposals** in both this parliament and beyond:

- We present a **first-phase package** in **Section 9**. In this period, we acknowledge the backdrop of fiscal constraint and set out reforms that are self-funding but designed to ensure the rolled-out UC delivers against its immediate goals.
- **Section 10** details a **second-phase package of reforms**, which is more ambitious, less bound by fiscal constraint and designed to meet the changing needs of low to middle income Britain in the next decade.

Section 2

The principles and trade-offs of welfare reform

Working-age welfare plays a central role in all advanced market economies. But the needs and aims of such systems are highly specific to their given time and context. Changes in the UK's labour market, demographics, housing costs and its fiscal environment mean that the introduction of UC must strike a very careful balance between providing financial support to low and middle income families, boosting work incentives and offering value for money to taxpayers. With this in mind, it is important to establish a clear framework for reform. This section considers the high-level factors that will influence the design of UC both in the short- and longer-term, and sets out the principles for reform that have guided our assessment of the new system.

Unavoidable trade-offs: the 'iron triangle' of welfare reform

Any welfare system 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. This 'iron triangle' of welfare reform underlies all the recommendations made in this report.

Holding any one of these three elements constant means that there is a direct trade-off between the other two. A fixed budget for example means that changes to the welfare system imply a straight choice between how much is spent on working families and how much is directed to the out-of-work. However, beneath these high-level trade-offs lie a set of more nuanced decisions. Should the system be more generous to families with children than families without? Is there a case for greater support for older or younger people?

Similar questions apply to the types of financial incentives the system has: it is not simply a choice between creating strong or weak incentives, but rather one of deciding how incentives should be *distributed* across different groups. This assessment will in turn be influenced by how responsive different individuals and families appear to be to specific incentives. In addition, there is also the question of *what* should be incentivised: is it more important to encourage people into work or to reward them for working more?

Improving one element of the system for a certain group – be it generosity of income, work incentives or a combination of both – will inevitably lead to the system being made worse for another group, if the total level of spend is to remain the same. In the case of UC, where the overall working-age benefit budget has been reduced since the policy was first announced – a trend that is set to continue – balancing these trade-offs becomes much harder.

The evolution of in-work support

In-work support dates back many decades

Today's welfare system began to take shape in the 1940s, built on the recommendations of the Beveridge report. Even 70 years ago, the creation of a possible 'poverty trap' was a concern, with a recognition that if benefits to support out-of-work people were too generous, they may decide not to work at all. But it was not until the introduction of Family Income Supplement in 1971 (succeeded by Family Credit in 1986) that support was paid to *working* families as a way of offsetting these fears.

Both were relatively small in scale compared to the current tax credit system; Family Credit gave a low-level boost to the incomes of working families with children, withdrawing entitlements at a rate of 70 pence for every pound of earnings beyond a certain threshold.

Tax credits improved support but 'hours rule' meant weak incentives to earn more

The tax credit system represented a far-reaching and major expansion of this approach. Under its various incarnations since 1999, it has focused on reducing child poverty while aiming to make work pay for those on low incomes. The more generous child tax credit provides greater support for families with children, while the working tax credit provides a boost to incomes once a minimum weekly number of hours are worked (16 for single parents, 24 for couples with children and 30 for those aged 25 and over with no children) – the 'hours rule'.

Under the current tax credit system, families are better off when meeting the hours rule than not working at all but there is relatively little financial incentive beyond – or indeed below – this point. Out-of-work benefits are withdrawn pound for pound at low levels of earnings – meaning families are no better off than when they are out of work – while in-work payments are subject to a variety of overlapping tapers. Recipients who simultaneously have their tax credit and Housing Benefit entitlements withdrawn and who pay tax and National Insurance (NI) can find themselves keeping just 9 pence of every extra pound they earn (27 pence for families without Housing Benefit).

The existence of blocks of hours at which it is not worthwhile to work – either at very low part-time hours where every pound earned is immediately withdrawn in benefits, or beyond the hours rules thresholds where only a fraction of each additional pound is kept – is inevitable within the current tax credit system. It creates a dual challenge: both offering no incentive to enter employment for those who face barriers to working more than a few hours a week and doing little to encourage progression once in a job. Attempting to meet these challenges by reducing the size of these blocks – by providing in-work boosts at lower hours of work and reducing the rate at which benefits are withdrawn alongside earnings for example – would lead to a large rise in government spend.

Short- and medium-term goals for Universal Credit

In UC, work allowances and a single taper rate aim to ensure work always pays

UC aims to build on the reforms of recent years but goes further by removing the distinction between out-of-work entitlements and in-work support. Recipients will instead be eligible for support on the basis of their family circumstance and accommodation needs. Rather than immediately removing out-of-work benefits when an individual enters employment and then providing an in-work boost at a specified number of hours, UC will let workers keep all of their entitlement up to a set earnings threshold, referred to as a 'work allowance'.

In doing so, it seeks to overcome at least one of the failings of the current system – namely in relation to the disincentive associated with working short hours. It will provide an important and improved incentive to start working, particularly for people who find it difficult or impossible to meet the hours rule in the current system. In addition, the subsequent taper rate applies to the individual's post-tax income, meaning that they will always be better off working one more hour (though the net gain may be relatively small in practice).

But demands of the tight fiscal environment could undermine that aim

These major reforms are being introduced against the backdrop of an outlook for expenditure on working-age benefits that looks particularly tight until the end of this decade. The previous coalition government made various cuts to the UC budget following its introduction and the new government looks set to maintain (at least) a freeze in the value of working-age benefits from April 2016 to April 2018. Having made a pre-election pledge to find a further almost £11 billion of cuts from the working-age welfare budget[9] in the next two years, it may well be that the new government will seek to make further savings from UC.

Introducing a reform during a period of such fiscal constraint has resulted in inevitable compromises, which are explored further in the following section. But at a very broad level, compared with the current system, UC improves incentives to enter work at lower levels of earnings and reduces the worst incentives to earn more faced by people claiming housing support. However, to offset the cost of making these improvements to incentives, spending is pared back in other areas. For example, some out-of-work provision is made less generous; eligibility criteria for in-work support are tightened; incentives to earn more are made slightly worse for many; and work incentives are made much worse for second earners in couples with children. Subsequent cuts to the UC budget – the freeze in work allowances until April 2018 for example – have further weakened incentives.

Such constraint forces us to be particularly resourceful in finding ways to reform UC. We have therefore taken a two-phase approach to our review, separating an initial period of roll-out (primarily in this parliament) from a second period in which UC must evolve to meet the challenges of the next decade.

To fulfil UC's potential; cost-neutral reforms now, affordable spending increases later

During the initial phase, we focus on: rebalancing existing support in a cost-neutral way (using funds either from within the existing UC budget or from closely-related tax and benefit expenditure targeted at working-age families); making administrative changes that improve the functioning of the system; and trialling design changes for possible future implementation.

Our short-term proposals do not attempt to account for potential further, as yet unannounced, cuts to the welfare budget. These are wider choices for government and fall outside of the remit of our review. We believe, however, that the basic shape of our approach – and the rebalancing we suggest should be made within UC – is likely to remain appropriate even if there is a reduced level of overall spending. (Of course, any such reduction could lead to the weakening of incentives in UC that might create new problems that we have not considered.)

Beyond this initial phase, the need for fiscal constraint is unlikely to hold in quite the same way. For instance, maintaining the UC budget as a share of GDP – in line with OBR expectations – would imply a real-terms increase in spend in the region of £10 billion between 2020 and 2025. We are ambitious but sensible in the scale and cost of our recommendations for this period, reflecting the fact that various factors are combining to increase the importance of putting adequate funds into supporting those on low to middle incomes.

[9] The Conservatives committed to making a further £12 billion of welfare cuts before the general election. Of those identified so far: Freezing working age benefits is expected to save £1 billion, reducing the benefits cap to £23,000 is expected to save £0.1 billion and removing housing benefit from 18 to 21 year old jobseekers would save a further £0.1 billion. See: http://www.ifs.org.uk/publications/7762

The challenge of supporting low to middle income households

When charting the future path of UC, it is helpful to acknowledge the numerous pressures that have affected and will continue to affect the role that working-age welfare plays in the UK. Here we consider four, non-exhaustive areas in particular: the labour market; housing; childcare needs; and demographic shifts. Given the scope of this review, we assess the impact that the labour market will have in greater detail than the other three considerations.

A changing labour market – high employment growth but worries over quality and wages

Over the last six years, real average earnings have fallen dramatically. This is, of course, a reflection of the depth of the economic downturn suffered by the UK and across much of the globe. It is also the flipside of a surprisingly robust story on employment, with the recovery in jobs proving particularly impressive, especially in the last two years. Yet the pay squeeze may also have its origins in a structural shift, evident even before the downturn, in which the pay packets of large sections of the workforce stopped rising in line with aggregate productivity gains.[10]

Even if the overall employment picture has been good in recent years, new concerns are being raised about the *quality* of employment some people face. An apparent increase in more precarious forms of work – zero-hours contracts, part-time working and self-employment – is likely to introduce uncertainty into people's day-to-day lives. If these trends persist during the economic recovery, then our in-work support system may need to take an increasingly flexible and sympathetic approach to entitlement over time.

Judged across a longer period, the UK has consistently been at the wrong end of the international low pay league table. One-fifth of workers (22 per cent) are low paid.[11] And only one-quarter who were low paid in 2001 managed to permanently escape onto higher pay a decade later; for too many, low pay is a way of life.[12] Women, the young and part-time workers are consistently over-represented in the low pay group, while single parents, those in low-skilled occupations and – again – part-timers are at particular risk of being stuck in low pay.

A changing labour market – the rise of female employment

These headlines are little-altered in recent decades but the composition of low pay and employment within families *has* been changing. A sizeable gender pay gap remains but employment and pay outcomes for men and women have moved closer together.[13] Indeed, employment and pay gaps between pre-childbirth women and men have all but disappeared.

Women are becoming an increasingly important contributor to household incomes, particularly among the low paid.[14] Although the majority of main earners in couples with children entitled to in-work support are men, one-quarter are women. Among those UC-eligible families where both parents work, women are the main earners in one-in-five instances.

Alongside a general increase in female employment in recent decades, the proportion of single parents in employment has risen particularly dramatically. Around 60 per cent were in work in

[10] J P Pessoa & J Van Reenen, Decoupling of Wage Growth and Productivity Growth? Myth and Reality, 2012

[11] A Corlett and M Whittaker, Low Pay Britain, 2014

[12] See the following publication for further details: C D'Arcy & A Hurrell, Escape Plan: understanding who progresses from low pay and who gets stuck, Resolution Foundation, November 2014

[13] D Bovill, *Patterns of Pay: Results from the Annual Survey of Hours and Earnings, 1997 to 2012*, ONS, February 2013.

[14] SS Harkness, "Second earner to primary breadwinner? Women's wages and employment", Securing a pay rise: the path back to shared wage growth, Resolution Foundation, March 2015.

2014, up from 45 per cent in 1997 – a one-third increase in less than 20 years. This increase has corresponded with a period of significant policy attention on maternity and in-work support, suggesting a strong propensity for single parents to respond to incentives.[15]

For example, moving from an original requirement to work at least 24 hours a week in order to become entitled to Family Credit (and then subsequent incarnations of the tax credit system) to 16 hours has led to a clear spike in the number of single parents working precisely this amount. These patterns are in contrast to mothers in couples who, despite also tending to work part-time hours, display a greater variation in hours.[16]

A changing labour market – from worklessness to in-work poverty

The rise of employment among single parents appears to have been one of the primary drivers behind a sharp decline in worklessness among British families over the past two decades. Today, the proportion of workless households (15.9 per cent) is lower than at any time since at least 1996 (20.9 per cent). Among some groups, it barely exists: fewer than 100,000 non-disabled couples with children are workless.

Of the workless households that *do* remain, the majority face wider, non-financial, barriers to working. For example, one-in-ten are single parents with pre-school aged children and more than half the group are disabled or have caring responsibilities for others.

Worklessness, then, is less of a problem than it once was, and less prevalent than is often assumed. Given the nature of those groups most likely to form part of the workless population, making further progress is likely to require dealing with issues that go beyond the financial incentives that UC can have an impact on.

For example, some single parents with very young children will favour staying at home irrespective of the financial rewards offered. For those that *do* wish to work, childcare can remain a significant barrier (see below). Similarly, households with people who are disabled or have a long-term illness can face significant and often complex barriers to working that go far beyond purely monetary concerns. UC can provide an underpinning financial level of support, but meeting their varying and specific needs requires simultaneous provision of effective practical assistance.

A full consideration of these barriers is beyond the scope of this review,[17] but it is likely that the work allowance represents an important step forward by supporting low-hours working for those who may be poorly placed to take on longer hours. It is important therefore that the design of UC retains this feature. But it must also reflect the growing importance of the financial difficulties faced by households in which someone already works, or in-work poverty.

Following concerted policy action over the last 20 years, child poverty rates have fallen quite significantly but in-work poverty has taken on new relevance. Around two-thirds of poor children live in households in which someone works. What is clear is that it is no longer enough not to be workless. Indeed, raising living standards among lower and middle income households more generally has increasingly rested on dual-earning among couples.[18] Accordingly, it is no longer sufficient for our welfare system to prioritise driving worklessness down ever-further; it must also have regard for in-work progression.

[15] K Bell, M Brewer, D Phillips, *Lone parents and 'mini-jobs'*, Joseph Rowntree Foundation, 2007

[16] A more detailed discussion is in: V Alakeson, M Brewer and D Finch, *Credit where its due? Assessing the benefits and risks of Universal Credit*, Resolution Foundation, March 2015.

[17] While these issues go beyond the remit of this review, we will be considering the policy options that might help to raise employment levels among such groups in our 'full employment' project.

[18] M Brewer and L Wren-Lewis *Why did Britain's households get richer? Decomposing UK household income growth between 1968 and 2008-09*, Resolution Foundation, December 2011

A changing labour market – the implications for UC

In summary, the labour market backdrop set out above suggests three conclusions for UC's development and the balance it must strike between its objectives:

- First, UC must support people into work at least as effectively as the current regime does.
- Second, it should go further and support those families already in-work to improve their earnings. In the case of couples, this includes encouraging both members to work.
- Third, these ambitions should not be forced upon households. Variations in circumstances should be recognised and treated appropriately; UC should support behaviours that allow families to find suitable work-life balances.

Put simply, we want to retain and improve the support for short-hours working that UC offers (where appropriate), while going much further in relation to helping workers to escape low pay and poverty.

The importance of housing pressures – the rise of private sector renting and the shift to cash-based support

Since the 1970s, there has been a shift away from building social housing and affordable homes to instead providing cash support to renters. Figure 1 sets out some of the implications of this change. It illustrates how, since the turn of the century, increasing demand for rental properties has led to 'eligible rents' – tenancies for which Housing Benefit is available – rising around twice as quickly as earnings. As a result, the Housing Benefit bill has risen in real terms from £15.8 billion in 2000-01 to £24.6 billion in 2013-14, with two-thirds of this increase stemming from support to private sector renters.

To keep the welfare system affordable in the face of these trends, eligibility for housing support has repeatedly narrowed. The previous government introduced caps in the level of support provided with housing costs.[19] However, while this has reduced spend relative to what it would otherwise have been, the overall Housing Benefit bill has continued to rise.

Another method of containing housing support costs is to withdraw entitlement sharply as earnings rise. The current system does this, creating an effective taper rate of 91 per cent.[20] UC takes a different approach by applying a lower taper rate – an equivalent of 76 per cent[21] – but from a much lower earnings threshold. Both approaches have the effect of reducing the incentives to enter work or earn more.

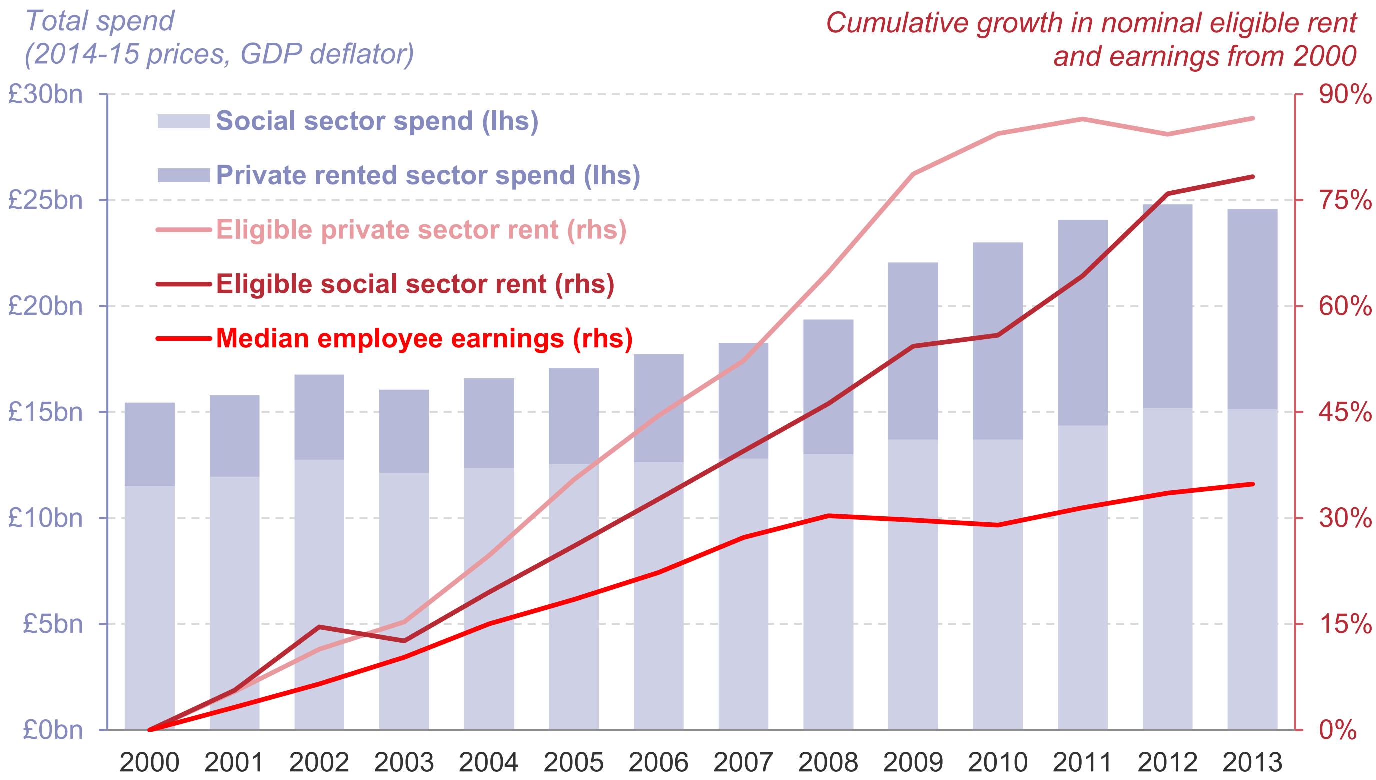
It is clear however that tinkering with the benefit system to meet housing cost pressures is not a long-term solution. Structural reform of the housing market is badly needed, both increasing the supply of affordable housing and improving how the private rental market functions. Tackling these challenges is beyond this review but action on these issues will be vital for the sustainability of the working-age welfare budget.

[19] An evaluation of this policy found that those affected by Local Housing Allowances did not pay less rent, see M Brewer, C Emmerson, A Hood & R Joyce (2014) *Econometric analysis of the impacts of Local Housing Allowance reforms on existing claimants*, IFS

[20] When paying income tax and NI, and tax credits and housing benefit are withdrawn

[21] When paying income tax and NI, and UC is withdrawn

Figure 1:
Growth in Housing Benefit spend, eligible rents and average earnings



Notes: Eligible rent is the amount of rent that Housing Benefit will provide support with. In the social sector some service charges are excluded. In the private sector only rent up to a certain amount, the Local Housing Allowance, can be covered by Housing Benefit..

Source: Office for Budget Responsibility, Welfare trends report, October 2014, ASHE 2000-2013

Childcare provision and support – increased help but affordability, availability and quality issues remain

Despite considerable policy attention in recent years – and notwithstanding the government's welcome intention to extend the free childcare offer for all 3 and 4 year olds by a further 15 hours a week where all parents work – access to childcare remains a barrier to work. Parents struggle to find childcare they can afford, when they need it and at the standard they desire.[22] The generosity of support provided by the state is of course a factor for families, but it is not the only one. Increasing government payments in the face of future cost pressures risks dealing only with a *symptom* of a wider market issue.

The childcare market is fractured and highly localised. It is a labour-intensive industry, with staffing accounting for more than 70 per cent of running costs. It therefore appears difficult to make substantial reductions in the cost of provision without a drop in quality, particularly in what tends to be a low profit sector.[23] And, while successive governments have directed funds towards childcare, there is an unresolved tension between the extent to which this provision is designed to facilitate increased employment and the extent to which it is designed to support child development.

[22] G Cory and V Alakeson, *Careers and carers: Childcare and maternal labour supply*, Resolution Foundation, January 2014 and DfE, *Childcare and early years survey of parents 2012-2013*, January 2014

[23] DfE, *Childcare Provider Finances Survey*, May 2012

In the face of these pressures, and given the greater importance of getting both parents into work as a means of boosting living standards as discussed above, the government needs to develop a cohesive strategy. UC will form only one part of this agenda, accounting for £2 billion of the £7 billion annual budget of government provision expected over this parliament. Again, we do not focus on these deeper issues in this report, but we view them as central to an overall package of reform designed to support low to middle income households in the coming years.

Demographic pressures – dealing with an ageing society

Putting working-age welfare spend into perspective, our ageing population will continue to apply pressure not only on benefits but also on government spending as a whole. Today, pensioners represent 24 per cent of the 16-plus population. Long term, this is expected to increase, reaching 29 per cent by 2060 (despite planned increases to the State Pension age).[24] There is also a coming boom in the number of children starting school, placing pressure on education budgets.

In the last parliament, the coalition government protected health and education budgets along with the incomes of pensioners. The new Conservative administration is expected to continue this approach in this parliament. Not only do these decisions make funding an effective welfare system increasingly difficult, they also place a greater emphasis on supporting people into work and earning more, in order to increase tax revenues and ease the financial burden of an ageing society.

The devolution debate

Alongside responding to these four evolving policy areas – the labour market, housing, childcare and demographics – welfare reform under UC must be sensitive to the growing shift towards devolution of powers to the Scottish Government, Welsh Assembly and English city regions.

To be clear, our review is grounded in the status quo and deals primarily with adjusting UC to make it work within the current policy environment. We have therefore not attempted to assess what level of devolution would best suit the delivery of different aspects of working-age welfare – though we do favour taking a consistent approach to clearly connected policies. For example, we believe it is a mistake to deliver housing support via a centralised UC process while retaining a localised approach to Council Tax Support. Either both should be devolved or both should be centralised (see Section 6).

While we have no stated preference for the extent of devolution that the welfare system should aim for, it is obvious this debate will continue over this parliament and beyond. With this in mind, it is important that UC is designed in such a way as to allow space for flexibility in response to future developments.

A thematic approach

It is clear that UC must meet the demands of a changing world. Both established and developing trends in the labour market, in housing and childcare and in relation to the nature of the nation's demographics and political structures present significant challenges. To hone in on ensuring that this reform can be effective, our review has considered four broad themes that could have an important impact on the ability of UC to deliver, and to improve living standards for low to middle income families:

» Theme 1 covers financial **incentives to enter work** for different groups and looks specifically at the appropriateness or otherwise of the UC approach to work allowances.

[24] ONS, *2012-based National Population Projections*, November 2013

- Theme 2 focuses on **progression in work**, highlighting the importance of the financial incentives provided by the taper and the practical support that can be provided to help people move out of low pay.
- Theme 3 considers the **benefits and support that are integrated within UC** and the interactions of the new system with those payments that are not incorporated. It looks also at how UC can fit with the devolution agenda.
- Theme 4 looks at **how easy the system is to use on a day-to-day basis**, particularly for the self-employed and families with childcare costs, along with the impact and fairness of the entitlement rules.

We identify problems and set out potential solutions across each of these themes in the four sections of Part II, before bringing our recommendations together into a single set of reforms in Part III.

Principles for reform

However, the above themes have a potentially broad scope. It is important to understand that, while a variety of wider trends create challenges for UC, there is a limit to the influence that UC can have on these issues. From the start, we recognised that it was vital that our recommendations focused on achieving our core ambition to improve incentives to start working and then progress, rather than attempting to tackle wider issues and thereby compromising their effectiveness.

To underpin this approach, we established a set of guiding principles for reform – listed in Box 3 – that reflect our sense of what is required from a working-age welfare system in 21st century Britain. The principles are designed to acknowledge and reconcile the trade-offs between coverage, adequacy, simplicity and cost associated in any welfare system.

Box 3: Overarching principles for our review of UC

- Priority should be given to **securing a more integrated benefit system** that interacts effectively with other elements of working-age support to **ensure a smooth transition** into work and **encourage progression**.
- From the user's perspective, it is **essential that the system is perceived as simple and is easy to use**. It should **provide regular, reliable and accurate payments and not introduce major new reporting burdens**. Achieving this should **maximise the extent to which people respond to the financial incentives** UC creates.
- **Financial incentives should support more people to work**, not focus on simply reducing the number of families where nobody works. And the system should **avoid encouraging people to reduce their amount of work or level of earnings in a way that imposes a burden on the taxpayer**.
- **Reducing the number and level of rates at which benefits are withdrawn** is important to improve incentives to progress and **make it easier to understand how incomes change** as people work more.
- But **the presentation of a single smooth taper – attractive as it may be – should not be prioritised above creating a simpler more integrated system**, particularly when **delivering a genuine single taper is an unrealistic ambition** without much more radical further reform.
- The **generosity of the standard allowances** (which largely mirror current out-of work entitlements) **should not be reduced beyond their present level**.
- **UC cannot solve the underlying problems in wider, related areas of government policy by itself**, such as the increasing cost of housing or childcare, or providing affordable healthcare to low-income families. The **focus of the review is on areas of policy directly within the control of DWP** and, most importantly, on the **functioning of the UC system and the work incentives that it creates**.
- In **the short term** – as UC is rolled out to a much greater number of families over this parliament – **changes to UC must be self-funding**, either from within the level of expected spend on UC or from **spend allocated elsewhere to support working-age families**.
- **In the longer term**, beyond the initial roll-out phase, the ambition must be to **ensure that UC works as effectively as possible to deliver its key aims of making work pay, encouraging progression** and a **simpler more easy to use** benefit system. Additional funding should be made available where it will improve outcomes.

Section 3

Weighing up the current proposals

Our interim report Credit where it's due? *provided a detailed analysis of the impact of UC, concluding that the biggest advantage of the reform would be the introduction of a single working-age benefit system that makes moving into work much simpler. Work incentives are expected to be improved by the introduction of work allowances, which will make work pay at low hours. These will help those who face barriers to working longer but who currently find there is no financial return associated with entering work at short hours.*

But while that will help to deal with one of the drawbacks of the tax credit system, the distribution of these allowances, combined with a high taper, increases the risk that some groups – particularly single parents who rent and workers without children – become trapped in low pay jobs. Our interim report also highlighted that a focus on reducing the number of households in which no one is employed has led to very weak incentives for second earners *to work.*

This section summarises our assessment of the impact of UC as it is currently designed, discussing in turn each of the significant changes the reform will introduce. While there are many encouraging aspects that should simplify the system and make work more financially rewarding, there are also undesirable consequences that we argue should and can be minimised.

Six benefits rolled into one

Of all the potential advantages that UC can boast over the current system, two in particular strike us as being both immediately realisable and valuable: the clarity of work incentives and the ease of comprehension and use.

UC will make it clearer whether a person will be better off working more

Discussions of barriers to work often focus primarily on issues like skills and the availability of jobs in the local labour market. While these concerns are of course crucial, these viewpoints can overlook the importance of the system itself and how easy it is to understand. The complicated process of having to claim a new set of benefits or provide details of a change in circumstances can act as an obstacle to moving into work.

These fears stem from two issues: a complicated benefits system that is difficult to understand and the high rate at which benefits are withdrawn as earnings increase. The interactions between benefits – for example, the amount of Housing Benefit a person gets depends on income from tax credits as well as earnings – can make it difficult to work out whether taking on extra hours in worthwhile. By joining six benefits and tapering payments away at a single rate, UC should clarify the gains a person will receive from moving into employment or taking on extra hours.

And will provide a single contact point for recipients

Currently, when people move into work they must inform different agencies of the change in their circumstances: Jobcentre Plus to cease their claim for out-of-work support; HMRC to claim in-work support; and the local authority to update their claim for housing support. This process in itself can be daunting and difficult to navigate. An important attraction of UC is that it should reduce the administrative burden placed on claimants. Recipients will only need to complete one form to claim the equivalent of six income-related benefits, with entitlements automatically calculated as a person moves into work and increases their earnings.

Key finding

The main advantages of UC stem from combining six benefits into a single, simpler system. It will simplify the trade-offs and returns to moving into work, as well as the administrative process itself, making it easier for people to understand their return from working or earning more. These features should lead to more people entering and progressing in work.

Not all benefits are included in UC

UC is complicated by the exclusion of Council Tax Support

Not all income-related benefits were amalgamated into UC – the exclusion of some key benefits makes the claim that UC will mark a transition to a single system of benefits slightly misleading. For example, the exclusion of Council Tax Support (CTS) represents a major compromise to the idea of integration and simplicity. The added complexity associated with excluding CTS is compounded by the fact that 325 local councils in England have been given the option to vary the level of support they offer to different groups.[25]

In contrast to the previous system of Council Tax Benefit and the default approach under CTS, residents have to make a minimum contribution to their council tax in 250 local areas – a regressive measure hitting the lowest income families the hardest. Likewise, support is withdrawn at different rates across localities as incomes increase. This violates one of the core principles of UC: to have a single taper rate at which support is withdrawn. In reality, there are many different taper rates that vary from area to area.

'Passported benefits' like free school meals are also left out

It is not just CTS that has been left out of UC. There are a variety of supports, usually referred to as 'passported benefits', that people are entitled to because they qualify for other benefits. Free school meals (FSMs), probably the best-known example of such provision, are currently provided to families in receipt of out-of-work income-related benefits, or who are in very low hours of work and not receiving working tax credit.

UC deliberately blurs the distinction between in- and out-of-work support. While this is expected to improve transitions into work, it also makes it harder to discern the point at which FSMs, and other passported benefits, stop being payable. At the time of publication, the government has not announced a clear set of proposals to determine in which circumstances people will be eligible for these benefits under UC, though the previous coalition government indicated that an earnings threshold would be used. Whatever approach is taken, accommodating for passported benefits will complicate matters. And if people are left worse off in work once the value of entitlements is considered then the objective of making work pay through UC could be undermined.

[25] The Scottish Government and Welsh Assembly have also been devolved responsibility for their Council Tax Support regimes.

i Key finding

The failure to integrate Council Tax Support undermines the logic of a single working-age benefit system because people will have to claim for this separately.

i Key finding

The additional taper rate that is applied when Council Tax Support is withdrawn will make it difficult for people to understand whether they are better off from working. Similar complications will arise in relation to interactions with 'passported benefits' such as free school meals.

Eligibility for all six benefits is automatically determined

A downside of any means-tested benefit is that not everyone who is entitled avails of it. This is especially problematic when new benefits are introduced. For example, in 2000-01 less than two-thirds of families eligible for the Working Families Tax Credit made a claim. By 2003-04 (and following a switch to child and working tax credits), take-up had reached around 90 per cent.

While this rise was welcome, take-up among some groups remains low. For example, of those who are eligible to claim working tax credit, just 30 per cent of workers without children do so.[26] Similarly, take-up of Housing Benefit is much lower among working families than it is among those who are out of work (45 per cent compared with 95 per cent, respectively).[27] These gaps should all but close under UC, because the single point of contact means those currently claiming one type of support but not another will automatically receive all of their entitlements.

i Key finding

Having a single application process is expected to ensure people who are entitled to multiple benefits receive all those payments. That is, 'take-up' of benefits should increase. This will help to ensure that lower-income families earmarked as in need of support actually receive it.

Reporting requirements simplified for most, complex for some

Under UC, a real-time earnings feed will allow employers to provide HMRC with a monthly report of their payments to employees. This will reduce the need for workers to report changes in their circumstances. Once in work, entitlements are calculated using the information provided on their monthly earnings. As earnings change, the UC award will be updated accordingly.

[26] HMRC, *Child benefit, Child Tax Credit and Working Tax Credit Take-up rates 2010-11*, November 2013

[27] DWP, *Income Related Benefits: Estimates of Take-up in 2009-10*, February 2012

However, not all information that UC requires will be as straightforward to report. Two groups in particular might face difficulty and new burdens: the self-employed and parents with childcare costs. In both cases, the information UC requires on a monthly basis is not necessarily readily available. That is because both self-employed income and childcare costs often do not fit into a regular monthly pattern.

In UC, work allowances treat benefit recipients' earnings much more generously as they start to work

The problem stems from the fact that UC's smooth operation is protected at the expense of shifting the reporting burden onto recipients. This may sound like a minor point but is potentially a major new hurdle for over 1 million families receiving UC to surmount. And it is more than an administrative burden: for some it will have real financial cost because their UC entitlement will be reduced. For example, those self-employed who face fluctuations in their earnings from month to month could find themselves getting less from UC than do employees who – over the course of the year – have the same salary.

Key finding

Although most claimants will face fewer reporting requirements under UC, complicated processes for the self-employed and people with childcare costs could lead to new burdens being placed on a significant minority of UC recipients. For them, it increases the likelihood of errors or misreporting of information, and could have a material impact on the UC. award paid to some

Improved incentives to enter work through the work allowance and taper

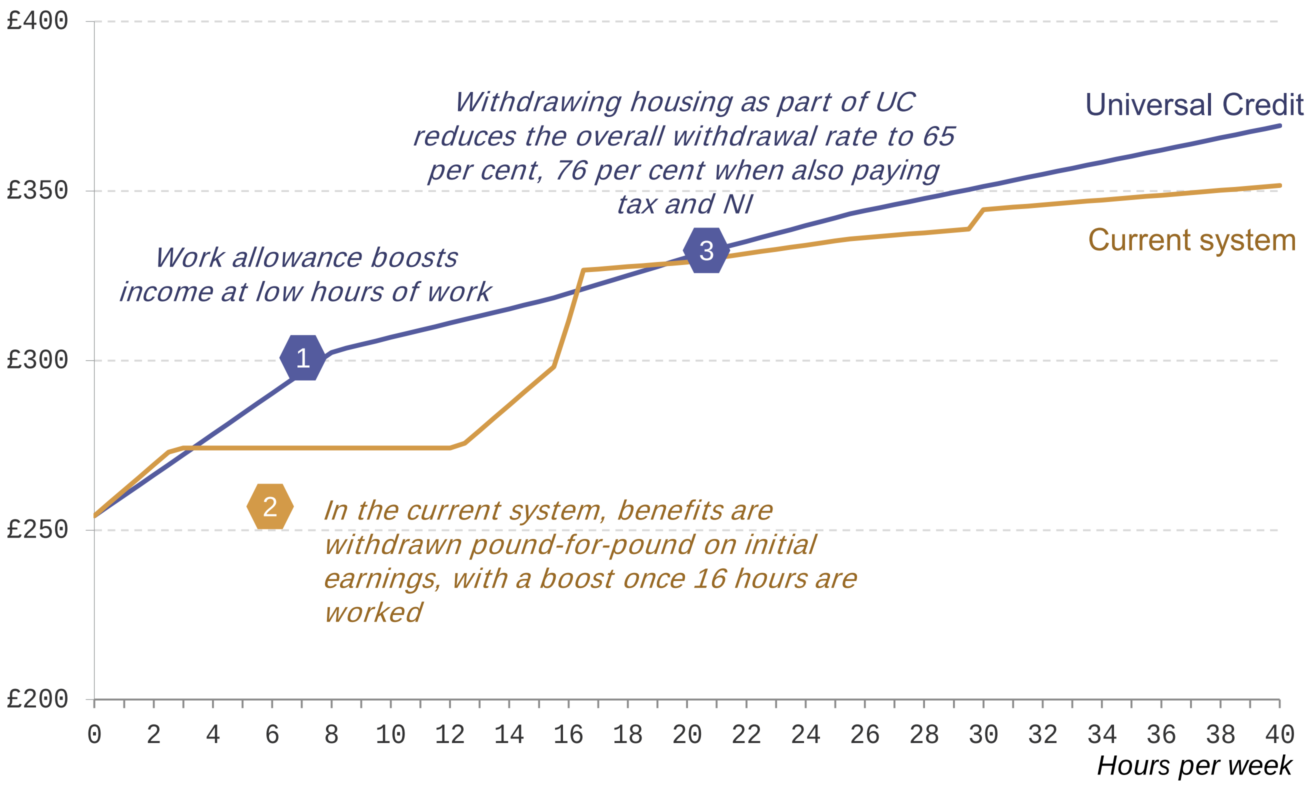
A central focus of UC – making work pay – rests on the introduction of work allowances. In the current system, out-of-work entitlements are withdrawn pound for pound as a person's earnings increase (beyond a small disregard of up to £10 a week). Working tax credit provides a strong incentive to enter work by boosting income, but this is only available once a person is working a specified minimum number of hours. Beyond this point, tax credits and Housing Benefit are 'tapered away' as earnings increase.

In UC, work allowances treat benefit recipients' earnings much more generously as they start to work.[28] Benefits are only withdrawn once a person's earnings exceed a certain level – the limit of the work allowance. This increases the gain someone receives from entering work, making taking on low-hours roles much more attractive than in the current system. Such a feature may be of particular benefit to people with young children, caring responsibilities or disabilities. Figure 2 shows the difference between the two schemes in the case of a single parent earning £7.50 an hour.

[28] Work allowances are different depending on whether a person rents, lives in a couple or has children. The work allowance for a single parent ends at 26 hours at NMW, 9 hours if they rent. For a couple with children the work allowance ends at 19 hours at NMW, 8 hours if they rent. Section 4 provides more detail.

Figure 2:
Change in household net income at different hours of work under UC and the current system. Single parent with one child aged 2 years old earning £7.50 an hour who owns their home

Net weekly income for a single parent with one child aged 2, earning £7.50 an hour and £100 rent



Source: Resolution Foundation analysis using the RF microsimulation model

The single taper rate within UC will be most welcomed by those who previously had their housing benefit withdrawn at the same time as their tax credits. This group currently lose 79 pence of every extra pound they earn, rising to 91 pence if they pay income tax and NI contributions, and to 93 pence if also receiving CTS. Around 10 per cent of workers entitled to tax credits face an overall withdrawal rate of over 90 per cent. Abolishing these punitively high 'effective tax rates' – the 'tax' paid on every extra pound of earnings – is often said to be one of the big gains of UC; for many, that will certainly be the case.

However, there will also be a large share of UC claimants who actually face slightly higher effective tax rates than in the current system. For example, when UC is withdrawn while paying income tax and NI, workers will lose 76 pence of every extra pound earned as opposed to 73 per cent in the current system. Overall, the government estimates that, while reducing taper rates for 1.5 million workers, 2.1 million will experience a higher taper rate.[29]

There is also no 'single taper'. Although the UC withdrawal rate is fixed at 65 per cent, the effective tax rate for recipients jumps to 76 per cent when paying income tax and NI. And the continued exclusion of CTS means that it is tapered away on top of UC. Removing the bump in the withdrawal rate when income tax and NI start to be paid seems beyond the current realm of possible reforms: it

[29] DWP, *Universal Credit Impact Assessment, December 2012*. Note that these estimates do not take into account the impact of CTS on taper rates.

would involve reducing the UC taper significantly once income tax and NI were paid, which would be expensive. But the closer integration of other benefits – like CTS – with UC does seem plausible.

Key finding

The introduction of work allowances will make it more worthwhile for people to enter work. They focus additional support at low levels of earnings, opening up such roles to people who may not find it worthwhile to work in them under the current system.

A single taper rate of 65 per cent applied to the benefits that are part of UC will remove the highest effective tax rates that people face in the current system (some in excess of 90 per cent) – particularly where Housing Benefit and working tax credit are withdrawn at the same time. However, many people will face a slight increase in their effective tax rate under UC, with the amount of each extra pound of income that is 'lost' rising from 73 per cent to 76 per cent.

UC creates potential behavioural risks

The introduction of work allowances and a single taper within UC means it differs significantly to the current tax credit system. This change in determining in-work entitlement has important impacts on both the generosity of the benefit system and the shape of work incentives, with implications for people's incomes and work behaviours. It also creates new constraints and trade-offs when considering altering the design of UC:

- First, it makes entering work at low hours of work much more attractive. The current system by design penalises and discourages people from working fewer hours than the requirements of working tax credit (16 hours for a single parent, 24 hours for a couple with children, 30 hours for over-25s without children). For some groups then – those with disabilities or caring responsibilities unable to work for longer – the introduction of work allowances represents a clear step forward and makes sense from the taxpayer's perspective. But for those who face fewer barriers to working longer hours, it runs the risk of incentivising sub-optimal outcomes. As well as the direct impact on the individual, this has implications for taxpayers.
- Second, the slower withdrawal of housing support in UC makes the new regime significantly more generous to renters than homeowners. To offset this, work allowances for families who rent are lower. While the logic here is apparent, it reduces the attractiveness of work. In particular, single parents who rent – overwhelmingly mothers – will find that their work allowances are exhausted at very low hours of working. This could lead to those who are affected reducing their hours of work. Some may choose not to work at all.
- Third, work allowances are provided to *all* families to support the principle that work should always pay – even if the individuals in those families have no barriers to working full-time. This means that working adults without children have increased levels of benefit entitlement relative to the current system at lower hours of work. As noted above, those over 25 must currently work at least 30 hours a week to access tax credits; those under-25 get no support at all when in work. Under UC, members of this group therefore have a potential new incentive to work fewer hours, with their lower earnings being cushioned by more generous in-work support.
- Finally, each family has only one work allowance, after which point benefits begin to be withdrawn. For a couple, this allowance is usually used up by the main earner, leaving the second earner facing the loss of 65 pence in every pound from the very first pound they earn. This is a deliberate part of the policy design: resources will be targeted on reducing the number

of *workless* households by focusing on primary earners rather than second earners.[30] As we saw in the previous section, this is a contentious choice given the growing prominence of in-work poverty; the importance of second earners to living standards and poverty reduction; and the UK's low level of worklessness among households other than the disabled or single parents with very young children. It is also likely to be another way in which UC outcomes look less good for women than they do for men.

These potential behavioural risks are particularly focused on single parents, workers without children and second earners. The taper rate may lead some to reduce their hours of work, accepting a relatively small drop in income as an appealing trade-off for significantly fewer hours spent working. For others, particularly second earners, it may encourage them to stay out of work altogether as the high withdrawal rate on all earnings means that work is no longer financially worthwhile.

i Key finding

The current precise distribution of work allowances across different groups will, in combination with the 65 per cent taper rate, potentially produce new costs, new behavioural risks and weaker incentives to work for some. Single parents who rent and workers without children might reduce their hours of work, while second earners may become less likely to work at all.

i Key finding

UC shapes incentives to get people into work, reducing the number of households in which nobody works. However, incentives for individuals to progress, that is, to earn or work more, are little improved for most and made slightly worse for some. UC recipients will lose 76 pence of each additional pound earned when also paying income tax and NI, compared to 73 per cent in the tax credit system.

In-work conditionality will focus on hours worked rather than pay progression

A new system of 'in-work conditionality' has been proposed to help offset the behavioural risks outlined above. In essence, this will constitute an extension of the type of conditionality usually applied to Jobseeker's Allowance recipients to people with low earnings. People will be expected to spend time looking for more hours of work or better pay until they earn up to the equivalent of 35 hours a week at minimum wage, with some variation to reflect individual circumstances.[31] In practice, the proposals represent little change for most parents relative to the hours requirements of working tax credit. But for others, such as those with children at secondary school or no children at all, expectations are higher. A possible extra 1million people could be brought into the conditionality regime and therefore the potential threat of sanctions.[32]

[30] For a discussion of the targeting of incentives on tackling worklessness see, for example, DWP, *Universal Credit Impact Assessment*, December 2012.

[31] People with other responsibilities, such as caring for young children or disabled adults have reduced or no work requirements. See Section 7 for a full discussion of in-work conditionality and practical in-work support.

[32] DWP, *Improving employment outcomes under Universal Credit for in-work claimants*, 2013.

However, such a system is untested and untried not only in the UK but also internationally.[33] Given this lack of precedent, it is hard to envisage the new system being effective in the short-term: any experimental reform will take time to bed in. It will also do little to help people move out of low pay. That is because in-work conditionality targets a minimum number of hours of work at the minimum wage, meaning that someone working full-time at the minimum wage will have no ongoing contact with the regime whereas someone working part-time at a higher hourly wage could. This is problematic because the proportion of workers in the UK below the low pay threshold (equivalent to £7.69 in the UK in April 2014) is higher than most countries in Europe and has remained stubbornly high for two decades.

UC provides an opportunity for government to interact with low-paid working families and provide support to help them increase their earnings and progress in the labour market. Different groups require different types of assistance to overcome barriers and move out of low pay. Support focused on progression would, like in-work conditionality, take time to be effective but could be a more productive approach than the threat of sanctions when developing relationships with those stuck in low pay. Unlike in-work conditionality, this approach also has the benefit of being able to draw on an existing evidence base of what works.

Key finding

In-work conditionality is unlikely to be immediately effective in reducing the risk that people choose to work fewer hours under UC, with falls in their earnings being cushioned by the taper. Low pay is a significant problem in the UK that a sanctions-based regime of in-work conditionality is not designed to deal with.

The merging of in- and out-of-work benefits will result in the adoption of tougher out-of-work eligibility rules

In calculating entitlement to benefits and their subsequent withdrawal, choices must first be made about what minimum level of support people should receive. These choices are, in turn, dependent on decisions about what constitutes 'income'. For example, how should savings or pensions be treated?

In the current system, different definitions are used depending on whether an individual is in receipt of out-of-work benefits or tax credits. The merging of the in- and out-of-work benefit systems under UC means that such distinctions are no longer useful. It is important that there is coherence in how different types of income are treated to prevent sudden jumps in entitlement when moving into or out of work, and to make it easier for people to understand what will happen to their income as a result.

However, rather than a balanced merging of the existing in- and out-of-work rules on how income is treated, UC defaults to the tougher out-of-work benefits rules. Taking the example of maternity payments, while tax credits are reduced by 41 per cent of the value of maternity allowance received, UC is deducted pound for pound – in line with its current treatment of income against receipt of benefits like Jobseeker's Allowance.

Entitlement under UC is therefore reduced, with the effect of 'residualising' in-work support. That is, UC narrows and reduces entitlement in a way that could make it appear to be a system to be relied on only when absolutely needed, rather than a supplement that recognises the innate pressures associated with being a low to middle income working family.

[33] Organisation for Economic Co-operation and Development (OECD), *Connecting people with jobs: Activation policies in the United Kingdom*, July 2014.

Additionally, the current system of out-of-work benefits provides a range of rates of support based on individual and family circumstance: age, parental status and presence or otherwise of a partner. In UC, the level of support for single parents aged under-25 has been reduced, aligning support with other people of this age but reducing support compared to other parents. Other families with children retain, broadly, the same level of support as in the current system.

i Key finding

Combining and simplifying the in- and out-of-work benefit systems has led in all instances to the exporting of the strictest versions rules of generosity and treatment of unearned sources of income. This has inequitable impacts, particularly on families with children, that are not an inevitable consequence of achieving a more aligned system.

Summarising our key findings

» Combining six benefits into a single system will simplify the trade-offs and returns to moving into work, as well as the administrative process itself. These features should lead to more people entering and progressing in work.

» But the failure to integrate Council Tax Support undermines the logic of a single working-age benefit system because people will have to claim for this separately. This exclusion of CTS and the uncertain treatment of passported benefits such as free school meals also mean there is no single taper rate in practice.

» The introduction of work allowances will make it more worthwhile for people to enter work. They focus additional support at low levels of earnings, opening up such roles to people who may not find it worthwhile to work in them under the current system.

» UC shapes incentives to reduce the number of households in which nobody works. Incentives to progress are little improved for most and made slightly worse for some. UC will remove the highest effective tax rates that people face in the current system. But many people will face an increase from 73 per cent to 76 per cent when paying income tax and NI.

» The distribution of work allowances and the relatively high levels of income withdrawal faced by UC recipients will potentially create additional costs, new behavioural risks and weaker incentives to work for some groups. Single parents who rent and workers without children might reduce their hours of work, while second earners may become less likely to work at all.

» In-work conditionality is unlikely to be immediately effective in reducing the risk that people choose to work fewer hours under UC. Low pay is a significant problem in the UK, which a sanctions-based system of in-work conditionality is not designed to deal with.

» The introduction of a single application process is expected to improve benefit take-up. This will help to ensure that lower-income families earmarked as in need of support actually receive it.

» Although most will have fewer reporting requirements, complicated processes for the self-employed and people with childcare costs could lead to new burdens being placed on some UC recipients.

» Combining and simplifying the in- and out-of-work benefit systems has led in all instances to the exporting of the strictest versions of rules of generosity and treatment of unearned sources of income. This has inequitable impacts, particularly on families with children.

In the next four sections (Part II), we build on the assessments set out above by making proposals for reform across four broad themes:

- **Incentives to start working (Section 4) –** rebalancing incentives across different groups to more effectively support improvements in living standards;
- **Progression in work (Section 5) –**using a new balance of incentives, support and conditionality to help lift people out of low pay;
- **The coverage of UC (Section 6) –** reviewing the thinking behind the scope of UC and providing closer integration with other working-age benefits; and
- **The ease of interaction with the system (Section 7) –** improving the extent to which the day-to-day operation of UC is fair and fit for purpose across different user groups.

Part II

Making the most of Universal Credit

Section 4

Getting into work – incentives to start working

The incentives created by UC should encourage all adults in a household to work or earn more and improve their standard of living. It is also important to ensure that people are encouraged to find good quality employment. This should raise their chances of moving out of poverty, while providing a suitable balance with other responsibilities they may have, such as providing care for a disabled relative or spending time with their children.

This section explores the employment outcomes that UC should seek to support, taking into account how circumstances – and patterns of work – can change over the life cycle. It explains where the current design of UC falls short in achieving those aims and sets out approaches designed to rectify these issues. A more detailed assessment of the impact of the proposed measures – taken in combination with the other recommendations in this parliament – is set out in Section 8.

Rebalancing work allowances

The DWP's 2012 impact assessment of UC concluded that it targeted resources towards reducing the number of workless households by "always ensuring that work pays" and by "increasing the incentive for at least one member of the household to enter work."[34] With that in mind, it is worth considering the out-of-work group of potential UC recipients in more detail.

Roughly 8 million families will be eligible for UC, with no one in work in just under half. This workless group of 3.9 million comprises:

» 2.4 million with someone who is disabled or who has caring responsibilities for someone with a long-term illness or disability;

» 1 million adults without children;

» 0.4 million single parents (two-thirds have a child under the age of 5); and

» 0.1 million couples with children.

In addition, there are approximately 0.9 million couples where one partner works but the other does not (see Box 4 for a more detailed discussion of employment rates among parents).

Dividing the out-of-work population in this way is an important first step in assessing how appropriate UC's approach to getting people into work is. In particular, we must consider the extent to which these different family groups are likely to respond to the financial incentives provided by the new welfare system. **Honing in on the more responsive groups – for whom UC can potentially have the biggest impact – will help us to refocus its limited resources in the most effective way.**

[34] DWP, *Universal Credit Impact Assessment*, December 2012.

Box 4: Parental employment

Employment rates and hours worked vary across family types. Whether a person has children – and whether they are the main carer – tends to influence their likelihood of working, how many hours they work and, as a result, their living standards.

As Figure B4.1 shows, employment rates vary significantly across different groups of parents. Within couples, fathers have a much higher employment rate of around 90 per cent. They also tend to work full time, although those who are eligible for UC are more likely to work part time. In contrast, mothers in couples have employment rates of around 60 to 80 per cent, rising with the age of their youngest child. This gender pattern is unchanged since 2002, although there is some suggestion that this typical model is starting to change among lower-income families. In one-third of low-paid couples, the mother is now the highest earner. Nevertheless, the traditional split persists for the majority of families with children.

Single parents have a similar employment rate to mothers in couples as their youngest child reaches school age, but are less likely to work when their children are younger. The likelihood of mothers working full time also increases with the age of their youngest child.

The vast majority of single parents, whether working or not, are entitled to some UC, but only 30 per cent of couples with children are. Among working couples with children in UC, both parents are employed in just one-quarter. Of those spouses not in work, 45 per cent have a youngest child under the age of 3.

These patterns of work show the different labour market outcomes for different groups of parents that the design of UC should seek to support and improve. The main earner in a couple is already likely to be working full-time but at a low rate of pay. Their partner is unlikely to work at all so would benefit from stronger financial incentives. Single parents may need stronger incentives to start working when their children are very young, but the longer-term challenge is to help them maximise their earnings potential once in work through stronger incentives to progress.

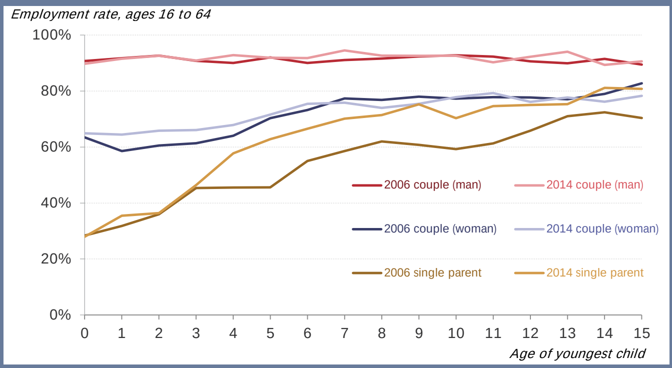


Figure B4:1
Employment rate by family member

Source: Household Labour Force Survey, Q2 2006 and 2014

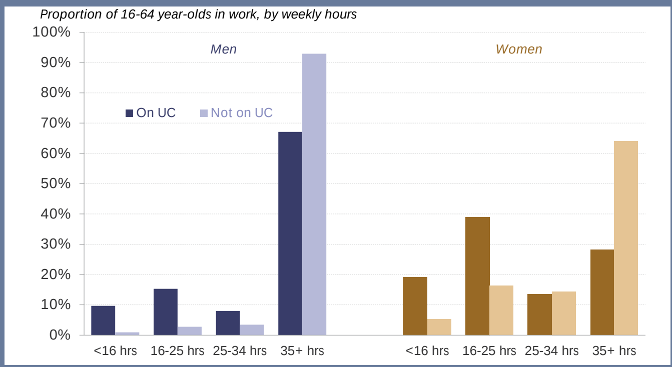


Figure B4:2
Pattern of hours worked in UC

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

Work allowances create 'sweet spots' after which benefits are withdrawn

The work allowances in UC allow families to retain a certain level of earnings before their benefits are withdrawn, giving them a strong incentive to start work. These allowances differ depending on broad family characteristics and housing circumstances. Beyond the allowance, benefits are withdrawn at a rate of 65 pence for every pound of additional earnings, increasing to 76 per cent when also paying tax and NI. We might therefore consider the point at which an allowance is exhausted to be the 'sweet spot' of employment for an individual: every hour worked beyond this point pays less than hours within the work allowance. For parents, additional childcare costs could remove *any* financial incentive to work beyond the sweet spot.

Table 1 sets out the different monthly work allowances in 2015, as well as the number of hours a person would have to work a week at the minimum wage (£6.50) before the work allowance is exceeded. Work allowances are dramatically lower for families who rent, in part to offset the greater entitlement these families would otherwise receive through support with their housing costs. It also prevents families who rent but earn relatively high incomes from receiving additional payments. Where an adult cannot work due to sickness or disability[35] their family is entitled to the 'limited capability to work' work allowance. This work allowance is higher than for families without children, but can be lower than for families with children; the higher rate applies in such circumstances.

Table 1: Work allowances in Universal Credit, 2015-16

	Monthly cash amount	Weekly equivalent hours at NMW
Higher work allowance (no housing costs)		
Single without dependent children	£111	4
Single with dependent children	£734	26
Single with limited capability to work	£647	23
Couple without dependent children	£111	4
Couple with dependent children	£536	19
Couple with limited capability to work	£647	23
Lower work allowance (has housing costs)		
Single without dependent children	£111	4
Single with dependent children	£263	9
Single with limited capability to work	£192	7
Couple without dependent children	£111	4
Couple with dependent children	£222	8
Couple with limited capability to work	£192	7

While we support the principle behind establishing different allowances for different groups and reducing their value for those who get help with their housing costs, we believe the existing balance of allowances is badly calibrated. For some, work allowances are surpassed too quickly, making short-hour contracts more appealing. In contrast, among groups who tend not to face barriers to work, the allowances may be too *high*. We consider the position of some key groups below.

Single parents

'Sweet spots' will be significantly lower for renters than for homeowners

As discussed in Section 2, single parents appear to have been particularly responsive to the incentives provided by the tax credit system. A large proportion of part-time workers do a minimum of 16 hours per week, the point at which people can qualify for working tax credit.

[35] DWP determine capability to work through a Work Capability Assessment which tests an individual's day to day ability to work.

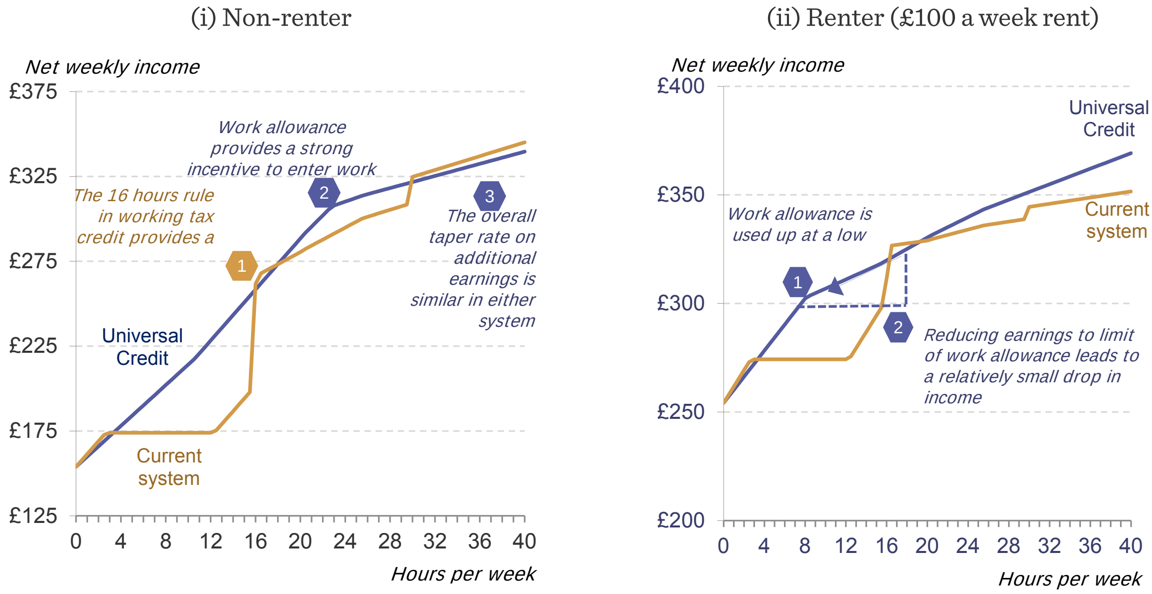
Previously, under the Family Credit system, there was a clustering at 24 hours, the threshold at which that payment became available.[36]

Based on the experience of previous welfare reform therefore, we would expect single parents to be quite responsive to the new financial incentives provided by work allowances in UC. This means that, other than those single parents who already choose to work full time, we might expect many to respond to UC by focusing their hours of work at around the 'sweet spot' at which their work allowance runs out.[37]

As Table 1 shows, single parent renters receive a work allowance of £263 a month, equivalent to working just nine hours a week at the minimum wage (fewer hours at higher levels of pay). For some, this creates new support for working very short hours – something that might fit well with their parenting responsibilities but which does not make sense under the current system where benefits are lost on a pound-for-pound basis as earnings rise. However, it also implies a shift in the 'sweet spot' of work from 16 hours under tax credits[38] to nine hours or fewer, particularly after factoring in childcare costs.

In contrast, non-renting single parents (63 per cent of all single parents on UC) have a work allowance of £734 a month, equivalent to 26 hours at the minimum wage. Members of this group might therefore be incentivised to *increase* their hours of work relative to today's 16-hour norm. These various pushes and pulls are set out in Figure 3, which uses the specific example of a single parent earning £7.50 an hour.

Figure 3:
Incentives to work for single parents in the current tax credit system and UC
Single parent families earning £7.50 an hour with one child aged 4



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

[36] K Bell, M Brewer, D Phillips (2007) *Lone parents and 'mini-jobs'*, Joseph Rowntree Foundation

[37] Unlike tax credits, this will not produce a binary choice between not working, working 16 hours or working full-time hours. Instead, the point at which the work allowance runs out will vary on a case-by-case basis, reflecting differing hourly rates of pay.

[38] One-in-five single parent renters who would qualify for UC work precisely 16 hours a week.

The left-hand chart highlights how the net income of a non-renter would rise in line with their gross earnings when only working a few hours per week,[39] providing a much greater incentive to enter work than exists in the current system. Whereas the availability of tax credits at 16 hours creates a clear incentive to work at or beyond this level in the current system (point 1 in the chart), UC moves the 'sweet spot' higher – to around 23 hours in this instance (point 2 on the chart).[40] Moving from 16 hours to 23 hours would boost this individual's net income by around £53 a week, a greater reward than in today's system.

The right-hand chart sets out the picture for a single parent renter, in this example paying £100 rent per week. Their out-of-work entitlement is significantly higher than the non-renter's, reflecting the additional housing support they receive. However, the renter's work allowance runs out much more quickly – at just eight hours in this example. As with the non-renter, there is an obvious incentive to work shorter hours that is not present in the current system. However, in this instance, the 'sweet spot' comes much earlier. If the single parent in this example were to work eight hours rather than the 16 hours encouraged by the current system, they would reduce their gross earnings by £60 but face a much smaller reduction in net income of just £21. The reduction would be smaller still if the parent was also able to save on childcare costs.

Fixing incentives for single parents

While it may suit some single parents to trade an amount of income for more time spent with their children, earning at the limit of the work allowance would leave the renter in Figure 3 with an income of only £11,000. After this point, they would face a high effective tax rate – with implications for their living standards and prospects for progression. Migration towards this 'sweet spot' by someone who is currently working 16 hours would, of course, also have consequences for the taxpayer.

Ultimately, some parents may decide that it is not worthwhile to enter the labour market at all. If their work allowance means that their 'sweet spot' is nine hours a week or fewer (increasing their income by a maximum of £60 a week), they may find that arranging childcare or adjusting daily routines around work is not worthwhile. **These paltry gains may mean more single parents stay out of the labour market for longer**. This would be a potentially damaging outcome in the short- and longer-term; a wealth of evidence shows that extended periods out of work raise the chances that a mother (whether a single parent or in a couple) will never return to work, or return at a lower rate of pay and at part-time hours.[41]

We believe that **it is important that the incentives in UC support single parents to both achieve an appropriate work-life balance and maximise their earnings potential** and standard of living. We therefore argue that single parents should be provided with a strong incentive in UC to earn at least as much as they currently do. **Increasing the work allowance for single parents to the equivalent of 15 hours a week at the minimum wage, or £423 a month, would cost approximately £600 million a year once UC is fully rolled out. It would provide 400,000 single parents with an extra £30 a week on average.**[42]

Figure 4 shows the impact of our proposal on a single parent's income as they work or earn more. In this example, the new work allowance shifts the individual's 'sweet spot' from eight hours a week to around 13 hours. With the rate of benefit withdrawal unchanged after this point in both versions of UC, our reform leaves the individual £24 better off than in the existing UC baseline when they work more than 13 hours per week.

[39] The withdrawal – outside of UC – of Council Tax Support at a taper rate of 20 per cent means this is not quite true at the very lowest levels of earnings, with the chart showing an upward 'kink' at around 11 hours of work.

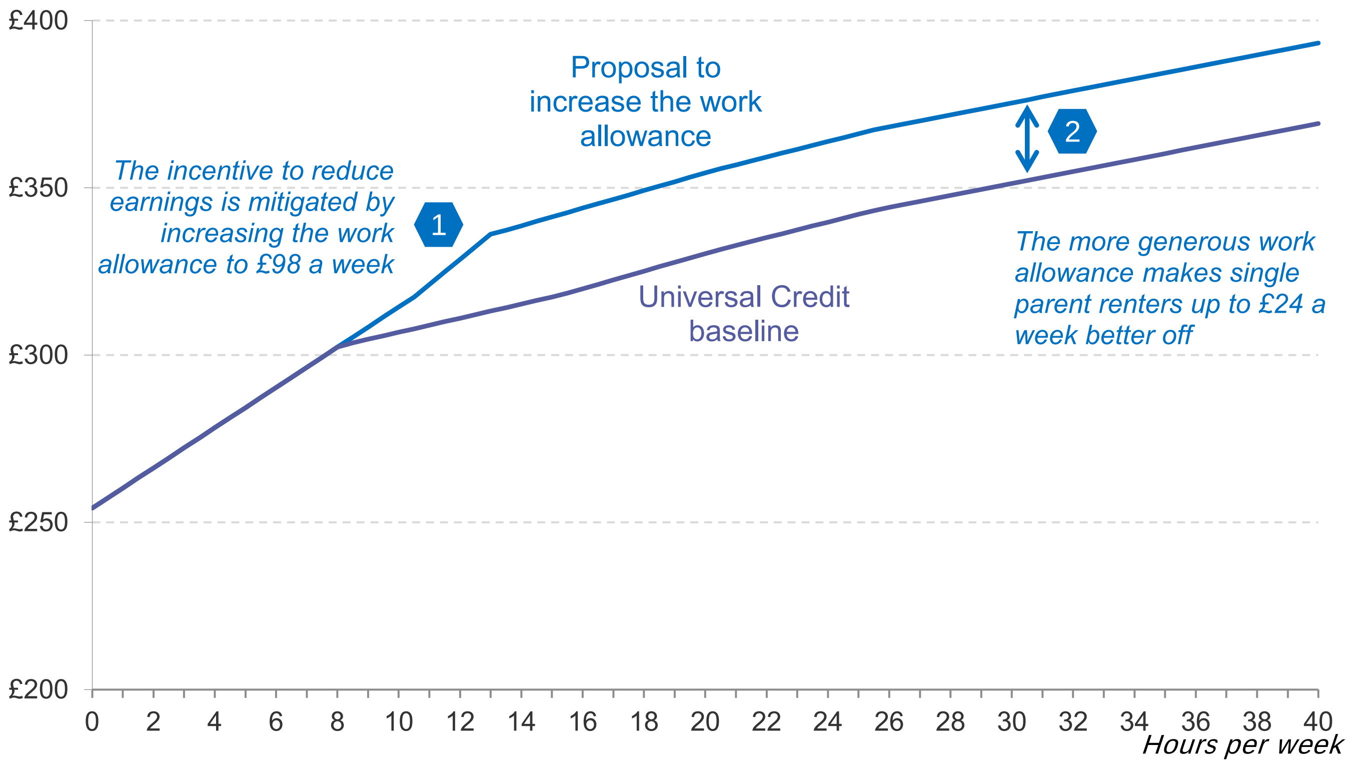
[40] In this example, this also happens to be the point at which NI becomes payable.

[41] G Paull and M Brewer, *Newborns and new schools: critical times in women's employment*, DWP, 2006.

[42] This is before taking account of any potential behavioural effects from single parents who may well choose to work more than they would with a lower work allowance.

Figure 4:
Improving incentives to work for single parent renters
Single parent earning £7.50 an hour, with one child aged 4, weekly rent of £100

This is the line that explains the chart below



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

This approach improves outcomes for renting single parents relative to homeowners but still keeps a clear distinction between the work allowances of the two groups – something we consider necessary to balance the generosity of the system. It is also a relatively expensive move, which we will need to provide funds for from elsewhere. We detail our approach to this below.

However, in our previous report *Credit where it's due?*, we estimated that if single parents working part time limited their earnings to their work allowance, government spend would increase by a net £0.4 billion a year.[43] The government would effectively be paying a supplement to allow people to work fewer hours than they do now. Our proposal will help to mitigate any such cost.

Recommendation 1

Increase the single parent work allowance to the equivalent of 15 hours a week at the National Minimum Wage. This means raising the allowance from £3,100 a year to £5,100 in the short term, at a cost of £600 million.

[43] Our estimate adjusted the earnings of single parents working fewer than 30 hours a week.

Non-disabled adults without children

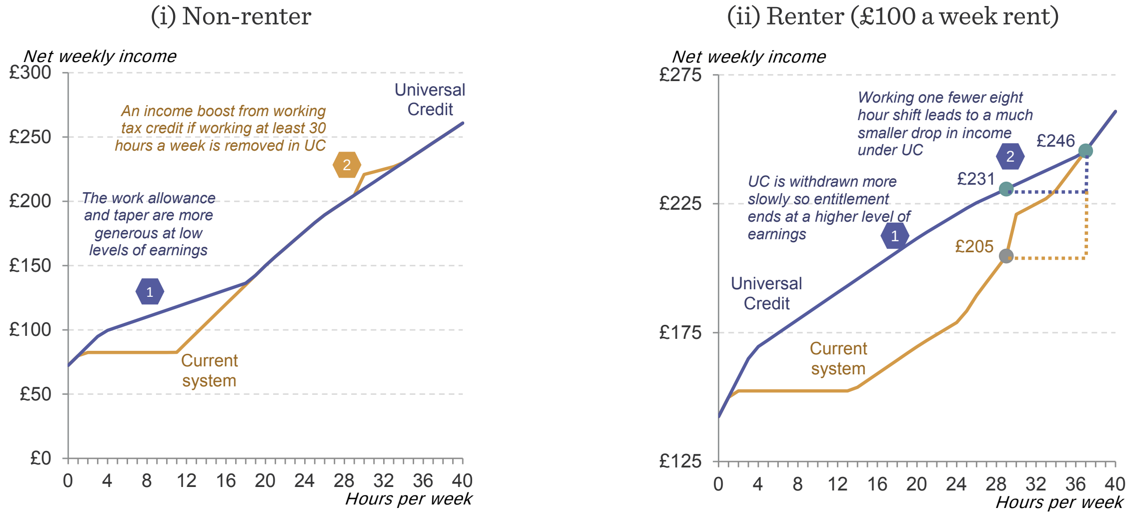
Work allowances in UC unnecessarily support short-hours working among non-parents

Unlike single parents, non-disabled adults without children have few barriers to working. The assumption is that if they are able to work part time, then they are probably able to work full time. Yet despite being introduced during a period of fiscal constraint, **UC extends an extra £500 million of support to this group in order to make short-hours working more attractive** than it currently is. The risk is that government will supplement non-parents to work less.

Under the current system, people aged 25 and over who work at least 30 hours a week can become eligible for working tax credits. This hours-related boost is removed in UC, with out-of-work entitlement instead being gradually withdrawn as an individual's earnings rise. In addition, UC extends in-work support to non-parents *under* the age of 25 for the first time. Working adults without children will therefore tend to be better off in UC than under the current system, up to the point at which their UC support is fully tapered away.

Figure 5 shows how support for this group differs between the two systems. The chosen example here is a 30 year old who earns £7.50 an hour. The charts illustrate the extra support that UC provides at lower levels of earnings. Outcomes between UC and the existing system broadly align after 18 hours of work for the non-renter and after 37 hours for the renter (reflecting the significantly slower pace of withdrawal of housing support under UC, relative to the current approach).

Figure 5:
Incentives to work for people without children in the current tax credit system and UC
Single person earning £7.50 an hour, aged 30



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

As Table 1 showed, work allowances for non-parents amount to £111 a month – irrespective of whether they are renting or not – which is equivalent to just four hours a week at the minimum wage. In this instance, **the risk is less that individuals will move to their 'sweet spot' but rather that they will be supplemented by the state to reduce their hours from their current workload**. Each £1 of gross earnings they give up is offset by between 65 pence to 76 pence of reduced tax and increased UC. As the renter chart in Figure 5 shows, a full-time worker could give up an eight-hour shift, losing £60 of gross earnings but just £14 of net income.

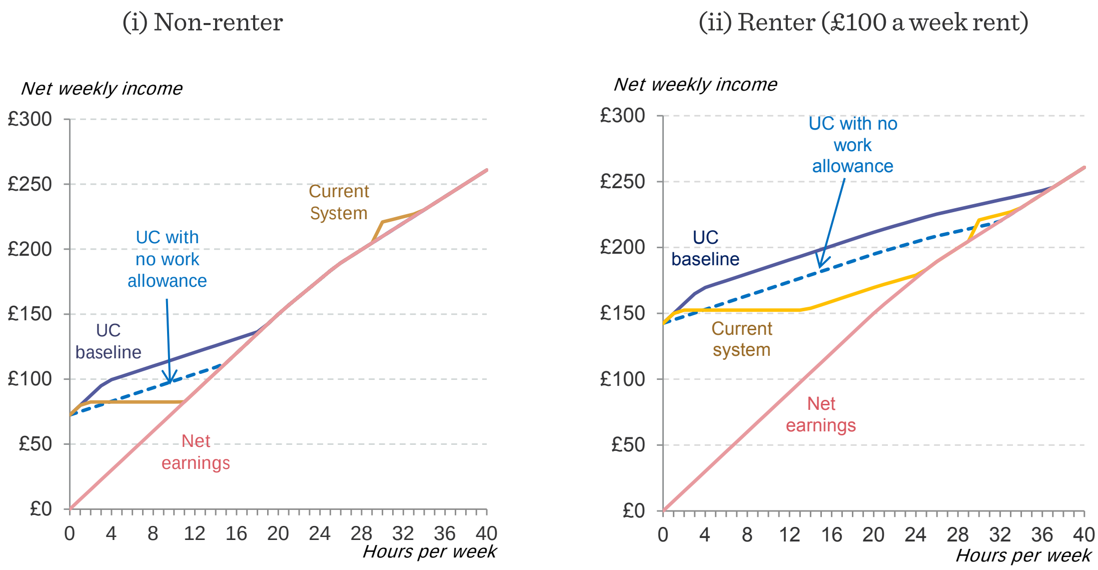
There is little evidence on how workers without children will respond to such extensive interaction with the welfare system. Few in this group interact with the current tax credit system; those that do work full time (though at low rates of pay). However, the OECD argues that it is odd for a welfare system to provide additional support at low levels of hours or pay. To counter such an arrangement, it makes the case for a much stronger system of conditionality to push people to work beyond those hours or to find higher paying roles.[44]

Fixing incentives for non-disabled adults without children

To prevent the state supplementing a reduction in working hours within this group, **we recommend that the work allowance for non-disabled workers without children should be removed**. This will limit the expansion of support to members of the group and reduce the likelihood that those working full time with housing costs will reduce their hours. However, the application of the taper will mean that individuals will continue to enjoy higher incentives to enter work than in the current system, in which they lose access to out-of-work benefits on a pound-for-pound basis. Our proposals do not seek to restore the in-work support (that is, the working tax credit payment) lost to those within this group aged 25 and over who worked at least 30 hours a week and do not have housing costs.

Figure 6 sets out the effects of these proposals by revisiting the examples used in Figure 5. Relative to the current UC baseline, the removal of the work allowance means that the non-renter is about £20 a week worse off until they are working around 18 hours. That said, they are better off than in the current system because they no longer have their out-of-work entitlements withdrawn on a pound-for-pound basis. The picture is similar in the renter example, though the individual remains worse off than under the UC baseline until they are working full time in this instance.

Figure 6:
Sharpening incentives for workers without children
Single person earning £7.50 an hour



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

[44] OECD, *Connecting people with jobs: Activation policies in the United Kingdom*, July 2014.

Recommendation 2

Remove the work allowance for non-disabled families without children, creating savings of £600 million.

Some argue that there is a case for taking younger workers – perhaps those aged under-25 – out of the UC system altogether; both Labour and the Conservatives floated such ideas before the general election. The Conservatives have so far committed to removing housing support for under-21s, but we are yet to see how further proposals might take shape under the new government. Our view is that even if government offers a separate form of practical support for younger people just starting out in their careers (something we explore in Section 5), younger people will still need financial assistance with housing costs. We therefore believe they should remain within the UC system.

When UC is fully rolled out, the savings from reducing the work allowance for workers without children would offset the cost associated with our recommendation to increase the work allowance for single-parent renters. By balancing work incentives between these two groups, we believe we can retain and improve the benefits of the work allowance for those most likely to respond to financial incentives. The reforms would better encourage both groups to earn or work more (and for single parents to find an appropriate work-life balance), while reducing the need for further practical measures (such as conditionality) to prevent people reducing their hours of work.

Couples with children

Work incentives for couples with children are entirely focused on the primary earner

UC should provide the appropriate incentives to enable both parents in a couple to work a combination of hours that suits them and their lifestyles, with the opportunity to increase their earnings or hours of work if they wish to do so. More specifically, this means shifting the balance of work allowances across main earners (95 per cent of whom earn more than the appropriate UC work allowance) and second earners within couples (who therefore effectively have no work allowance).

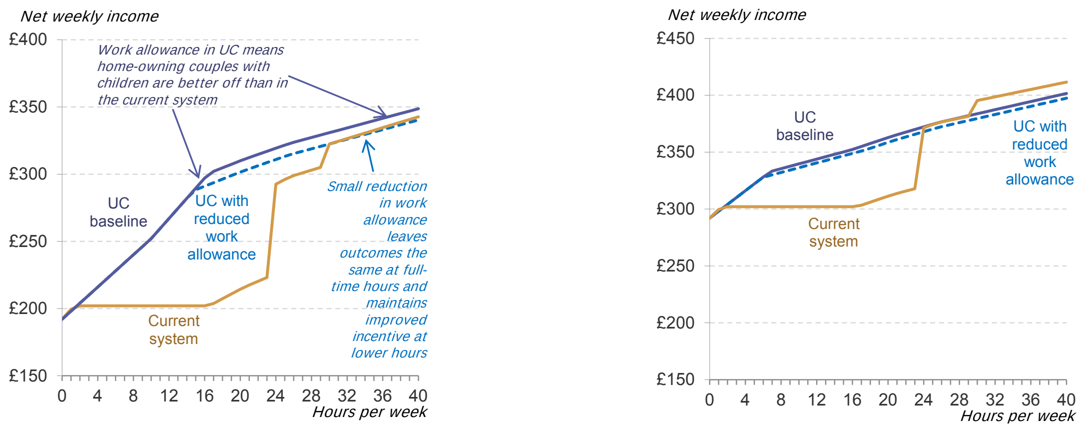
Historically, main earners in couples with children tend to be relatively unresponsive to changes in financial incentives. This certainly appears to be the case among male main earners, with paternal employment rates consistently hovering around 90 per cent (see figure B4.1 in Box 4). Given that women without children tend to be less responsive to changes in financial work incentives than mothers, we believe the difference in employment rates in couples between mothers and fathers reflects caring responsibilities rather than gender. The apparent unresponsiveness of primary earners leads us to argue that **it should be possible to reduce the work allowance that applies to main earners in a couple without a significant impact on working behaviours**.

However, work allowances also play a crucial role in determining the overall level of income a working family can achieve. Table 1 showed that the total work allowance for couples with children was £536 a month for homeowners (equivalent to 19 hours a week at the minimum wage) and £222 a month for renters (equivalent to eight hours a week at the minimum wage). Earlier incarnations of UC proposed by the government were more generous to working couples with children than the present version of UC. Making significant further cuts to the work allowance for couples with children would begin to make them worse off compared with the current system – an outcome we wish to avoid.

Figure 7 shows income under the current tax credit system and in UC, using the specific case of a couple with one child in which just one adult works, earning £7.50 an hour. At full-time hours, the UC baseline is slightly more generous to non-renters and slightly less generous to renters than the existing regime. Reducing the work allowance for renters would therefore make them even worse off.[45]

Figure 7:
Work incentives for the main earner in a couple with children
Couple with one child aged 4, main earner wage of £7.50 an hour, spouse does not work

(i) Non-renter (ii) Renter (£100 a week rent)



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

However, a small reduction in the work allowance (equivalent to two hours at the minimum wage) of non-renting couples with children *is* possible without making this group worse off than in the current system. Doing so would release a further £200 million to improve incentives where they are more likely to affect work decisions.

i Recommendation 3

Reduce the work allowance for couples with children by the equivalent of two hours a week at the minimum wage, saving £200 million.

Fixing work incentives for second earners in couples with children

As discussed above, second earners – the partners in couples who work or earn less than their spouses, or don't work at all – have very weak incentives in UC to either enter work or increase their hours. In the overwhelming majority of cases, **a couple's work allowance is entirely used up by the main earner, making the already poor incentive structure in the current system even worse**. The immediate application of the 65 per cent taper from the first pound that they earn means that a second earner with a gross salary of £10,600 would find their household income improving by only around £3,600 (compared with £6,000 in the current system).

[45] Having removed the work allowance for workers without children, which was equivalent to £26 a week or four hours at the minimum wage.

It is a point acknowledged in the DWP's impact assessment, which states that "as the focus of [UC] is to help reduce workless households there is a risk of decreased work incentives for second earners in couples (primarily women)."[46]

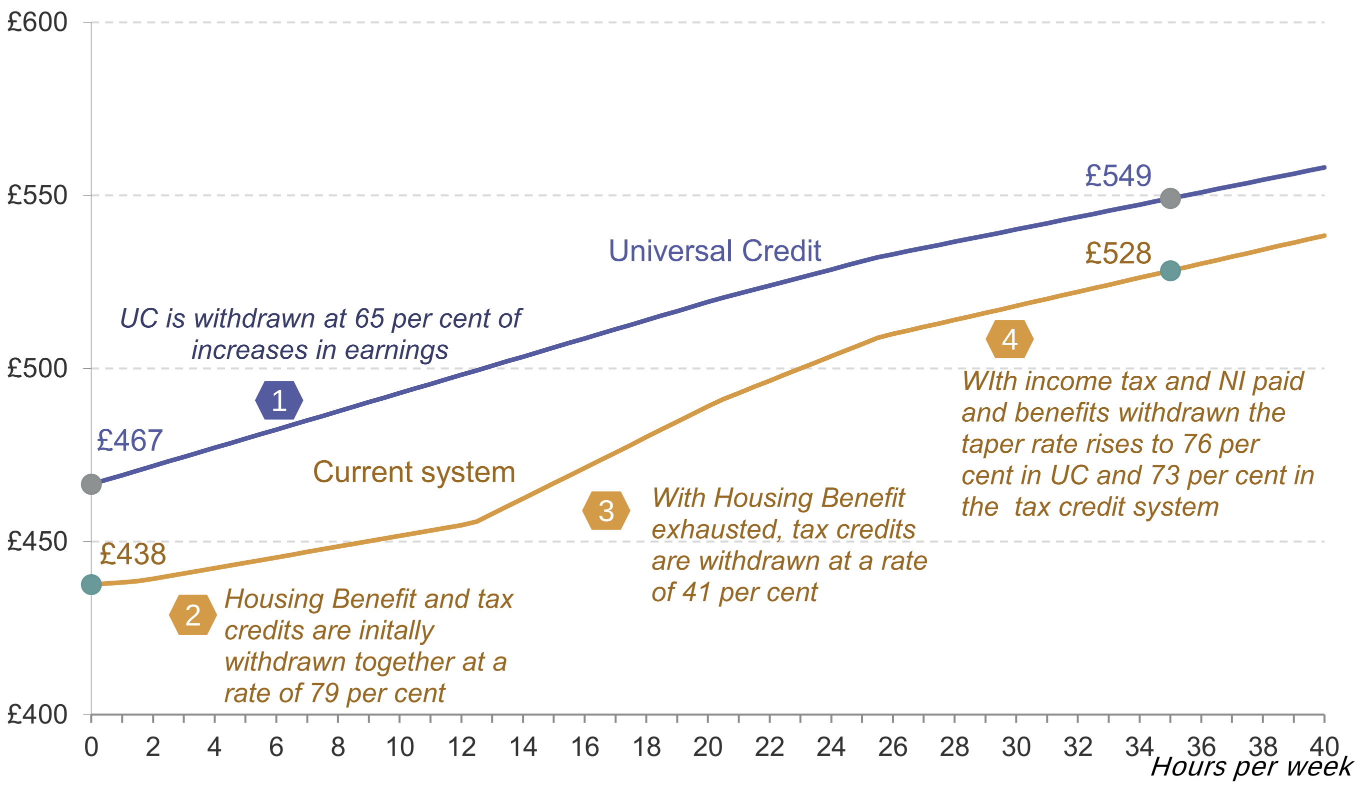
Figure 8 shows the limited return under either system, using the specific example of a second earner with two children and a spouse working full time at £7.50 an hour. Under the current system, the second earner initially sees 79 pence of each pound earned lost in the form of reduced Housing Benefit and tax credits. Once their Housing Benefit entitlement is entirely tapered away, their overall withdrawal rate falls to 41 pence in the pound. At higher hours of work, they become liable for NI and income tax too, increasing their individual taper to 73 pence in the pound.

Under UC, the second earner loses 65 pence of every pound initially, rising to 76 pence once they start paying tax. Although they face higher withdrawal rates under UC, their overall income is higher, reflecting the more generous baseline treatment in UC of couples with children in which just one person works.

Figure 8:

Weak work incentives for the second earner in a couple with children
Main earner works 37.5 hours a week, both earn £7.50 an hour, two children, weekly rent £100

Net income as weekly hours worked increase



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

[46] DWP, *Universal Credit Impact Assessment*, December 2012

The shape of these incentives seems odd given second earners are making an increasingly important contribution to family incomes and living standards – particularly among low-paid couples with children. They do nothing to support recent trends of more couples sharing work and family responsibilities. **It is possible that recent increases in the number of second earners who work – both parents are employed in 25 per cent of couples on UC – will go into reverse in response to these weaker incentives**. At the very least, we might expect second earners to reduce their hours relative to their current position. As with single parents, the high cost of formal childcare only reinforces this potential response.

Introducing a work allowance for second earners would provide them with a much-improved incentive to start working. The crucial question though is what the appropriate level would be, given the inevitable trade-offs between raising incentives and the cost to the Exchequer. For example, simply matching the return a second earner would enjoy in the current tax credit system when earning £10,600 a year (the level of the personal tax allowance) would require a work allowance of £4,000 (£77 per week). This would come at a price tag of almost £2 billion annually.

In trying to reach a compromise, it is useful to note that median gross earnings for second earners with children are roughly £130 a week. This typical second earner takes home £77 of this under the current system but just £46 under the UC baseline. **We recommend that gap be closed in UC, by introducing a second earner allowance of £1,500 a year** (£29 a week).

More generally, this level of allowance would restore a similar incentive to enter work at part-time hours as exists under tax credits. It would cost around £600 million (similar to the cost of our work allowance proposal for single parents) and benefit in the region of 400,000 couples entitled to UC in which both parents work, with an average gain of approximately £19 a week. As with improvements to the renting single parent work allowance, we would expect this policy to have important dynamic effects (though again we take a conservative approach and do not attempt to include these impacts in our costs or savings). More second earners would be encouraged to enter work, and some of those incentivised to stop working due to the current design of UC would no longer do so.

Our proposal provides a symbolic staging point from which to improve incentives further in the future. It is a crucial step in making UC pro-women, a test it currently fails. Longer term, the system should offer incentives that help parents achieve sufficient levels of work shared across the couple in the way they consider most appropriate. At a minimum, this should mean allowing for the equivalent of having one-and-a-half people in work – that is, one full time and one part time – though the precise balance across a couple may differ to suit specific circumstances.

i Recommendation 4

Introduce a work allowance of £1,500 for second earners in families with children, at a cost of £600 million.

In the longer term, work allowances for second earners should be further increased in value, to a minimum of the equivalent of working 15 hours a week at minimum wage (£5,100 currently), to ensure a stronger incentive to enter work.

Work allowance uprating

While our recommendations so far have focused on improving work incentives before UC is fully rolled out, the challenge does not end once implementation is complete. The continued success of UC in making work attractive and financially rewarding depends on how work allowances are 'uprated' or increased in value over time. The default position is to raise work allowances in line with CPI inflation each April – although in practice, they have been frozen in cash terms until April 2018.

To maintain the incentive to enter work at a certain number of hours, **work allowances need to increase alongside wages**. For typically lower-earning UC recipients, this means at least keeping pace with growth in the minimum wage. To guard against erosion of the incentives provided by reallocation of work allowances we suggest above, **we recommend putting in place a 'triple-lock'. This would ensure that work allowances increase each year by the highest of growth in the minimum wage, growth in average earnings or CPI inflation**. We consider the impact (and budget implications) of such uprating in more detail in Section 9.

i Recommendation 5

Increases in work allowances should be subject to a 'triple-lock'. Annual uprating should be in line with the highest of growth in the minimum wage, growth in average earnings or CPI inflation. This will ensure that, over time, incentives for all parents to enter work at a minimum of 15 hours at the minimum wage are preserved.

Redirecting funds from the Married Couple's Allowance

Despite generating savings through withdrawing the work allowance for non-disabled adults without children and reducing it for main earners in couples with children, we must find an additional £500 million in order to make our immediate recommendations on work incentives cost-neutral. The two most obvious sources of funding within UC are to apply further reductions to work allowances or increase the rate at which payments are tapered away. However, as we have made clear, such moves would be detrimental to incentives to enter work and to progress. They would also have the perverse effect of counteracting the improvements to incentives that result from our previous recommendations, especially for second earners.

Instead, **we recommend redirecting funds from outside UC, namely by reforming the Married Couple's Allowance**. The allowance, introduced in April 2015, allows one person in a married couple to increase their personal tax allowance by up to £1,060 a year (using 10 per cent of their partner's allowance) if they earn less than the higher rate threshold (£42,385) and their partner earns less than £9,540 a year. This very modest transferable allowance – with a maximum benefit of £212 a year, or just £4 a week – effectively encourages one member of a couple to limit their earnings in order to improve their household income. It directly undermines the incentives created by the introduction of a second earner work allowance and, indeed, that of high personal tax allowances for individuals.

Moreover, it does little to support lower-income working families, especially those with children. Only 35 per cent of couples entitled to the allowance have children and one-third are pensioners.[47] For families entitled to UC, 65 per cent of the tax cut is absorbed by the UC taper (see below), reducing the gain to only £74 a year. Additionally, the allowance offers no benefit to cohabiting rather than married couples. There is no consistent, robust evidence that financial incentives of this type (or indeed from the structure of the wider tax and benefit system) have an impact on the marriage rate[48] and, perhaps more importantly, on the more positive outcomes of a stable relationship and child development that some seek to link to marriage.[49]

[47] R Joyce, *The new tax break for some married couples*, IFS, September 2013.

[48] B Stafford and S Roberts, *The impact of financial incentives in Welfare Systems on Family Structure*, DWP, 2009.

[49] C Crawford, A Goodman and E Greaves, *Cohabitation, marriage, relationship stability and child outcomes: final report*, IFS, October 2013.

Redirecting funds from the Married Couple's Allowance would release £900 million a year by 2020.[50] Doing so immediately would, of course, generate funds *before* UC is fully rolled out, giving us the option of investing some of these initial savings to fund the trials and pilots we recommend in later sections.

How much UC a person is awarded (and the extent to which it is tapered away) is based on their earnings after paying income tax and National Insurance (NI). Calculating entitlement in this way helps to reduce the overall effective tax rate

Different policies will have different effects across the income distribution: UC families tend to be in the bottom half of the income distribution, while those qualifying for the Married Couple's Allowance are primarily in the middle. As such, while over three-quarters of the gains from a second earner worker allowance would flow to the bottom half of the income distribution, just two-thirds of the gains from the Married Couple's Allowance reach households in the bottom half. Importantly, the second earner work allowance would also centre support on couples with children regardless of whether they are married.

i Recommendation 6

Redirect funds from the Married Couple's Allowance to reinvest in a second earner work allowance, saving £900 million.

Use excess funds in the early part of this parliament to fund trials and tests of a lower UC taper rate and new forms of in-work support (see later recommendations).

Interactions with income tax and National Insurance

UC entitlement is determined on a net earnings basis. That is, how much UC a person is awarded (and the extent to which it is tapered away) is based on their earnings *after* paying income tax and National Insurance (NI). Calculating entitlement in this way helps to reduce the overall effective tax rate. It makes it impossible for the rate of withdrawal to exceed 100 per cent, meaning that individuals will always be better off by working an additional hour (though it is still possible to reach close to 100 per cent with a high enough set of tapers acting in combination). Box 5 gives further detail.

[50] HMT (2014) Budget 2014: Policy costings

i Box 5: Determining entitlement to in-work support using net or gross earnings

The tax system is individualised and reporting periods are annual. In contrast, working-age benefit entitlements are determined on a family basis and are calculated more frequently. In both processes however, earnings are key – helping determine the amount paid to, or received by, a family or individual. There are two ways in which the benefit and tax system can interact:

» Simultaneously – that is, as an individual's gross earnings rise, they are subject to a tax liability and a withdrawal of benefits at the same time; or

» Sequentially – that is, an individual's gross earnings are converted into net earnings *before any calculation* of benefit withdrawal is made.

The current tax credit system and UC use a combination of sequential and simultaneous withdrawals:

» In the current system of in-work support, tax credits (41 per cent), NI (12 per cent) and income tax (20 per cent) are withdrawn simultaneously from gross earnings (producing a combined taper of 73 per cent). Housing Benefit and CTS are then withdrawn sequentially: HB at a rate of 65 per cent, creating an overall taper of 91 per cent; then CTS at rate of 20 per cent, creating an overall taper of 92 per cent

» Under UC, support is withdrawn sequentially (at 65 per cent) from net earnings (that is, after income tax (20 per cent) and NI (12 per cent) are paid), creating an overall taper of 76 per cent. CTS is then withdrawn sequentially at a rate of 20 per cent creating an overall taper of 81 per cent.

What is the impact of applying sequential or simultaneous tapers?

The main advantage of a sequential taper is that it makes it impossible for a person to be worse off from earning more – as can be the case in the current system. Withdrawing entitlement based on a proportion of remaining income means that there must always be some income left. However, it is still possible to leave a person with little of the extra amount they earned, as detailed above. Therefore, the number of different taper rates and the rates themselves are potentially more important than *how* they are withdrawn.

In practice, governments set taper rates for individual benefits with a view to the impact on the overall taper recipients might face. For example, the tax credit system stopped using a sequential taper of 55 per cent in 2006, and started using a simultaneous taper of 37 per cent. For a taxpaying worker, the overall taper was 70 per cent in either system. However, the overall taper rate for non-taxpayers – lower earners and especially second earners – was reduced.

The current design of UC reduces the very highest taper rates for those with Housing Benefit relative to the existing system, but increases the taper rate for second earners. This is a trade-off that results in much weaker incentives to work at all for second earners and reduced, though still relatively high, taper rates for families who rent.

A single taper based on net earnings has two key impacts compared with the tax credit system. First, it lowers the very highest effective taper rates for people with housing costs but introduces a much higher taper rate for second earners. Secondly, it reduces the extent to which tax cuts are passed through to UC families. This second factor takes on particular importance against the backdrop of the repeated above-inflation increases in the personal tax allowance delivered by the previous coalition government and set to continue in this parliament. The government's policy appears to reduce spending on lower-income families via tax credits and instead provide broad-based tax cuts for the majority of taxpayers. What is more, the further that the personal allowance rises, the less well-targeted at poverty it becomes.

Despite often being sold as a 'low earner' tax cut, three-quarters of the gains from raising the personal allowance go to households in the top half of the income distribution. This regressive move is exacerbated because UC recipients lose part of any tax giveaway in the form of benefit withdrawal. For example, while a £600 increase in the personal tax allowance would result in a £120 reduction in tax for a basic rate taxpayers – and therefore a £240 reduction for a dual-earning couple – the net gain for a UC-recipient couple with children could be as little as £84. Working families with children on UC are least likely to receive the full benefit of such tax changes, while dual-earning higher income couples outside of UC gain the most.

We therefore recommend that a simple adjustment be made each time the government raises the personal tax allowance (or similar thresholds) to ensure UC claimants gain as well.[51] This would involve raising the work allowance by 65 per cent (the taper rate) of the reduction in tax paid, or 20 per cent (basic rate of income tax) of the increase in the personal allowance. Workers on UC would receive the full benefit of the tax cut. Those earning below the personal allowance – who currently gain nothing from additional tax cuts – but above their work allowance would receive an additional boost to their income from this measure. An increase in the personal allowance of £1,000 would cost around £5 billion. Ensuring that those gains are fully passed on to UC recipients would add £350 million to the bill.

i Recommendation 7

Cuts in income tax should be passed on in full to families in receipt of UC via an equivalent adjustment in the appropriate work allowance. The cost of this measure should not come from the UC budget, but should instead be considered part of the overall cost of the tax cut.

Summary

This section has explored whether UC will offer stronger incentives for the out-of-work to take on employment. The introduction of work allowances is certainly a step forward from the previous system. By only withdrawing a person's award after they earn over a certain threshold, UC introduces a framework that is well placed to ensure work pays for claimants.

That said, while we support the logic behind setting different allowances for different groups, as well as reducing their value for those who get help with their housing costs, we believe the existing balance of allowances is badly calibrated. Some groups, such as single parents who rent their homes, may find working fewer hours more attractive under UC. Other groups, like adults who have no children and are not disabled, have larger work allowances than appears necessary given the apparent lack of barriers to working full time they face. Second earners in couples have no work allowance whatsoever and thus usually have weak incentives to work at all.

To rebalance these work allowances and make the most of their potential to increase participation and boost earnings, we argue that funds should be redirected to provide a larger work allowance for single parents who rent and to introduce a work allowance for second earners. To pay for this, we argue that the work allowance should be removed from families without children in which the adults are not disabled and reduced for couples with children. Additional funding will come from removing the Married Couple's Allowance. These reforms will allow UC to zero in on the groups who are most likely to respond positively to improved incentives by increasing their number of hours worked.

Finally, to make sure that UC continues to be an effective part of the welfare system in the future, we recommend that future increases in the personal tax allowance be passed on in full to UC recipients and that work allowances are uprated in line with the higher of earnings or inflation.

[51] D Hirsch, *Will future tax cuts reach struggling working households?*, Resolution Foundation, April 2013.

Section 5

Getting on at work – progression under UC

The previous section focused on the incentives provided by UC to enter work. But earnings progression for those already in work is an equally important issue. The UK has a persistent low pay problem, with one-fifth of all workers falling below the low pay threshold (two-thirds of median hourly pay). Of these, only one in four manages to make sustained progress onto higher wages. Tackling low pay and helping people to progress is at the heart of the struggle to improve living standards. Given that the low paid share many of the same characteristics and face the same barriers as the UC population, the new system could provide new opportunities in this struggle.

In theory improving progression at work can be targeted via a combination of ***financial incentives, conditionality/sanctions*** *and* ***practical support****. UC aims to make use of some mixture of all three of these approaches. But, while the single UC taper will remove some of the highest effective tax rates experienced in the current system, it will result in a slight rise for many. Relying instead on the new system of 'in-work conditionality' to raise earnings means taking a step into the unknown. The effectiveness and plausibility of bringing up to 1 million new people under the threat of sanctions is completely untested and will do little, if anything, to tackle low pay. And, as yet, we have no details of what practical support in-work conditionality might introduce.*

In this section, we discuss the shortcomings of the current approach to progression and set out options for reform. We outline a model that accentuates the role that incentives and support can play, while developing conditionality that can act as a backstop.

Progression via financial incentives – the taper rate

The taper is important for moving up, not just moving into work

The previous section discussed how the building blocks of UC can be used to make entry into work more financially rewarding. But how effectively do they support and incentivise claimants to seek additional hours at their current wage, or to find higher-paid roles? We deal first with how benefits are tapered away and what that means for progression.

As discussed in Section 3, the inclusion of housing support in UC, and its withdrawal at the same rate as other forms of in-work support, has reduced the most punitive effective tax rates faced by people in the current system. Currently, when Housing Benefit and tax credits are withdrawn in tandem, and income tax and NI are paid, an individual will lose 91 pence of each extra pound they earn. UC effectively caps this figure by withdrawing housing and in-work support together (at a rate of 65 per cent). This means the overall effective tax rate faced by those with housing support is cut to 76 per cent (when paying tax and NI as well).

However, those without housing support face *higher* tapers in the new system than they currently do. For those not paying income tax and NI, the rate jumps from 41 per cent under tax credits to 65 per cent under UC; for those who *do* pay tax, it rises from 73 per cent to 76 per cent.[52] In aggregate, **more people will experience a rise in their overall taper rate under UC than will experience a reduction**. Despite this, much of the rhetoric about UC seems predicated on the notion that there has been a big cut in the taper rate relative to today's system.

When first proposing UC, the Centre for Social Justice recommended a 55 per cent taper, but, due to budget constraints, the previous government settled on 65 per cent. Shifting to a 55 per cent taper is estimated to cost in the region of £3 billion. It would, however, reduce the overall effective tax rate faced by those paying tax and NI to 70 per cent – slightly below today's level.

Given the risk of remaining stuck on low pay for many of the workers entitled to UC, it is important that there is a strong incentive to seek better-paid work. Working eight additional hours at the minimum wage would increase gross earnings by £52, but after UC is withdrawn and tax paid, a worker would be only £12 better off. A taper set too high may similarly mean that taking on more responsibility in return for a pay rise does not seem worthwhile.

Choosing the 'right' taper rate requires some evidence-building

While a variety of studies provide a reasonable indication of how responsive different groups are to incentives to enter work and the number of hours they take on, we know much less about how people will react to incentives to progress. If people respond strongly and increase their earnings significantly, it is possible that through additional tax and NI payment and the reduced UC bill, a cut in the taper to encourage progression could pay for itself. As it stands however, there is too little evidence to make any definitive claims one way or another.

Given this uncertainty, we **recommend that, in the short-term, extensive trialling should take place to determine an appropriate taper rate**. Small variations in the taper rate are unlikely to have a noticeable effect, so we would suggest testing 55 per cent and 45 per cent taper rates as starting points. It would also be important to explore the extent to which lower tapers could offset reductions in work allowances without reducing incentives to enter work. Testing should take the form of randomised control trials to ensure robust conclusions are delivered. Such trials are likely to take time – perhaps several years – to generate comprehensive results, meaning that they should commence as soon as possible.

i Recommendation 8

Conduct extensive randomised control trials to determine the most effective taper rate for UC.

Informed by this, significantly reduce the taper rate over time (e.g. to 55 per cent or lower), as funds allow.

Reducing the taper rate is undoubtedly one of our long-term goals and we would like to take steps in this direction sooner rather than later. However, given the high cost of doing so, it is difficult to prioritise this measure above the reforms we set out elsewhere that are designed to improve incentives to *enter* work and the *fairness* of UC. We therefore recommend that, once a more effective taper rate is identified via randomised control trials, the UC withdrawal rate should be reduced to this level as soon as funds allow.

[52] These taper rates look particularly high when compared to marginal tax rates in the income tax system. Consider, for example, the debate that exists over whether tax and NI of over 40 per cent for those earning in excess of £150,000 is damaging to incentives and aspiration or not.

Progression via sanctions – in-work conditionality

In-work conditionality is designed to deal with the increased risk of people becoming trapped in low pay

It is clear that punitive taper rates for UC recipients can reinforce a perception that progressing and taking on more responsibility at work is not financially worthwhile.[53] This negative view may be reinforced when combined with the removal of the hours rules that exist in the tax credit system and the introduction of new incentives for some groups to enter work at low hours (as discussed in Section 4). Acting together, there is a risk that UC might lead to growing numbers of people becoming 'trapped' in short-hour, low-paying jobs – leaving the state to top up their incomes.

'In-work conditionality' represents the government's response to this risk. Under this new approach, UC claimants who are deemed not to be earning 'enough' will be expected to increase their earnings or face potential financial sanctions. For most claimants, 'enough' means earning the equivalent of 35 hours at the minimum wage per week (£227.50).[54]

Each adult has their own earnings requirement, but for a couple these can be combined and met through the wages of one or both adults. Certain groups with caring responsibilities will not have to meet the 35 hours threshold. Disabled adults and the main carer for pre-school aged children face no requirements. If the youngest child in a family is at primary school, then the individual's earnings limit is based on how many hours they can work at the minimum wage to fit around school hours – with this assessment being at the discretion of Jobcentre Plus advisers.[55]

These rules introduce complexity to UC. Over and above this, we have three primary concerns.

» First, there is **very little evidence of such a system being put into practice either historically in the UK, or internationally[56] and we are sceptical that the capacity exists to seamlessly bring up to 1 million new individuals into a sanctions-based regime**. It will take time before such a system proves to be effective – if it ever can be – which could be too late to prevent people from changing their work patterns in response to UC in the ways we might anticipate. That is why we prefer to rebalance and improve the financial incentives that people may face in the first place, reducing the extent to which they are incentivised to work at low hours. The need to create a new, potentially expensive conditionality regime within UC to guard against the risk that people choose to work fewer hours suggests that the incentive structure itself is flawed.

» Secondly, **developing an effective system could be made all the more difficult by the potential political unpopularity of a new sanctions regime**. Consider the example of a low-income individual working 32 hours at the minimum wage, faced with having their support withheld because they are deemed not to be working 'enough'. It is hard to imagine such an approach helping to establish positive relationships between recipients and the state in a way that is conducive to getting on at work. Problems of this nature present a risk to the legitimacy of the wider conditionality regime.

» Thirdly, **in-work conditionality misses the opportunity provided by UC to tackle the UK's structural low pay and progression problem**. While in-work conditionality is expressed in

[53] C D'Arcy & A Hurrell, *Escape Plan: understanding who progresses from low pay and who gets stuck*, Resolution Foundation, November 2014.

[54] As set out in the Universal Credit Regulations 2013 and explained at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/423688/admj2.pdf

[55] DWP Guidance suggests that advisers will decide on a case-by-case basis the reasonable number of hours that a parent can work, taking into account factors such as the location of school, the place of potential work and childcare availability. This is by no means simple and introduces a risk of actual or perceived unfairness in the process.

[56] OECD, *Connecting people with jobs: Activation policies in the United Kingdom*, July 2014.

terms of earnings, it is calculated with reference to an appropriate number of hours of work at the minimum wage. It is therefore entirely possible for individuals to meet this target without ever moving beyond a minimum hourly rate of pay. No career progression is required. In this sense, it appears little more ambitious than the current work programme, in which the focus is on placing people in full-time "sustained employment".

We are therefore not in favour of in-work conditionality as it is currently envisaged. We remain supportive of conditionality for those who are out of work (and for those on very low hours or earnings, as currently exists for JSA claimants). This is a system that has evolved over a long period and which, combined with an effective job-seeking regime, is a crucial element in helping people back into employment. We are clear that an appropriate balance must be struck between incentives to take a job and the likelihood of getting stuck in a low-paid role. **The UC conditionality regime should take into consideration the longer term as well as the immediate goal of getting people into work**.

A key component of such an approach will be the ability to identify the type of support that different groups will need. For some, the current out-of-work regime may suffice but for others, alternative help is required. Younger people may be better served by returning to the education system or engaging in training, rather than searching for a job. Parents returning to the labour market after taking time out to raise their children are also likely to have different needs, not just in preparing to start working, but finding the type of job that would suit them and their childcare arrangements.

Previously, the government sought views on how practical support could be provided to help people meet their in-work conditionality requirements[57] but the development of such support appears to have stalled. While we are in favour of more being done to help people to improve their earnings, as we discuss below, we do not think these early proposals go far enough.

Establishing a 'backstop' option of a minimum income floor for employees

While not supporting the introduction of additional in-work conditionality based on the threat of sanctions, we recognise that our proposals on improving financial incentives to enter and get on in work will not, in themselves, be sufficient to stop all instances of individuals 'underworking' and having their incomes supplemented by the state.

Below we set out the case for introducing a new system of practical in-work support which we hope will make a major contribution to boosting earnings among UC recipients. Here, we consider an alternative to the immediate sanctions of in-work conditionality, which could act as a 'backstop' to deal with those UC recipients who fail to respond to the new combination of support and incentives.

This rule could involve making clear to those with few employment barriers (such as non-disabled adults without children) that at some point their UC would be restricted if they remained at lower levels of earnings (unless they were taking part in some form of activity to improve their earnings). **Calculating UC entitlement on the assumption that a specified minimum amount has been earned each month (in effect a 'minimum income floor' for employees, similar to that introduced for the self-employed[58]) would provide a clear, simple to understand signal to workers.**

Recipients could be given the chance to establish themselves in the labour market before such action is taken, with, for example, the approach being deferred for the first year of their claim. This could prove particularly effective when combined with practical help to find work and opportunities to improve earnings.

[57] DWP, *Extending labour market interventions to in-work claimants: summary responses to call for ideas*, 2013.

[58] We discuss the self-employed minimum income floor in Section 7.

Recommendation 9

We do not support the current approach to in-work conditionality.

The current out-of-work conditionality regime should be retained but adapted to take into account the importance of longer-term earnings progression, not always focusing on the immediate goal of finding work.

To protect the taxpayer, a tough new 'backstop' should be held in reserve – to be used only if there is evidence that recipients aren't responding to the improved financial incentives we set out above and the practical in-work support we set out below. A 'minimum income floor' could be used to prevent people with few barriers to full-time working remaining at low levels of earnings over a sustained period. The floor would only apply after a given period of receiving UC.

Progression via practical support: options for reform

UC can provide a vehicle for tackling low pay

As noted above, we believe that the current proposals for in-work conditionality miss an opportunity to use UC as a vehicle to make inroads into the UK's endemic low pay problem. Many low-paid[59] workers will be in receipt of UC and so the policy is one way of interacting with a sizeable section of them. Of course, UC alone cannot solve the problem of low pay; wider government policy and support from business is necessary to open up paths in different industries and occupations. Nevertheless, UC can provide a means of identifying and then supporting those most at risk of low pay.

We have already set out recommendations designed to develop stronger incentives to progress, via a significant reduction in the UC taper rate. But it is not just financial incentives that affect progression opportunities. As well as offering a strong financial incentive to improve earnings, **the UC system has a key role to play in identifying workers that need effective, practical support to progress**. We believe it would be to the advantage of all parties – employers, government and individuals – to explore ways of achieving this.

However, the type of support that the UC population need when in work, or indeed out of work, will differ by their circumstances and characteristics. Not all individuals will need intensive help to progress. For some, the current support offered by Jobcentre Plus will be enough to move them back into work and subsequently a successful career. For many on UC, it will be important to strike the right balance between boosting total earnings and working hours that reflect the constraints and barriers they might face due to their personal circumstances.

Different groups can benefit from different levels of intervention

Previous Resolution Foundation research found that (controlling for other factors) low paid workers who remained constantly in employment or gained a degree were more likely to move onto higher wages. Other enabling factors included changing jobs, a positive outlook on the part of the employee, the provision of opportunities by employers and well-timed interventions. In contrast, being a single parent or working part time were found to be closely linked with failing to escape from low pay (see Table 2 for a more complete list).

[59] Low pay is defined as earning less than two-thirds of the median hourly wage: in April 2014 this was £7.69 compared to a minimum wage at that time of £6.31.

Table 2: Factors affecting probability of escaping low pay

Characteristic	Impact on probability of escaping
Remaining constantly in employment	+30%
Gaining a degree (first or higher) in the period 2002-2008	+16%
Remaining constantly working for a large employer (1000+ employees)	+14%
Having a degree (first or higher) in initial period	+9%
Having a positive outlook (state that 'future looks good' in initial period)	+5%
Being one year older	-0%
Remaining constantly working for a private sector employer	-5%
Living in a Local Authority rented house in initial period	-8%
Having been born in the UK	-9%
Being a single parent	-9%
Remaining constantly working part-time (< 20hrs/week)	-9%
Being registered disabled (in initial period)	-11%
Remaining stuck in hospitality sector (SIC9: major group H)	-11%
Remaining stuck in sales occupation (SOC2000: 7)	-13%

Notes: Table shows key significant factors linked to the likelihood of an individual moving out of low pay by the end of a ten-year period. For example, remaining constantly in employment would increase the probability of escaping low pay by 30 per cent.

Source: C D'Arcy and A Hurrell (2014) Escape Plan: understanding who progresses from low pay and who gets stuck, Resolution Foundation

The information that the UC system will collect, and the increased reach of the integrated system, will make it easier to 'segment' the population to reflect differing support needs. Different broad groupings of the UC population may well require specific forms of practical support to help them progress. The data collected by the UC system would, for instance, permit segmentation into the following 'at risk' groups:

- Younger people with low levels of qualifications working either part-time or in sectors that evidence suggests are associated with low odds of progression;
- Single parents or second earners, if working part time or in a lower-skilled role than is commensurate with their qualification level or previous occupations;
- People without dependent children, or the main earners in a couple with children, who have worked in the same industry or occupation for a number of years with little increase in pay;
- People with disabilities who may be looking to engage with the labour market; and
- People seeking work who have historically cycled in and out of employment or who have recently been working in a low-paying sector.

Developing effective in-work support rests on trialling different approaches

There is no established model to facilitate progression. We do not therefore favour a single approach, or the creation of a new agency to oversee this agenda. Instead, **we recommend commissioning and trialling a range of different in-work support measures from various providers**. These measures would bridge the gap between employers and employees but, most likely, would sit outside of Jobcentre Plus. The suppliers would provide tailored help to achieve sustained employment and earnings progression, while seeking an appropriate work-life balance.

These suppliers could include Work Programme providers and – with a need to understand local labour market conditions and the potential for further devolution at a country and city level – take advantage of local enterprise partnership networks and encourage local authority intervention. Such support should be tailored to the needs of the individual and the barriers to work they face – which may be location-specific in many instances. New models of support and a need to innovate must be promoted to ensure a broad spectrum of interventions is tried. A job brokerage model is a potential starting point.

It is important to understand just how radical a step it would be to introduce a system of practical support with such a strong focus on progression. The current Jobcentre Plus and work Programme apparatus overwhelmingly concentrate on finding employment, and then on making that employment sustainable. There is little, if any, focus on trying to maximise earnings potential or matching people's skills with roles that have an opportunity for progression. Likewise, scant consideration is given to allowing time for training in the short term that could lead to better pay and prospects in the long run.

A comprehensive system of support to help people progress in work is not an established feature in other countries. Though there is some limited evidence to draw upon in designing effective new interventions, it is by no means conclusive.[60] Even if there were, it is not possible to simply import a model from another country and expect instantaneous results. Sustained trialling and testing of any new approaches will be essential to ensure the system is effective and proven to work.

The limited evidence that we are able to draw on suggests there are four key insights around which support to help people to progress should be built:

- **Identifying the skills potential of individuals and matching that with better-paid work**. Many people, particularly those working part time, work in occupations for which they appear over-qualified.[61]
- **Providing appropriate training to improve skills**. People may have either few qualifications or outdated skills that no longer command a high wage. New training would enable them to find higher-paid opportunities.
- **Motivating people to progress.**[62] Some workers may be demotivated by past missed opportunities; others may fear changing their job because the work they have fits with other demands in their life (for example, caring for children). Some may simply not be thinking about their careers or future prospects.
- **Helping people to move job**. A key path for people to progress is to change their employer and move to a higher-paid position and out of a low-paid occupation.[63]

We are not necessarily proposing to apply conditionality to these interventions due to a concern that doing so would simply recreate the in-work conditionality regime we do not favour. But UC, a system with which people will regularly interact, would provide a vital contact point for such services. Finding ways to engage people already in work and motivating them to look for opportunities to progress through the UC system would be a crucial starting point in creating an effective system.

It is also likely that support would need to be provided flexibly to fit around people with busy working lives. Workers are potentially either at work or busy with other commitments outside of work. Contacting them and providing support would need to be sensitive to what works for the individual.

Engaging employers will be crucial for developing a new programme for progression

Ultimately, **the success of a new system of in-work support is likely to rest on securing the engagement of employers**. Providers wishing to match people to opportunities that enable progression – be it a new job or a job with future opportunities to progress – will need to have

[60] See, for example: R Dorsett, *The effect of temporary in-work support on employment retention: evidence from a field experiment*, National Institute of Economic and Social Research, September 2013.

[61] UKCES, *Ambition 2020: World Class skills and Jobs for the UK*, 2009

[62] R Hendraet al (2011) *Breaking the low-pay, no-pay cycle: Final evidence from the UK Employment Retention and Advancement (ERA) demonstration*, DWP

[63] A Hurrell, *Starting out or getting stuck? An analysis of who gets trapped in low paid work - and who escapes*, Resolution Foundation, November 2013.

strong relationships with employers in the local labour market.[64]

The hierarchies within firms and the lack of opportunity to progress that exists within some industries appears closely linked with a person's odds of escaping low pay.[65] To be successful, providers will also need to encourage and work with employers to design jobs with a clear path for progression.

Timewise, an organisation which focuses on promoting and finding flexible, better-paid opportunities, has found that the following interventions with employers are successful:

- Convincing decision-makers to change the culture within firms and to take action to tackle low pay. This means emphasising both the potential **business benefits of utilising the skills of existing employees stuck in low-paid, part-time work for which they are overqualified and redesigning more intermediate-level jobs to have flexible hours that enable more workers to progress;**
- Working with employers to **adapt the terms of their advertised vacancies**, making them more flexible and more likely **to suit the needs of a ready pool of suitably skilled candidates**.

Funding new forms of support requires a targeted approach and the identification of some immediate savings

Providing highly-tailored support to all working UC claimants would, of course, be extremely expensive. We therefore propose a targeted approach, to help those who are most in need of support and likely to respond best to interventions (but who are unlikely to progress without extra help).

In the longer term, **interventions to support progression would help to save money by reducing levels of entitlement to in-work support**, increasing income tax and NI revenue and addressing the extent to which people cycle in and out of work. In the short term, and to encourage employer engagement with the scheme, finding new sources of funding would be necessary. Resources currently earmarked to trial in-work conditionality could be used but additional funding may be needed.

We anticipate our recommendations in Section 4 – designed to rebalance work incentives across different groups – will generate savings during the initial period of UC roll-out. That is, some of the savings we expect to make by removing work allowances from adults without children will be available *before* the majority of the groups we intend to give additional allowances to (such as single parents) begin to be moved onto UC. There should therefore be some funds available in the very near term. There is also potentially significant revenue released by our recommended immediate abolition of the Married Couple's Allowance, the proceeds from which will similarly not be fully accounted for in the early years of this parliament.

We recommend that funding from both of these sources is used to set up pilots and trials to immediately test new forms of in-work support.

i Recommendation 10

Use funds released in the early part of the parliament by our earlier recommendations on work allowances and the removal of the Married Couple's Allowance to establish a series of pilots and trials of practical in-work support that are designed to support earnings progression. Building on these trials, an effective system of in-work support should be put in place over the longer term.

[64] ibid

[65] C D'Arcy and A Hurrell, Escape Plan: understanding who progresses from low pay and who gets stuck, Resolution Foundation, November 2014.

Summary

Despite the recovery becoming more sure-footed, the UK's low pay problem is unlikely to disappear overnight. One-fifth of the workforce has been low paid throughout the past 20 years, with periods of strong economic growth doing little to alter the situation. There are two points we should draw from this. First, for all its radicalism, UC will not be able to solve the low pay problem on its own. There are deep-seated and interconnected issues with productivity growth, the education and training system and collective bargaining which UC can do little to address. But second, given the extent of low pay and the limited proportion of people who manage to escape onto higher wages, the potential that UC does have to bring about some positive change should be made the most of.

As UC is currently designed, there is a risk that the introduction of work allowances will hold the system back from achieving that potential. Some groups will be incentivised to reduce the number of hours they work and their employment income. In-work conditionality is the primary tool within UC to address that concern, setting a minimum level of earnings that the majority of UC claimants must meet, with the ultimate threat of sanctions for those who do not meet this level.

We have identified three shortcomings of this approach. First, it is untried and untested, with little or no evidence internationally of what might work. Second, it risks being highly unpopular and making outcomes worse rather than better for low paid workers. And third, rather than encouraging UC recipients to seek better-paid roles or setting them on a career path, in-work conditionality only requires that a person find a minimum wage role that offers a minimum of 35 hours each week. In this sense, it's not ambitious enough.

To make the most of the opportunity UC presents, we recommend that the proposed conditionality regime be overhauled. We hope to reduce the need for such conditionality via a twin-track approach of boosting incentives to work more hours and introducing new, more positive and pro-active support for progression. Evidence has highlighted groups who will find progression particularly challenging, including single parents and the disabled; but less is known about what kind of assistance would make a meaningful difference. To give UC recipients the best chance of making sustained progress up the earnings ladder, a series of pilots and trials of practical in-work support should be conducted with the results informing the next steps of UC.

While out-of-work conditionality will remain necessary alongside this twin-track approach, we hope that in-work conditionality will no longer be needed. However, to protect the taxpayer in the event that there are still instances of people with few barriers to full-time working failing to take the opportunities on offer to do so, we have argued that a version of the 'minimum income floor' rule applied to the self-employed could be introduced instead.

Taking this combined approach, we believe UC can play an important role in moving Britain away from its dependence on low-paid roles and help more people on their way to higher wages.

Section 6

What's in and what's out – the coverage of UC

Possibly the biggest improvement of UC over the current system is its merger of six in- and out-of-work benefits into one. This is intended to ensure a smoother transition into work, thereby breaking down barriers associated with fears of losing entitlements and becoming worse off once in work. Withdrawing these six benefits together at the same taper rate should also make it easier for recipients to understand how their income will change as they increase their earnings. This is all welcome.

However, benefits such as Council Tax Support and free school meals have been left out of UC. This means that many of the claims made in favour of the current version of UC – that it brings together every working-age benefit and provides a single taper rate – are misleading. Their exclusion risks undermining the potential gains from the reform. How effective the financial incentives discussed in Sections 4 and 5 are will depend on whether the system is easy to understand and use. For this reason, it is a priority that UC integrates well with other parts of the working-age benefit system.

This section discusses the coverage of UC, assesses the treatment of those benefits that have not been incorporated into UC and considers how these should be approached to maximise the improvements that UC could bring.

Council tax support

The localisation of Council Tax Support – from one scheme to many

As UC was being developed in the early part of the last parliament, the government moved against the flow of integration by devolving responsibility for Council Tax Support (CTS) to the local level. **English councils were given the freedom to move away from the default CTS scheme rules but, alongside this, they had their budgets for supporting working-age families cut** (see Box 6 for further detail). Governments in Cardiff and Edinburgh were also given responsibility for delivering their own versions of CTS but, despite having their budgets reduced, chose to maintain the same level of support as under the previous Council Tax Benefit regime.

This localisation created a number of issues. Most immediately, **the budget cuts led to some households becoming worse-off**, with the precise impact varying across local authorities. For example, some out-of-work families must now make a minimum council tax payment (a regressive measure, falling hardest upon low-income families), while others face an increased taper rate. In some councils, households may have the entitlement they can receive capped at a lower council tax band, in effect reducing the support they receive.

Box 6: Support with Council Tax – current and past policy

Council Tax Benefit (CTB)

CTB was a national income-related benefit funded by DWP and delivered by local authorities in Great Britain. Entitlement was calculated at the family level and usually took the form of a reduction in the amount of council tax a family was expected to pay.

Out-of-work families paid no council tax, while those in work had their support reduced by 20 per cent of each additional pound of income over and above their out-of-work benefit entitlement. So for example, if a family was entitled to the equivalent of £25 a week of support while out of work, they would retain all of this support until their earnings reached £82.30 (the point at which their JSA entitlement ends). Thereafter, they would lose 20 pence of entitlement for every additional pound of earnings. Their entitlement would thus be exhausted when their earnings reached £207 a week.

In 2012-13, 5.9 million families (3.4 million of working-age) received £5.1 billion (£2.9 billion to working-age families) of support with their council tax.[1]

Council Tax Support (CTS) and localisation

A new Council Tax Reduction Scheme (commonly referred to as CTS in England), replaced CTB in April 2013, giving local authorities the option to move away from the default CTB model. Central government also reduced the CTS budget provided to local authorities for working-age families by 16 per cent, or £500 million a year. In contrast, support for pensioners was protected. Local authorities were forced to choose between cutting other areas of spending, increasing their council tax or reducing the generosity of their CTS schemes.

By April 2015, 284 (87 per cent of) local authorities in England had adopted at least one variation from the default:[2]

» 250 local authorities introduced a minimum payment – a regressive measure in which families have to pay some amount of council tax regardless of income.

» 75 local authorities added a cap on council tax support – calculating entitlement based on a maximum council tax band.

» 20 local authorities increased the rate at which CTS is withdrawn as income rises – worsening work incentives.

Scotland and Wales have taken different approaches, maintaining the levels of support their Council Tax Reduction schemes provide.

How CTS is currently expected to operate alongside UC

While CTS is not set to form part of UC, it *will* be affected by it. Once UC is implemented, the underlying ('default') CTB scheme, on which local variations are made, will change. Out-of-work families still have all of their council tax paid. For those in work, CTS is reduced by 20 per cent of all net, post-UC income, over and above their out-of-work entitlement:

» Where the work allowance applies, an increase in earnings of £10 would reduce CTS by £2 (20 per cent of the extra £10 earned).

» Where the UC taper applies, an increase in earnings of £10 would reduce CTS by £1.30 (the UC taper means the person loses 65 per cent of the extra £10 earned, leaving £3.50. 20 per cent of £3.50 is 70 pence).

» If a person also pays income tax and NI, an increase in earnings of £10 would reduce CTS by 48 pence (after applying the overall 76 per cent taper, leaves £2.40; 20 per cent of £2.40 is 48 pence).

The schemes put into place by different councils introduce further variation in these potential taper rates across local areas.

[1] DWP, *Benefit caseload tables*, March 2015.

[2] See counciltaxsupport.org for further details

The exclusion of CTS from UC represents a missed opportunity

This move away from the single scheme that previously existed and **the decision not to include CTS within UC appears to work against one of the central goals of UC – simplifying work incentives**. While CTS only slightly weakens work incentives for most people (because the amount of support it provides is low compared with other benefits), the multiplicity of CTS schemes across councils nonetheless make calculating the return from working more difficult.

From a cost-cutting point of view, localising CTS also represented something of a missed opportunity. Local authorities spent somewhere in the region of £800 million[66] assessing and administering Housing Benefit and CTS. The inclusion of just one of these two benefits (Housing Benefit) into UC means that **councils must keep much of their administrative structures in place**. This is highly inefficient, as is the need for recipients to complete one claim for UC and another for CTS – a duplication UC was intended to avoid.

The introduction of minimum payments associated with localisation of CTS has increased the risk that arrears build among recipients. This creates added costs for councils from revenue shortfall and debt collection. It is also costly to the affected individuals, in terms of the additional stress on the budgets of low-income families and the threat of being chased for debts. Arrears increased by £145 million in the first year that CTS was localised, a jump of over 20 per cent. They increased most in councils that introduced the largest minimum payments. With the number of councils asking for a minimum payment of at least 20 per cent set to rise from 94 to 129,[67] arrears may yet build further.

Simple integration of CTS into UC as a new 'element' would be expensive and poorly targeted

Given the complexity, cost and stress created by the localisation of CTS, **our preference is to bring it into UC in some form**. The most obvious step would be to incorporate it as an additional element in UC – similar to the housing element. Entitlement to CTS would then be withdrawn through the UC taper in the usual way.

However, the cost associated with such a proposal is high, at around £1.4 billion a year. This is driven by two factors. The first simply reflects the restoration of the £500 million that was cut when CTS was localised (that is, there would no longer be any variation from the default benchmark). The second arises because the support would be subject to the work allowance and 65 per cent taper. This means it would take much longer for council tax support to be withdrawn than is currently the case, with most working families in UC receiving a boost to their income equivalent to their council tax bill.

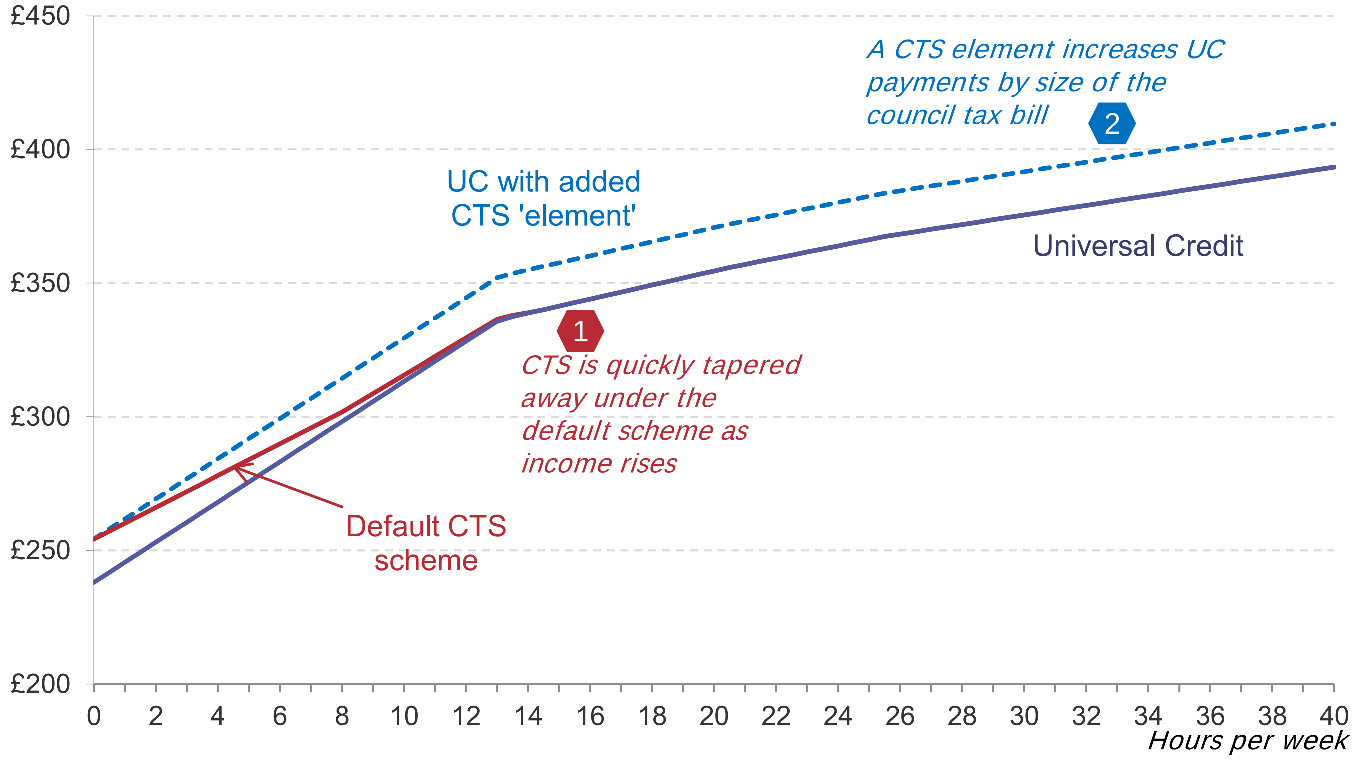
Figure 9 presents the example of a single parent earning £7.50 an hour. The yellow line displays how CTS is administered in the current proposals (i.e. outside of UC) in the most straightforward instance in which the relevant local authority retains the default approach. It shows that CTS is paid in full for out-of-work families, but reduced by 20 per cent of every increase in income, including awards of UC. It is reduced quickly in this instance, and is entirely tapered away before the point at which the recipient's work allowance runs out. In contrast, the green line shows how integrating CTS by adding it as an 'element' would provide a straight cash boost at all points relative to the baseline UC system. While attractive in principle, **this simple integrative approach is an inefficient use of limited funds**.

[66] Audit Commission, *Councils' expenditure on benefits administration*, January 2014.

[67] counciltaxsupport.org

Figure 9:
A new Council Tax Support element compared to the default scheme in UC
Single parent, earning £7.50 an hour, £100 rent has one child

Net income as weekly hours worked increase



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

Retaining a separate taper for CTS but administering it within UC creates an efficient and cost-saving alternative

Because of the difficulty outlined above, we stop short of recommending that CTS should be fully incorporated into UC in the short term. We believe however that **major improvements could be achieved by using the UC framework to *administer* CTS**. This would allow recipients to claim CTS through UC, have their appropriate level of entitlement communicated to their local authority by DWP (without the recipient having to act as an intermediary) and then receive a bill for any outstanding amount from their council.

Delivering the default CTS scheme – with a 20 per cent taper – in this way would have three positive effects relative to the current plan:

» Work incentives would be boosted because this approach represents a simpler, easier-to-understand interaction for users;

» Incomes would be boosted among some of the lowest income UC recipients because the £500 million of cuts introduced alongside localisation would be reversed. Council tax arrears should fall as a consequence; and

» Administrative costs would be reduced because local authorities would no longer have to undertake means-testing. This would allow significant savings to be made from the over £800 million currently spent on administering housing support and CTS.

We anticipate that **these administrative savings, and a significant reduction in arrears, should generate enough funds to pay for the reversal of the £500 million cut**. It is difficult to estimate the precise level of administrative savings achievable, particularly because *some* infrastructure between councils and DWP would need to remain in place. If our assumption proves overly optimistic, and further savings are needed to make this proposal cost-neutral, then we would favour increasing the 20 per cent rate at which CTS is withdrawn.

Incorporating CTS into UC in this way would provide around 4.4 million families with an average £2 a week extra support. However, this smaller average masks a wide range of outcomes with some gaining significantly more support. The largest boost would be to out-of-work families who would revert to having their council tax covered in full. Those in work who previously would have faced a higher taper would have this capped at 20 per cent, thereby seeing less of their income taken away.

Over the longer term, as more is understood about precisely which components of UC – the level of integration, the simplicity of use or the financial incentives – have the greatest impact on work incentives, there may be a case for making CTS a 'full' element of UC, akin to housing.

i Recommendation 11

Administer Council Tax Support (CTS) through UC, but with an additional taper being used in order to focus eligibility on lower-income households. CTS should be reduced by 20 pence for every pound of income (after tax and UC) a household has over and above their out-of-work entitlement – aligning it with the existing default CTS scheme. This will restore full support with council tax for out-of-work families at a cost of £500 million.

This cost – and the administrative burden – should be met from the savings associated with centralising the assessment process. The precise levels of savings that would be released are uncertain. If they were insufficient to meet the new costs, we would recommend increasing the 20 per cent taper in the short term.

In the longer term, the case for incorporating CTS as a full UC element should be reconsidered.

Housing support

Dealing with devolution

The incorporation of housing support within UC is a significant forward step in creating a simpler benefit system. It has removed the highest tapers that workers currently face when earning or working more and significantly simplified the claims process for recipients. It may also help to boost take-up of housing support among working families by removing the need to make an additional claim; the current level of take-up is just 40 to 50 per cent.

This integration may be challenged however, if the government chooses to devolve the delivery of housing support in the coming years. The government has announced that city regions should be allowed greater flexibility in how they spend government resources to make housing affordable at a local level.[68] This could include, for example, diverting funds to spend on increasing housing supply, or giving certain groups more support than others. Such devolution would also have implications for CTS.

[68] https://www.gov.uk/government/speeches/chancellor-on-building-a-northern-powerhouse

As set out in Section 2, we take no view in this report of the appropriate level of devolution of powers in relation to housing support or any other aspect of the welfare system. We are clear however, that housing support and CTS should be jointly administered. Both should either be within or outside of UC; as discussed above, splitting this administration is inefficient.

Given the apparent appetite for exploring more devolution, we think it is important for UC to be ready to provide the flexibility necessary for local provision without undermining the benefits of integration and simplicity. With that in mind, we suggest that if more freedom to alter policy at the local level is desired in relation to housing support, it appears far more sensible – following the approach of the Smith Commission[69] – to continue to calculate entitlement through a central system but allow for varying levels of support by locality. A system of local allowances for the private rented sector already allows the UC system (and the current Housing Benefit system) to do just this. Our view is that this functionality could be built upon to enable differing levels of support in different areas of the UK.

Recommendation 12

If responsibility to deliver housing support is devolved, payments should still be made through the UC system following the approach of the Smith Commission. This will provide local authorities with more flexibility over how they allocate government resources on housing.

'Passported' benefits

Benefits in-kind are designed to serve specific aims rather than just boost incomes

Since 1906 – when the concept of free school meals (FSMs) was first introduced – a large range of additional types of support for low-income families has built up, ranging from the provision of free prescriptions to help with insulating homes and lower energy tariffs. Collectively, these types of benefits tend to be referred to as 'passported' benefits, because eligibility is often determined through entitlement to out-of-work benefits; in essence, these benefits are a 'passport' to other forms of support.

Such benefits are often provided to achieve a specific policy aim, with responsibility resting with the relevant departments rather than being delivered by DWP or HMRC. For example, the Department of Health and the NHS determine the level of support and administer help with health costs.

In order to deliver against their policy goals, passported benefits do not tend to come in the form of a direct boost to income – a cash payment – but are instead delivered 'in-kind'. For instance, the direct provision of FSMs ensures that children receive a warm, healthy meal each day at school. There is evidence to suggest that providing greater financial support direct to families results in those resources being channelled towards children.[70] However, if the policy goal specifically relates to nutrition, then it makes sense to target specific service provision. We take the starting point that benefits should mirror current provision as far as possible and remain as benefits in-kind.

[69] Report of the Smith Commission for further devolution of powers to the Scottish Parliament, November 2014.

[70] P Gregg, et al *Expenditure patterns post-Welfare Reform in the UK: Are low-income families starting to catch up?*, CASE, 2005

More frequent and visible passported benefits are more likely to influence working patterns

The extent to which these benefits have an impact on work incentives is unclear. The generosity of provision, how often they are used and the awareness of these entitlements will all influence whether people take the loss of this support into account when moving into work. For example, missing out on having one-off loft insulation installed is unlikely to be an important factor when deciding whether to accept a job but losing daily FSM entitlement may be of greater concern.

The loss of free school meals at the point at which a household is no longer considered to be 'out of work' could discourage members of that family from entering work

With this distinction in mind, we consider FSMs in detail. We recognise that they are a tangible and frequent benefit for low-income families with children and would therefore have the greatest potential impact on work choices. Moving beyond FSMs, we also make recommendations for determining eligibility for help with healthcare costs (such as free prescriptions) and set out a wider principle for the provision of passported benefits through UC.

Withdrawal of free school meals in UC may harm incentives to work

Until recently, FSMs were provided only to 'out-of-work' families, benefiting 1.3 million children.[71] As of September 2014 however, FSMs are now available on a universal basis to around 1.9 million children in reception, year 1 and year 2 of primary school (the academic year in which children turn seven), as well as an additional 900,000 older children in workless families.[72]

Clearly, **the loss of FSMs at the point at which a household is no longer considered to be 'out of work' could discourage members of that family from entering work**. Under the current system, the boost provided by the receipt of working tax credit as FSMs are withdrawn more than compensates for their loss.[73] But with the border between being in and out of work blurred by UC, there is no longer an obvious cut-off point for FSM entitlement. The previous government stated that it was planning to use an earnings threshold but no details have ever been specified.[74]

However, as shown in Figure 10, removing entitlement at a specified earnings threshold could create what is known as a 'cliff edge', a steep drop in entitlement making people lose out from working more one more hour. In the chart, the dotted line sets out the household's (in this case, a single parent with two children) income, as if the value of the received FSMs were converted into cash. At the arbitrary level of working hours at which FSMs are removed, the family's 'income' drops by around £20 a week.

[71] More accurately, this relates to children in families in which either no one is in work, or no one is working enough to be in receipt of working tax credit (16 hours for a single parent, 24 hours for a couple). Currently around 600,000 families in England are eligible under these criteria (covering around 1.3 million children of all ages).

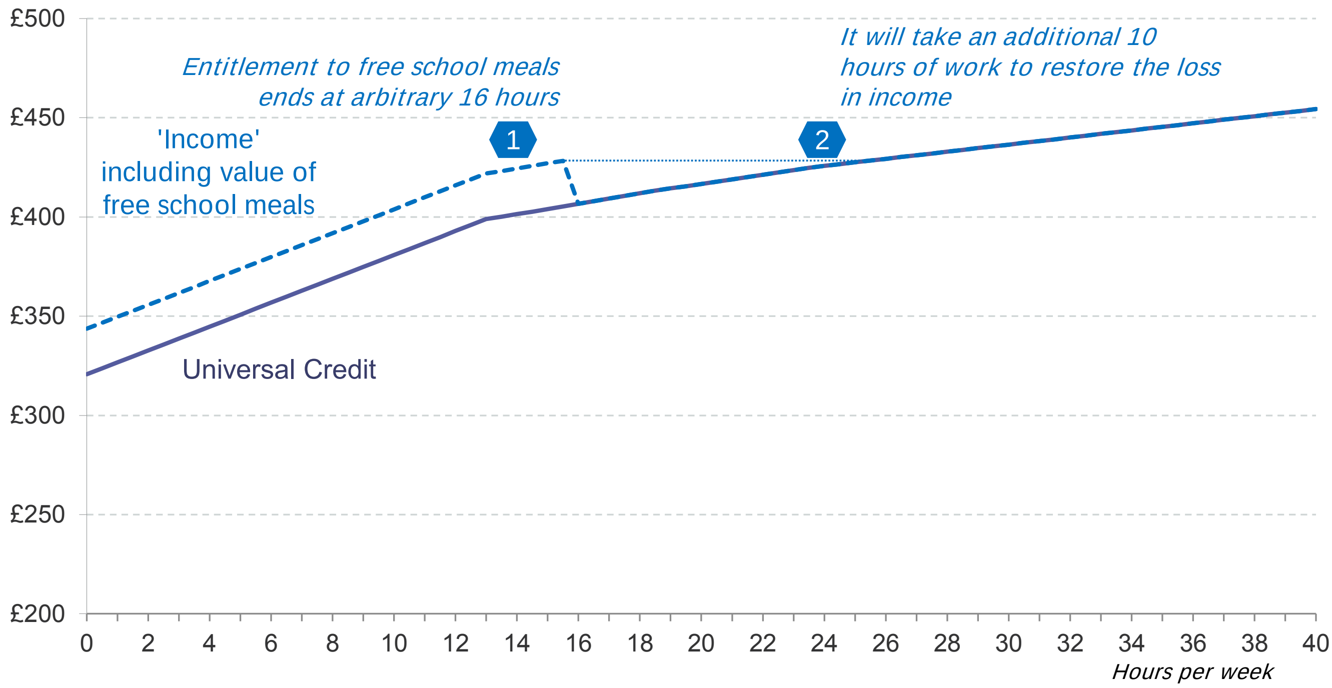
[72] DfE *Schools, pupils and their characteristics: January 2014*, 2015.

[73] FSMs are generally worth between £2 to £2.30 each, or £10 to £13 a week per child

[74] See Written question 504. Also, the decision is in-part complicated by other DfE policy rules being based on entitlement to free school meals, such as eligibility for pupil premium funding.

Figure 10:
Free-school meals and income in Universal Credit
Single parent with 2 children, earning £7.50 an hour and rent of £100 per week

Net income as weekly hours worked increase



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

The impact on work incentives is worse if the threshold is set – as in the chart – at a point at which the UC taper applies to earnings. In this scenario, it would take a much greater increase in earnings to offset the overall loss in income due to the loss of FSMs than if the threshold applied where earnings were still subject to the work allowance. In Figure 10, the single parent only regains the overall 'income' they receive at 15 hours once they work 25 hours. At any number of hours in between, they would find themselves worse off. Creating a stretch of income in which people are penalised for working more should be avoided.

Options for dealing with free school meals under UC must trade-off simplicity with cost

There are a number of options to avoid or limit the damage to incentives arising from the interaction of FSMs and UC. Each approach has its own advantages and disadvantages, with costs and complexity the main trade-offs. Possibly the simplest way to avoid the cliff-edge effect would be to make FSMs universal, available either to all children or to all children living in UC families. The former would simply expand the FSM scheme to all children while the latter could be achieved by adding a FSM element to UC, providing families with the cash to buy meals from schools. However, both options are expensive: providing FSMs to the entire UC population could cost £750 million. In addition, anything linking FSMs to UC receipt would still produce a cliff edge – this time for those at the upper limit of UC.

Less costly options are inevitably more complicated. For example, an earnings threshold could be introduced in UC at the point at which FSMs are withdrawn. This would provide a cash payment to make up for the fall in income once a family hits the earnings threshold. This would work in much the same way working tax credits currently more than offset the loss of FSMs, but the value of the new payment would be smaller and would be tapered away quickly (before the point at which earnings exceed the work allowance). This would minimise its impact on work incentives and limit the cost, but this approach is complex and introduces entirely new elements to the UC system. A further drawback stems from the potential high effective tax rate created in combination with the withdrawal of CTS.

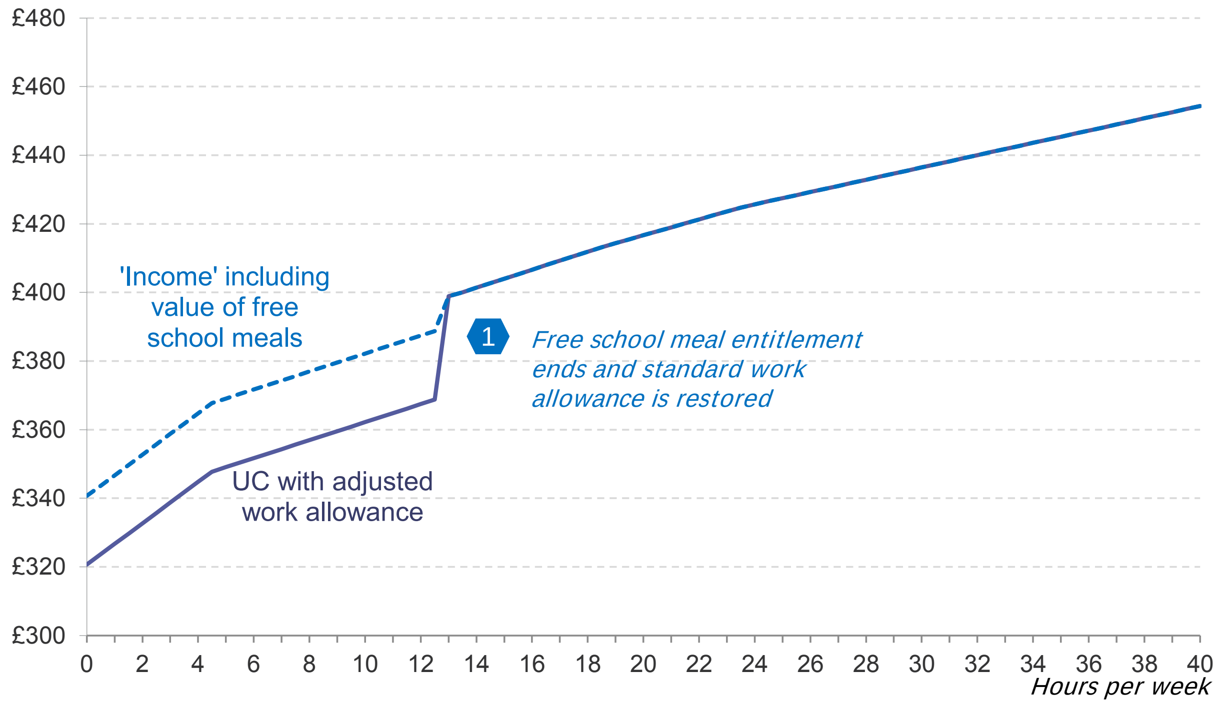
Reducing work allowances for FSM recipients until the point at which they are removed maintains positive work incentives

Our judgement is that **FSMs should be provided to low-income families**. However, to keep costs under control, **these low-income families should simultaneously be moved onto lower work allowances**. They therefore start having their UC entitlement tapered away *sooner* than would otherwise be the case. Once they reach a specified earnings threshold, their entitlement to FSMs would be removed, but they would also revert to their standard (higher) work allowance. This would have the effect of boosting their post-UC incomes and so offset the loss of the in-kind FSM benefit.

What would that mean in practice? Figure 11 shows how a single parent with two children, earning £7.50 a week would be affected. The initial application of a lower work allowance means that the single parent's UC entitlement starts being tapered after just two hours, with their award subsequently being tapered away at 65 per cent. After 13 hours, they reach the earnings threshold and their access to FSMs is removed. Because they move back onto a higher work allowance however, their UC entitlement is recalculated and receives an immediate boost – cancelling out the loss of FSMs. Our proposal therefore ensures that the family is always better off when earning more.

Figure 11:
Recommended solution to determine free school meal eligibility in UC
Single parent with two children, earning £7.50 an hour and rent of £100 per week

Net income as weekly hours worked increase



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

The earnings threshold at which FSM entitlement ends would be set at an appropriate level to ensure people are not made worse off when working more. We estimate that this policy will create no additional costs to the provision of FSMs. A small number of families (fewer than 25,000) with low earnings who are eligible for FSMs under the current system may no longer receive them under our proposal, but they will still be better off overall due to the boost to income at low levels of earnings that work allowances provide.[75]

Recommendation 13

Families should retain their entitlement to free school meals (FSMs) up to a specified earnings threshold. Their work allowances should be reduced below the standard level, so that they face gradual withdrawal of their payments at lower hours of work. Once they reach the FSM earnings threshold, they should revert to the standard work allowance, boosting their income and providing a clear incentive to increase their working hours.

Support with health costs and other passported benefits should have eligibility criteria aligned with UC definitions

The NHS provides out-of-work families[76] with free prescriptions, free dental care and support with the cost of other aids, such as spectacles. These needs may be one-offs or recurring, with the latter being more likely to affect work incentives.[77] The NHS also provides some additional support with health costs for families who are in work but who have low incomes. Eligibility is determined through a test devised by the Department for Health (DH), reflecting its assessment of the impact of health-related payments on the cost of living.

Ensuring that health care is accessible and affordable is a key task of DH, but the introduction of UC provides an opportunity to better align support and raise awareness of the DH scheme. **We recommend, in line with proposals made by DH and the Social Security Advisory Committee,[78] that DH set an earnings threshold for entitlement for free support with health costs, to align as far as possible with coverage in the current system**. The current income-related scheme, which covers a proportion of health costs, depending on a DH assessment of a family's circumstances, should be aligned with the UC measure of income.

A similar alignment with the measure of UC income should apply to all passported benefits, with the generosity and extent of provision for low-income working families being determined by the departments responsible for those policies. Relative to the current UC system, for some claimants this approach may reduce the attraction of working a small number of hours. However, our key concern is to ensure that incentives to work beyond this point – for more hours – are not damaged.

The UC system should be utilised not only to help determine eligibility but also to raise awareness of entitlement to the full range of passported benefits. It could, for example, automatically provide relevant information to recipients based on their circumstances.

[75] For reasons of simplicity, we set only one FSM-adjusted work allowance for each family type (renters or homeowners; couples or singles). Annex B provides further detail of what these are and the impact of our recommendations on different family types.

[76] As with FSMs, this is the point at which entitlement to out-of-work benefits ends, or in-work support starts, for families with children.

[77] Although it is possible to bulk purchase prescriptions at a much cheaper rate; £100 for a year, compared to £8.20 for each one.

[78] DWP, *Universal Credit: the impact on passported benefits*, 2012.

Recommendation 14

Passported benefits should have their original policy intent preserved by remaining as benefits-in-kind outside of UC, but they should have their eligibility criteria aligned with UC definitions. The point at which eligibility for such benefits ends should be pinpointed to minimise any negative impact on the incentives UC claimants have to work.

Childcare support

The barriers to work associated with childcare costs

We alluded to the impact that paying for childcare can have on the return from working in Sections 4 and 5, but have not yet considered how UC can best help to improve this situation. Of course, parents with children in school and those with 2-4 year olds receiving early years' entitlement have reduced childcare demands. For other parents (including those who have some *but not all* of their children covered by school or early years' entitlement), childcare costs can act as a significant barrier to entering work or increasing hours. This is a particular problem for the lowest-paid single parents and second earners with pre-school children.

UC provides support with childcare costs through what is referred to as the 'childcare element'. This covers up to 85 per cent of childcare costs, up to a monthly cash limit. Parents pay the other 15 per cent out of their post-UC income. Box 7 provides more details, along with a description of the new 'Tax-Free Childcare' scheme being introduced for families outside of UC.

Box 7: Government support towards childcare costs

UC will provide support towards childcare costs through a childcare element – similar to the childcare element in working tax credit. For families that have one dependent child, UC will cover up to 85 per cent of their childcare costs, up to a limit of £175 a week. For families with two or more children, UC will also cover up to 85 per cent of childcare costs, but up to £300 a week. Entitlement is determined on a monthly basis. To qualify, all parents in the household have to be in work, though there are some exceptions to this. For example, only one parent in a couple needs to work if their partner has a disability.

All 3-4 year olds, and the 40 per cent most disadvantaged[1] two year olds can receive 15 hours a week of free childcare, known as the early years' entitlement. This is largely provided during term time only (38 weeks), though there are moves to make this available across the year (but without increasing the annual number of hours). Families in which both parents work and have a 3-4 year old will be entitled to an additional 15 hours a week of free childcare under this government's proposals.

Tax-Free Childcare will cover 20 per cent of up to £10,000 a year (equivalent to £190 a week) in childcare costs for each dependent child in the family. Entitlement to the scheme is determined on a quarterly basis. To qualify all parents must be in work but not in receipt of UC or tax credits, and without an individual with gross earnings of more than £150,000 a year (potentially up to £300,000 a year in a couple). While the 20 per cent rate matches the basic rate of income tax, entitlement is not related to the tax system.

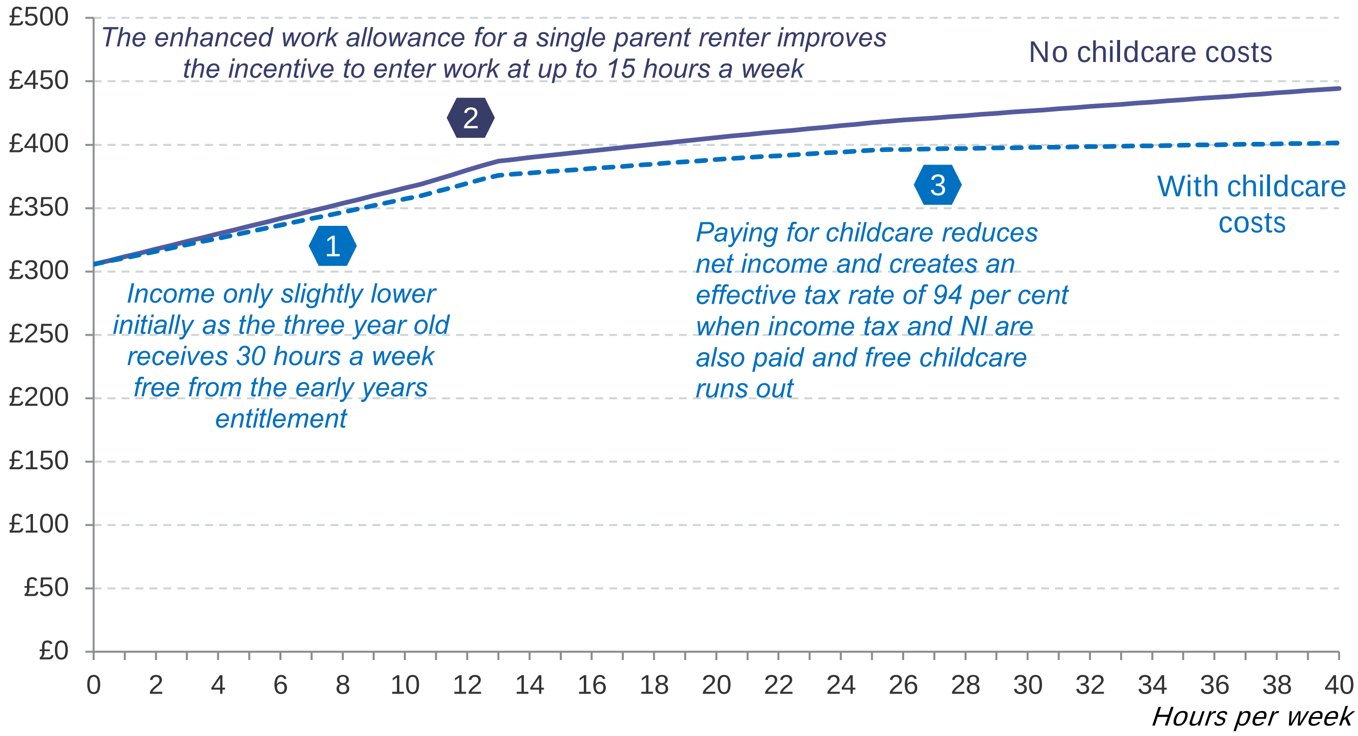
[1] Defined as being in a family with out-of-work benefits or income of less than £16,000.

With such costs potentially being sizeable, childcare needs increase the effective taper rate a family faces when they work. This strengthens their incentive to limit earnings to the point at which their work allowance runs out. The already weak incentive to enter work that second earners face under UC (from having no work allowance) is made much worse when childcare is added to the equation.

Figure 12 considers the example of a single parent with two children (aged one and three) earning £7.50 an hour. The solid line shows post-tax, post-UC income where no formal childcare is required, while the dashed line shows income where childcare costs *are* a factor.[79] The two lines are relatively close together for the first eight hours of work (up to point 1 on the chart), with the presence of the work allowance and free childcare entitlements making it worthwhile to work short hours. However, beyond this point there is very little return from working more hours where childcare costs are a factor. Once income tax and NI become payable, the parent is facing a marginal reduction in their income of 94 pence in the pound. If they reach the point at which they receive the maximum level of childcare support available, any additional work would result in a *reduction* in take-home income.

Figure 12:
The return from work when paying for childcare
Net income at different hours worked for a single parent earning £7.50 an hour, rent of £100 a week and 2 children aged 1 and 3

Net income as weekly hours worked increase



Notes: Net income figures are a weekly average of annual net income. Childcare use also reflects a weekly average of annual usage, taking into account variation in childcare costs across the year. Modelling does account for new 30 hours offer for three and four year olds.

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

[79] Both examples are analysed against a baseline in which the single parent work allowance has been increased in line with our recommendation in Section 4.

It is hard to determine the extent to which childcare barriers limit work, not least because families may *choose* not have both parents in full-time employment. However, it is likely to be a significant factor in such decisions for some.[80] In families on UC with children under five, 60 per cent of single parents are out of work and three-quarters of couples only have one parent in work. Likewise, of the 1.3 million families on UC in which all parents work, around half have at least one parent working part time. In total, around 500,000 families with children where all parents work are expected to claim support with their childcare costs in UC.[81]

Improving the childcare offer under UC

In order to improve incentives to first *enter* and then *progress* at work, UC can provide additional support to parents with the cost of childcare. However, this should be targeted at those who need it most. The proposed expansion of universal free childcare for working parents (from 15 hours to 30 hours)[82] will only provide additional support to those with 3-4 year olds. Parents of children under three (excluding the lowest-earning parents of 2 year olds) receive no free entitlement, even though their childcare is more expensive.[83] We believe this group would benefit most from further help.

We recommend that **support for parents with children under three should be increased, by raising the proportion of total childcare costs that can be claimed for in UC from 85 per cent to 95 per cent**. This will help to reduce the greatest financial barriers to work and target additional support at those families who need it the most. We stop short of covering all (100 per cent of) costs, in order to ensure that parents remain incentivised to make the most efficient childcare arrangements possible.

We do not believe it would be appropriate to increase coverage for *all* families on UC. Work incentives, when paying for childcare, are not as weak among higher-earning workers within UC and those with school-age children. And while parents with three and four year olds will not find their marginal return from working one more hour much improved by the expansion of free entitlement, they will now be better off when working full time.

We estimate that our proposal will cost an additional £150 million a year. This increased generosity should be paid for by redistributing spend from the Tax-Free Childcare scheme. As set out in Box 7, this scheme will provide up to £2,000 a year of help with childcare costs for each child in families earning up to £300,000. **Reducing the earnings limit[84] for an individual receiving Tax-Free Childcare to £65,000 a year** (a limit of up to £130,000 a year per family) would remove entitlement from only the top 5 per cent of earners but release £150 million to fund improved support in UC.[85] We believe this would ensure a more equitable balance of spending priorities.

[80] G Cory and V Alakeson, Careers and carers: Childcare and maternal labour supply, Resolution Foundation, January 2014.

[81] DWP, *Universal Credit: Increasing the childcare offer*, December 2014.

[82] The Conservative Party Manifesto 2015.

[83] Average cost of childcare for 25 hours a week is £6,000 for an under-2 year old. 3-4 year olds will receive 30 hours free during term times, reducing the annual cost for a 3 to 4 year old to £1,500 a year.

[84] Note that a cap based on family income would be a more sensible approach than using a measure based on a single earner in the household. The current approach to Tax-Free Childcare can mean that a household with two parents earning £80,000 each would receive Tax-Free Childcare, but a household with one parent earning £150,000 and the other £10,000 would receive nothing

[85] Resolution Foundation analysis using the IPPR tax-benefit model

Recommendation 15

Increase the childcare support given to UC recipients with pre-school children (under the age of three) to 95 per cent of their childcare costs, at a cost of around £150million.

To cover the cost of this improved offer, the Tax-Free Childcare earnings cap should be reduced to £65,000 per person (rather than £150,000), removing entitlement from the top 5 per cent of earners.

Improving the process of claiming support with childcare costs in UC

UC will change the way in which parents claim support for childcare costs. In the current tax credit system, a parent claims for a *monthly average* of their expected *annual* childcare costs, which they must estimate at the start of each year's claim. In UC, the monthly limit applies to childcare costs *paid for* in the previous month. In principle, this should be easier for the individual to calculate. In practice, it generates three significant problems:

- Where childcare costs vary over the year – they can be more expensive in the school holidays, for example – the limits will be exceeded in some months, making UC less generous across the year as a whole. Parents may be discouraged from working at all, or may reduce their hours of work in those periods.
- *Paid* childcare costs may not reflect the cost of the childcare *used* in the previous month. For example, parents who pay for a term (approximately 12 weeks) of childcare in one month – with the overall cost exceeding the monthly limit – would not receive support with all of their costs.
- Having to pay for the childcare first and then claiming support with the cost could mean that some parents are unable to find the money to intially access childcare (this can also be an issue in the tax credit system).

These may sound like minor administrative glitches, but from the point of view of parents, they can have huge significance. A relatively simple solution to the first two issues would be to introduce a less frequent reporting period. However, an annual period would not be responsive to changes in circumstances and create the risk of over- or under-payments across the year, a common problem with working tax credits.

Instead, we favour **introducing quarterly reporting periods, with quarterly limits applying to the amount of childcare support that can be claimed**. As far as possible, these should be aligned with the school term timetable. Entitlement would be determined based on the previous month's circumstances but then last for the next three months. Entitlement should be reassessed on a quarterly basis unless there are significant changes in circumstance, such as a big increase in earnings or loss of employment for an extended period of time.

The final problem we identify – the need for an advance payment – could be solved by providing government support for childcare costs *before* parents need to make the payment. This creates a risk however, that parents could use the money to pay for things other than childcare. To prevent this, payment could potentially be made direct to providers, though the practicality of this would need to be explored first. We feel this is a second order priority for the medium term, unless it could be achieved without delaying the development of the UC IT system. A system of advance payments should not be introduced until direct payment is a viable option.

i Recommendation 16

Calculate entitlement to childcare support on a quarterly basis – broadly aligned with the school term timetable – making it more flexible and easier to use.

Explore the medium-term possibility of paying childcare providers direct through the UC system, thereby opening the possibility of advance childcare payments for those UC recipients who have difficulty meeting the upfront costs.

The coherence of government childcare support

The proposals above seek to make the existing system of support do more to strengthen incentives for the groups most likely to respond. They make no attempt to change or improve an overly complex government system of support with childcare. Fixing the overall structure of childcare support goes beyond our remit. However, we do provide some guidance for making improvements in the future.

At some point in this parliament, **it may be possible to combine the support provided by UC and Tax-Free Childcare into a single system rather than having two overlapping schemes**. If Tax-Free Childcare had been fully operational when UC childcare policy was being developed, it may have been a viable delivery mechanism for childcare support to low-income families. But because neither system is currently in place, it is impossible to make any firm recommendation in this area, beyond a longer-term direction of simplifying – and hopefully integrating – government childcare provision.

The need for such simplification is highlighted by a consideration of the complexity created by the interaction of Tax-Free Childcare with UC. The Government has estimated that 50,000 families on UC would be better off if they switched to Tax-Free Childcare, and that each year around 100,000 families on Tax-Free Childcare will go through changes in their circumstances (such as having another child or a reduction in earnings) that would make them better off if they were on UC.[86] Yet there is no automatic mechanism that will move families between the two schemes; rather, they will have to make their own assessments.

This is not just a – very difficult – static financial decision: parents must also weigh up different entitlement periods and the additional flexibility afforded by Tax-Free Childcare (in which parents can save childcare funds to spend when needed). This all adds up to a very complex decision and an overall system that is not designed around parents.

Alongside demand-side considerations, further expansion of government support with the *supply-side* of childcare (such as the early years' entitlement) is often proposed. There are good examples of affordable childcare models in other countries that allow parents to work more while also focusing on child development. Elements of such proposals and examples are worth exploring further in the UK, but it will be a long process.

The new government's proposal to provide 30 hours of free childcare a week for working parents of 3-4 year olds is a further step on the path to such a system. It is a considerable extension in the government's free entitlement offer that will help to reduce pressure on the demand side and may entice more parents back to work. But even with this additional investment, much more time and money will be required before our childcare market is capable of providing 'free' or subsidised, high-quality childcare places at the times needed for all working parents.

Historically, the early years' entitlement has had more of a focus on child development than supporting employment. But the government's pledge to provide an additional 15 hours a week of

[86] HMT and HMRC, *Tax-Free Childcare: consultation on childcare account provision*, May 2014.

free childcare for *working* parents of 3-4 year olds suggests something of a change in priority. The new offer brings welcome additional support for parents, though it tends to be of most benefit to higher-earning parents not entitled to UC.[87] It is also unlikely to drive significant improvements in the provision of places at atypical hours – an important barrier to overcome if demand-side support is to be replaced outright.

Childcare is likely to remain high up the political agenda, particularly with costs seemingly always on the rise. It is beyond the remit of this review to opine on a roadmap for future reform of childcare provision in the UK for what could take a further decade. But we believe **a suitable first step would be to ensure that government takes a more joined-up, strategic approach to the policy**.[88] With an expected annual budget of around £7 billion being allocated to childcare provision, it is vital that the government acts to maximise the return from its investment.

i Recommendation 17

The government should implement a coherent long-term strategy to reduce the cost and increase the availability of childcare to working parents, with greater alignment between the different government schemes.

Over the long-term, it should seek to move to a single system of demand-side childcare support alongside the move to a more universal supply-side system.

Summary

Combining several benefits into a single payment is an entirely sensible reform. This simplification and the withdrawal of those benefits at the same rate represents the most encouraging step forward that UC offers over the current system. But, contrary to how UC is sometimes portrayed, not every working-age benefit has been incorporated. Widely used and relied upon types of support (such as CTS and FSMs) have been excluded. While it is not straightforward to bring these benefits within UC, ignoring the negative effects that this decision could have on incentives to work and earn more may stop UC from being as successful as it could be.

In the case of CTS, we argue it should be administered through UC, but with an additional taper to make sure the greatest support is focused on lower-income households. FSMs should continue to be available to children in low-income families, but an earnings threshold with an income boost at the point at which FSMs are removed would guarantee claimants can take on additional work without worrying about the financial repercussions of losing this benefit.

Childcare is another area that is crucial to the successful functioning of UC, but problems with affordability, availability and quality go well beyond the scope of this review. In the long run, those questions must be addressed, and government should develop a strategy that provides a better offer to working families. In the immediate future however, the priority must be to make sure childcare costs do not dissuade families, and particularly mothers, from working. To achieve this, we recommend that UC recipients with pre-school children should receive help with up to 95 per cent of their childcare costs. By ensuring these changes are made, UC can make a stronger claim to be a greatly simplified system that incentivises work.

[87] Parents on UC already have 85 per cent of their childcare costs covered, and as many are single parents are more likely to work part-time so may not need a full 25 hours to support their current working pattern.

[88] Similar conclusions have been reached by the House of Lords Select Committee on Affordable Childcare

Section 7

A user-friendly system – interacting with UC

Before UC is rolled out to the lion's share of the more than 8 million families who will be eligible, it is vital that the system works efficiently and reliably. The negative publicity that has surrounded the implementation of UC so far risks undermining faith in the system.

Any significant problems with the system once it is up and running for most claimants – such as inconvenient reporting requirements, rules that are hard to follow or payment mechanisms that leave families feeling worse off – would reinforce this view. The improved work incentives that UC creates (and that we have recommended further changes to) may have their impact blunted if people do not believe the system will make accurate and reliable payments. Time spent getting these aspects right now, before the system is in widespread use, could pay dividends later and have a major impact on the success of UC.

The preceding section set out which benefits should be a part of UC. In this section, we consider the interactions of people with the UC system – what the day-to-day experience of being on UC might feel like for different groups – and how eligibility rules and reporting requirements might affect some recipients' behaviours and outcomes.

The importance of UC being easy to use

The integration of six benefits into one – seven with Council Tax Support included as we suggest – should make the benefits system much easier to use for recipients. For the simplest cases, recipients will only have to provide their details once to have their entitlements calculated. The use of real-time earnings information provided by employers will automatically calculate entitlement each month for the vast majority of people in work.[89] As we have argued, these are, in principle at least, big wins.

However, **this simple framework is unlikely to hold where recipients have more complicated characteristics**. In Section 6, we showed that the system is complex for people claiming support with their childcare costs. People who are self-employed, renting or moving in and out of work will need to report changes in their circumstances on a regular basis.[90]

Some information would be difficult to report in *any* benefit system. For example, with distinctions often blurred between whether people cohabit or live separately, it can be difficult to determine who is in a couple. But UC reporting tends to place the burden of complexity onto the recipient (and other actors with the system, such as landlords) in order to make the system's processes more straightforward. This is particularly the case for the **self-employed** (discussed

[89] A small number of employees will have to enter their earnings themselves as some small businesses do not have to provide earnings to the RTI scheme.

[90] Our 'interactions framework' is provided at Annex C and sets out the different types of information people will need to report to claim each component of UC. It details what information is needed, how difficult this is to provide by the recipient and how often it needs to be provided.

below) and people with **childcare costs** (discussed in Section 6). We argue that UC must seek to limit the extent to which the unavoidable burden of reporting is aggravated by unnecessary rules and systems.

The self-employed

How the self-employed differ from employees under UC

The way that UC calculates entitlement for people in work is based around the real-time information (RTI) feed the UC system will receive from HMRC. RTI comes from the monthly data on employee earnings that businesses submit to HMRC for tax purposes. For most workers, the earnings data reflect an average of their annual salary, without significant variation from month to month. The amount of UC they receive will therefore remain broadly stable over time. For the self-employed however, this is unlikely to be the case. For them, **variation in demand over the course of the year and a tendency to be paid in lump sums at the beginning or end of a contract can lead to income being much higher in some months than others.**

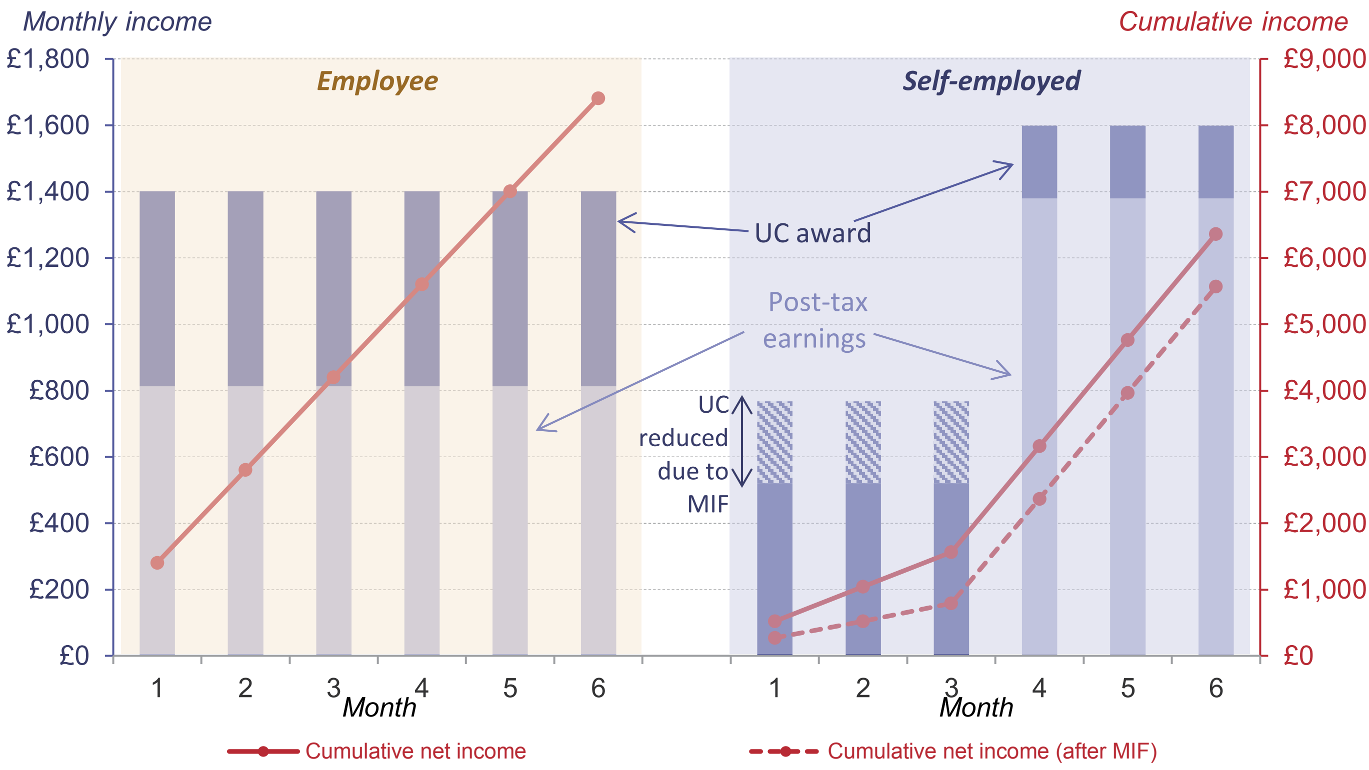
The self-employed pay their tax based on their previous year's profits, unlike employees who are in the PAYE system and pay their tax when they get paid their wages (often monthly). This annual arrangement is designed to account for the variable nature of their income across the year. The tax credit system takes an annual approach for the same reason. However, the UC system requires the self-employed to report their income on a *monthly* basis in order to fit with its pattern for calculating entitlement for other recipients. While making the system more consistent, this inflexible approach can create difficulties for the self-employed.

It is **not just an administrative burden of having to prepare and report monthly accounts**: this approach can have financial implications too. **Relative to an employee with the same annual level of earnings, a self-employed worker can find that their irregular income generates more or less UC entitlement.**

Figure 13 presents an example of the latter, setting out indicative monthly income profiles over a six-month period for an employed person and a self-employed worker. Both earn the same amount over the period (£4,800), but the employee is paid in six equal instalments while the self-employed person earns nothing in the first three months and significantly more in the final three months. The self-employed person receives around £500 from UC in months one to three,[91] but just £200 in months four to six, on the basis that they have relatively high earnings. In contrast, the employee has a steady UC income of around £600. The result – extrapolating across a full year – is that **the employee receives around £3,000 *more* on an annual basis than the self-employed person – despite having the same cumulative earnings**.

[91] It would be amount to under £800 in the absence of the cap imposed by the minimum income floor which we discuss in more detail below.

Figure 13:
Comparing income for an employee and a self-employed person in UC
Couple with one earner and one dependent child



Source: Resolution Foundation analysis

The minimum income floor

Another innovation in UC that only applies to the self-employed is the minimum income floor (MIF). The **MIF aims to both prevent deliberate under-reporting of self-employed income and discourage individuals from persisting with unprofitable enterprises while receiving state support**. When the MIF is applied, the self-employed have their UC payment calculated as if they earn at least the equivalent of 35 hours at the minimum wage (£990 a month). People earning less than this amount will therefore receive the same UC award, regardless of whether they earn, for example, £400 a month or £800 a month. Importantly, as a result they will receive a lower UC award than an employee with the same earnings would.

The MIF is expected to save the government around £1.1 billion each year[92] in lower payments once UC is fully rolled out. However, as shown in Figure 13, it has the added impact of increasing the extent to which self-employed people can find themselves worse off than employees with the same annual earnings. **Parity of outcome between the employed and self-employed was a stated aim of the government when developing UC;**[93] **in its current form, it is set to fall short**.

[92] OBR, *Economic and fiscal outlook*, December 2014.

[93] See Q288 in Work and Pensions Select committee evidence, 17 September 2012.

Making UC fairer and simpler for the self-employed

The inevitable clash between variable patterns of income and the reporting requirements of UC leads to there being no perfect, neat solution to this problem. However, our recommended approach seeks to both remove the disparity of treatment between employees and the self-employed and find as simple a solution as possible for both government and the self-employed.

Fundamentally, we believe **there is a strong case for allowing the self-employed to report their income differently to employees**, reflecting the fact that they *are* different with very different treatment in the tax system. In the same way that UC is built around the RTI feed for employees, it should be built around the tax system for the self-employed.

Therefore, we recommend that **the self-employed should report their income to the UC system on the same basis as they do in the tax system**. This would mean making an average monthly award of UC based on their current annual income, using the previous year's annual income as an approximation. It will also mean that there is no need to introduce the recently announced 'surplus earnings rules' for the self-employed. These rules allow profits and losses to be carried forward and offset in future months but increase the extent to which the self-employed are worse off compared to employees.[94]

Calculating UC on a monthly basis is expected to reduce significantly the under- or over-payments that are an unpleasant feature of the tax credit system. Our proposal will reintroduce this problem to some extent, but the self-employed are currently expected to bear the brunt of this burden through lower UC entitlements. **Any increase in under- or over-payments caused by annual reporting of income for the self-employed is a price worth paying to ensure more equitable treatment with employees**.

In part, the issues faced by the self-employed in UC arise from the need for further reform in the tax system.[95] Budget 2015 announced proposals to simplify how the self-employed report their income for tax purposes. The opportunity should be taken to align reporting for UC and tax purposes as far as possible, reducing burdens on the self-employed. But most importantly, whatever future alignment takes place, it is vital that parity is maintained in the treatment of families with similar incomes whether they are self-employed or employed.

i Recommendation 18

Allow the self-employed to report their income for the purposes of UC in line with the requirements of the tax system. At present, this is usually on an annual basis in arrears.

Making the minimum income floor fairer

A new approach to how the MIF is applied is also required. It certainly seems sensible to take steps to prevent people from taking advantage of the system (and we have flagged the potential introduction of a similar scheme for *employees* above). However, in instances where an individual's annual income is above the specified floor of £11,900, it is wrong that the MIF should be applied in certain months – as it is currently set to do – just because of variability in that income over the course of the year. Instead, **we recommend that the MIF should be applied on an annual basis**.

[94] The MIF is included in the calculation when offsetting losses against income, reducing UC awards in months where losses occur.

[95] Office of Tax Simplification, *Employment Status Report*, March 2015.

This will retain the disincentive to under-report self-employed income, but remove the unfair treatment associated with applying it on a monthly basis.

An additional aim of the MIF is to prevent unprofitable self-employment being subsidised indefinitely by the welfare system. With this in mind, a start-up period of one year is allowed for the newly self-employed, with the MIF not applying in this period. A further year can be taken once every five years if a business has a temporary dip in performance. There is little in this approach that actively supports businesses to become more viable though.

However, the MIF process could provide an opportunity in this regard. For example, the UC system could provide an annual statement – alongside the annual reporting process – that explains to recipients that their business is considered to have too-low a rate of return. Subsequent signposting to practical business support could play an important role in helping such individuals improve their business or make the decision to take an employee job instead.

This approach would have three clear advantages over the current system. First, it would provide a clear signal for a business to look for ways to improve its profitability, or to start looking for alternative employment. Secondly, the reduction in UC caused by the MIF would be easier to understand. That is because UC would be paid at a flat monthly rate based on last year's income. Finally, the unjustified inequitable treatment of the self-employed would no longer occur.

i Recommendation 19

Apply the minimum income floor for the self-employed on an annual, rather than monthly, basis to prevent inequitable treatment compared to employees.

Use the MIF process to signpost people running businesses that are deemed to provide too little income towards appropriate support designed to improve their profits, or encourage them to seek more productive employment.

Alignment of the in- and out-of-work benefit systems

In addition to the reporting issues, some people lose out in UC compared to the current system because of the way in which the rules between the in- and out-of-work benefit systems have either been simplified or aligned when merged together. Taken together, these measures mean that some on UC can find themselves treated unfairly relative to the non-UC population: building up savings will reduce UC entitlement for working families; income tax cuts are not fully passed onto UC families (as discussed in Section 4); and parents under the age of 25 have had their basic entitlements cut. Here we discuss ways of remedying some of these problems.

Removing the disincentive to save

In the current welfare system, out-of-work income-related benefits are reduced for people with savings between £6,000 and £16,000 – and they receive nothing at all if savings exceed £16,000. This strict approach prevents the out-of-work benefit system from being accessed by people with large amounts of savings. Recipients of in-work support are given more leeway however. For those in receipt of tax credits, every pound of income from the interest paid on savings reduces awards by 41 pence, but only if total savings income[96] is greater than £300 a year. In practice, this means that few families have their tax credit award affected by their savings because any income from this source tends to be small.

[96] And other forms of 'unearned income' such as from stocks and shares and occupational pensions.

UC marks a significant change in outlook, by applying the tougher out-of-work stance on the treatment of savings to *all* recipients. In doing so, it extends to UC the logic that benefits are only there to supplement income at a time of need. It also **undermines incentives for low earners to save and plan ahead**.

This would appear to run counter to the general thrust of the previous government's attempts to incentivise and support saving behaviour. More favourable treatment of ISAs and the removal of the vast majority of savings income from tax were presented as ways of rewarding families for 'doing the right thing'.[97] In practice, most of these changes were always going to be of greatest benefit to those higher-income families that had the greatest resources from which to make savings. Set in this context, the decision to disincentivise savings among lower-income working households in receipt of UC appears contradictory.

To ensure that families entitled to UC retain a strong incentive to save, while protecting the integrity of out-of-work support, we believe that **savings in ISAs should be disregarded *entirely* in the calculation of UC**. We estimate that this measure would cost £200 million a year when UC is fully rolled out, benefiting around 200,000 current savers on UC – mostly couples with children.

i Recommendation 20

Exempt savings held in ISAs against the UC savings limit for families, at a cost of £200 million.

Aligning UC elements for the under-25s

The standard 'elements' available in UC are broadly equivalent to the benefit rates in the current out-of-work system. However, consolidation of the number of different levels that apply mean that young parents lose out relative to the current system. A confusing range of rates for couples with partners of different ages has been replaced by a simple four-way split, based on whether a claimant is single, in a couple, under-25 or 25-plus.

This provides some welcome simplification, but also means that t**he more generous benefit levels available to parents under-25 have been removed**. Most of the families affected are out of work with dependent children – comprising 175,000 single parents and 20,000 couples with children in total.

The main justification for this cut in support is to sharpen work incentives.[98] But doing so by making young parents – a group amongst some of the most disadvantaged – worse off, does not appear to be an equitable choice. If incentives to work are not strong enough, they should be improved through work allowances, tapers and employment support and conditions – not by reducing out-of-work support. Therefore, the basic level of support offered to parents under the age of 25 should be increased to match the 25-plus rates. We estimate this to cost £150 million, benefiting 200,000 single parents and 50,000 couples with children by an average of £12 a week.

[97] HMT, *Budget 2015*, March 2015.

[98] DWP, *Universal Credit Impact Assessment*, 2013.

Recommendation 21

Align the under-25 basic allowance for parents with the 25-plus rate, at a cost of £150 million.

Improving the treatment of unearned income

As with savings, UC treats forms of income other than earnings – such as occupational pensions, contributory benefits like maternity allowance and spousal maintenance payments – more harshly than the current tax credit system. Again, it adopts the approach currently used in the out-of-work benefit system, meaning that these forms of income will reduce UC entitlements pound for pound. Applying this less generous treatment to all elements of the benefit system does, of course, create substantial savings. That said, it will reduce incomes for some, most notably in-work families and out-of-work families with children.

The treatment of all sources of unearned income must strike the right balance between supporting low-income families and protecting the state from making payments to people with sufficient resources to maintain their standard of living. At the same time, it must preserve incentives – for example, in relation to building savings – and ensure that the UC population has equitable access to support offered to other working-age families.

The expected restraint on spend during this parliament has inevitably led to difficult choices in relation to these requirements. We have already recommended immediate changes to the treatment of savings in UC, and the level of support provided to parents under the age of 25.

Our final short-term priority is to treat income from maternity allowance[99] more generously. Currently, every pound of maternity allowance received by a UC recipient will result in an offsetting one pound reduction in their UC award. **We recommend that maternity allowance instead should be subject to the UC work allowance and taper – in the same way that Statutory Maternity Pay is**. This will benefit up to 50,000 families at a cost of £100 million a year once UC is fully rolled out. Although this measure has a relatively small impact, we think it will provide important additional support to one of the most vulnerable groups on UC: low-income families with young babies.

In the longer term, UC should treat sources of unearned income[100] in line with the current in-work system of support, unless there is a strong case that this would lead to the destabilisation of out-of-work support.

Recommendation 22

Treat maternity allowance in the same way as earned income, meaning that it is subject to the UC taper rather than resulting in a pound-for-pound reduction in entitlement, at a cost of £100 million.

In the longer term, as resources permit, it should be a top priority to treat occupational pension income and spousal maintenance payments in the same way as earned income (and therefore subject to the taper).

[99] Maternity allowance is a contributory benefit usually paid to pregnant or new mothers who do not qualify for Statutory Maternity Pay but have worked in the last 66 weeks.

[100] Outlined in more detail in Annex C.

The UC payment mechanism

Moving away from the default position of monthly payments

The default position in UC will be to make benefit payments monthly. This differs to the current benefit system not simply because different benefits are paid either weekly, fortnightly or every four weeks, but also because it removes the ability for some recipients to *choose* how frequently they receive their benefits.

For example, tax credit recipients can request a change in payment frequency if it better suits them. Similarly, the timing of Housing Benefit payments tends to match when an individual's rent is due. In contrast, UC will only be paid at an interval other than monthly if recipients are deemed to be at "risk of financial harm".[101]

The main rationale for paying UC monthly is to mimic the payment of monthly salaries, so that UC helps people to "prepare for, and manage the world of work".[102] But this argument appears to overstate its case. While it may be correct that the majority of employees are paid monthly, one-in-five are paid weekly or fortnightly, increasing to three-in-four of those earning less than £10,000 a year[103] – the sort of earnings range that is likely to be most relevant to UC families.

There is no evidence to suggest that moving to a monthly budgeting system would help low-income families struggling to cope financially, or that it would better prepare them to start working. Indeed, the government have introduced online guidance to help people cope, anticipating that they will struggle to do so.[104] Low-income families – especially single parents – often operate on very tight week-to-week budgets; less frequent payments could make it harder for them to get by.[105]

Many families are also likely to be disadvantaged by having to wait more than five weeks to receive their first UC award. For an individual or family in a time of financial need, this does not seem a reasonable approach. It will simply exacerbate the budgeting problems discussed above and leave some families with little or no income during the intervening period.

In the current system, different benefits are paid at different times. Therefore, while a person may not be paid all of their entitlement immediately, they can at least be in receipt of some of it. UC offers advances[106] to help families cope, but these must be applied for; it is not the default position.

Improving the flexibility of housing support payments

The final issue we consider with regard to the process of payments relates to housing support. In the current system, payments are made directly to landlords. In contrast, UC will take the default position of paying support towards housing costs direct to recipients. The justification is that UC recipients will become used to making rent payments themselves, and have a better understanding of rental costs, in the same way that non-UC families have to.[107]

[101] DWP, *Personal budgeting Support and Alternative Payment Arrangements*, March 2015.

[102] DWP, *Universal Credit and budgeting*, February 2015.

[103] Women's Budget group *Universal Credit: frequency of payment briefing note*, September 2011.

[104] Available here.

[105] op cit

[106] A Short Term Benefit Advance can be applied for if you show yourself to be in financial hardship and are waiting for your first payment of benefit.

[107] DWP, *Universal Credit: Welfare that works*, 2011

However, **in areas where this approach has been piloted, Housing Benefit arrears have increased.**[108] This, of course, creates difficulties for landlords. But it can also place UC recipients in a less stable financial position – where future UC payments are reduced to cover the cost of arrears. Ultimately, it can lead to eviction. Provision has been made to allow payments to be made straight to landlords, but this is only allowed once a recipient is assessed as being 'at risk' of running into arrears.

Taking a more common sense approach to payment timings and processes

UC payment mechanisms have been designed with two key goals in mind: the creation of a simpler-to-administer benefit system and to help prepare people for the 'world of work' outside of the benefit system. By taking this approach however, further complexity has been loaded onto the recipient rather than government, and a default position has been created that can lead to unnecessary hardship.

A far more sensible approach would allow recipients to choose the method and timing of payment that best meets their needs and circumstances. This option should be in place as a matter of course, rather than being offered as a last resort, as is currently the case.

i Recommendation 23

Allow UC recipients to request a more frequent payment period that best suits them.

Allow recipients to request that housing support payments be made directly to their landlords.

The 'surplus' earnings rule

We discussed above how irregular earnings across the year among many self-employed workers mean they can find themselves entitled to more or less UC than an employee with the same annual level of earnings. The same is true of those *employees* who have variable earnings patterns (though of course, this is a much less common issue among employees). For example, a person with an annual salary that – spread equally across 12 months – would mean they did not qualify for UC could gain some entitlement if they went unpaid in some months.

Aside from the obvious concern about equity, there is the worry that employers could alter the frequency at which they pay their staff in order to take advantage of this feature. That is, they could choose a payment period that maximises the UC entitlement of their employee. The government's answer to this problem is to introduce a complicated set of rules that will help to smooth out the pattern of earnings where there is significant variation.

UC recipients who lose entitlement in a given month due to an increase in their earnings will have their 'surplus' earnings held on record (or 'banked') by the DWP for the next six months. This 'surplus' is the difference between their total earnings that month and the earnings needed to reduce their UC award to zero (though the first £300 goes unrecorded). So, if they become ineligible for UC once their earnings top £500, and they actually earn £1,000, then they would have a 'surplus' of £200 (£1,000 earnings minus £500 UC threshold minus the £300 buffer) recorded.

If their earnings subsequently fall, such that they move back into UC entitlement within six months, the recorded 'surplus' is used in the calculation of their UC award. Continuing the example above, if the individual claimed for UC in the following month because their monthly

[108] DWP *Direct Payment Demonstration Projects: Key findings of the programme evaluation* , 2014

earnings had dropped to £400, then their entitlement would be calculated on the basis of £600 income because of the previously established 'surplus' of £200.

Not only is this policy extremely hard to understand, it can also lead to a person who finds work subsequently receiving no UC at all if they fall back out of work, leaving them with very little income to live off until their surplus earnings are used up.[109] It is unrealistic to expect someone who moves into employment to recognise this potential eventuality and therefore save some of their new income in case they stop working within the following six months – even if they do have, overall, a higher income over the period.

Indeed, if recipients begin to perceive this measure as creating a risk of having no income if they fall out of work, they may be discouraged from starting work at all, re-creating a barrier that the design of UC has tried hard to remove – especially for people who currently cycle in and out of low paid work.

We oppose a 'surplus' earnings rule, arguing that it creates unnecessary complexity and risks creating a disincentive to work. There is no evidence on the extent to which collusion between employers and employees to game the system might become a real risk to the taxpayer. If such behaviour on the part of employers and employees *did* occur, a more generic ruling allowing government to take action to prevent fraudulent behaviour would be a more sensible approach. Special arrangements could be put in place for the limited number of workers who have genuinely variable earnings due to the nature of their occupation, instead of applying this set of complicated rules to the entire UC population.

i Recommendation 24

Do not introduce a 'surplus' earnings rule, because it will introduce significant complexity and create a potential disincentive to take on work or increase earnings.

Summary

Much of the public debate around UC has focused on the delays and IT issues it has encountered. In this review, we have chosen to focus our attention primarily on whether or not the incentive structure within UC will make work pay rather than these concerns around its implementation. That is not to say that practical issues – how claimants will interact with the system on a day-to-day basis – are not important. Unless UC is user-friendly for all kinds of recipients, the improvements it offers over the previous system may be diminished.

Thankfully, there are a number of 'quick wins' that would make UC less of a challenge to interact with for claimants without adding excessive costs, complexity or burden to the system. The government should opt for a common sense approach when it comes to how often payments are made in UC, allowing recipients to choose what payment periods would best suit them rather than adhering to the arbitrarily strict position around monthly payments as at present. Similarly, recipients who get help with their housing costs can have their support paid directly to their landlords in the current system before they fall into arrears. Restoring the ability to do so under UC would be a sensible addition.

Other reforms are less straightforward or bring added costs. We believe, however, that without acting on these issues the potential of UC will be undermined. Some primarily attempt to ensure the system treats different groups as fairly as possible. To this end, the self-employed should be

[109] See https://www.gov.uk/government/news/universal-credit-government-proposal-to-take-account-of-past-earnings-in-repeat-claims-consultation-announced

able to report their earnings in line with the tax system rather than on a burdensome monthly basis. A potentially more serious consequence of the monthly reporting period and the minimum income floor is that self-employed people with 'lumpy' income may lose out relative to those with a more regular inflow. Calculating the minimum income floor on an annual basis would be a fairer approach, as would removing the 'surplus' earnings rule, which will not only add undue complexity to UC but damage incentives.

To make sure parents are not treated differently based on their age, the under-25 basic allowance for parents should be aligned with the 25-plus rate. In terms of how income other than from work is treated, maternity allowance payments should be treated in the same way as earned income, meaning that it is withdrawn in line with the UC taper rather than on a pound-for-pound basis. Finally, to make sure rules within UC do not prevent the kinds of behaviour other recent government policy has sought to encourage, any savings held in ISAs should not count against the UC savings limit for working families. Together, these changes should help make UC a fairer, more user-friendly welfare system.

Section III

A reformed UC

Section 8

Phase I – A package for this parliament

In the previous sections we have set out our recommendations for how UC can be reformed. But what impact will these measures have when taken together? The way in which UC's rules affect families varies depending on their circumstances, meaning policy changes that appear sensible in isolation might, in combination, have reinforcing or offsetting consequences.

This section assesses the combined impact of our first phase of recommendations; that is, those reforms that should be applied as UC rolls out across this parliament. We present a suite of cost-neutral proposals for this period. Our intention is to ensure that UC, at the very least, delivers on its primary aims of making work pay and providing a simple-to-use, integrated system.

A cost-neutral package of reforms

Box 8 summarises the measures we recommend for implementation over this parliament as UC is rolled out. This package is intended to be cost-neutral in 2020. Some of our proposed changes will make UC less generous to specific groups, while being more generous to others. Some of our recommendations deal with practical, process issues without incurring further benefit spend. Overall, it strikes a balance between introducing the right incentives to work and delivering a better-integrated and easy-to-use system.

Who gains or loses out as a result of our recommendations? At the broadest level, they **take support from**:

- **workers without children** – to reduce the risk that they choose to work fewer hours;
- **married couples**, many without children – who are incentivised to work fewer hours; and
- **higher-income families** – who are receiving unnecessarily generous childcare support

These savings are **reallocated to**:

- **second earners** in the lowest-income working families – to provide them with an incentive to enter work;
- **in-work single parent renters** – to prevent them becoming trapped at low hours of work;
- **low to middle income families with young children** – to reduce the barriers to work created by childcare needs; and
- **the lowest-income in-work and out-of-work families** – to increase support with council tax.

Parts of this package will be controversial but we think it is important that our reforms over this parliament pay for themselves. No recommendation has been easy to reach, with each one involving trade-offs with other outcomes.

We estimate that **this combined package will be cost neutral in 2020-21 and in every year of the parliament up to that point**. We do not account for any savings that would accrue from the improved employment outcomes we expect from our proposals. Indeed, there may even be some excess savings generated in the short term. That is because many of our savings are drawn from those groups set to be covered by the early phases of UC roll-out – simple cases, mostly without children. In contrast, the groups we propose providing greater support to, primarily in-work families, are not due to start receiving UC until towards the end of the decade. The removal of the Married Couple's Allowance would also release significant savings with immediate effect.

Phase I: Recommendations during the initial implementation of UC	Cost in 2020
1. Incentives to start working	
Increase the work allowance for single parents with housing costs from £3,100 a year to £5,100 a year	£600m
Introduce a work allowance for second earners in families with children of £1,500	£600m
Remove the work allowance for non-disabled families without children	-£600m
Reduce the work allowance for couples with children by the equivalent of two hours at the minimum wage	-£200m
Abolish the married couple's allowance to re-invest in a second earner work allowance	-£900m
Pass on cuts to direct tax in full to families in reciept of UC via an equivalent adjustment in the appropriate work allowance, the cost should be part of the exchequer cost of future tax cuts	n/a
2. Progression – improving earnings	
Conduct randomised control trials to investigate the most effective taper rate for the long term	n/a
Do not pursue in-work conditionality but retain out-of-work conditionality, taking into account longer term progression considerations	n/a
Focus in-work support on progression with a series of pilots and trials to understand the most effective types of support	
3. A better integrated benefit system	
Integrate council tax support (CTS) into UC but withdraw entitlement outside of the single taper, funded by administrative savings	cost neutral
Free school meals should be provided to all families out-of-work, with entitlement kept at low levels of earnings, but with a reduced work allowance for families who are in-work	cost neutral
Other passported benefits should remain outside of UC but eligibilty criteria should be closely aligned with UC and minimise impacts on work incentives	
Increase support with the cost of childcare to cover 95 per cent of costs for parents of children under the age of three and report childcare costs on a quarterly basis	£150m
Reduce the earnings threshold in tax-free childcare to £130,000 per couple (£65,000 per person)	-£150m
4. Interactions with UC: A system that is easy to use	
Self-employed report earnings annually, in line with the tax system and the MIF applied on an annual, rather than monthly basis, in line with how incomes are reported	minimal cost
Allow UC recipients to request a more frequent payment period that best suits them	
Alllow UC recipients to request that housing support payments are made direct to their landlords	
Increase the under-25 rate for parents to the 25-plus rate	£150m
Savings in ISAs should not be taken into account at all when cacluating entitlement for families	£200m
Treat maternity allowance as earned income subject to the taper (in line with statutory maternity pay)	£150m
Total	Cost neutral

Impacts of the package

In assessing the impacts of our short-term package of proposals, we compare it both to the existing tax credit system and to the 'baseline' scheme of UC proposed by the government.[110] In all instances, we use 2020-21 as our comparison year. Below, we estimate the distributional impacts and changes to incentives to either enter work or earn more associated with our approach. The effects of some recommendations are difficult to model, largely due to the quality of data that is at our disposal. In most cases, we expect these unmodelled impacts to be small relative to changes in overall spend.[111]

Importantly, **all of the impacts we model only capture a *snapshot* of the expected impact of UC**; that is, we assume that people continue to work and earn as they do now. The real gains from our reforms will come as a result of people changing how they work and earn in response to the new incentives structure. These behavioural changes are very difficult to capture or predict, but it is clear that the living standards of low-income families would be raised if more people were to enter work and improve their earnings as a result of our reforms. And clearly such an outcome would also benefit the public finances through both revenue gains and benefit spending reductions.

DWP's own analysis suggests that UC is expected to have a wide-ranging impact on different working-age families. Relative to the existing tax credit system, some families are expected to gain, while others are set to lose

Given evidence that past changes in incentives *have* led to behavioural change, for some groups in particular, **there is every reason to think that we are understating the savings that the reforms would bring**.

The balance of gains and losses

DWP's own analysis suggests that UC is expected to have a wide-ranging impact on different working-age families. Relative to the existing tax credit system, some families are expected to gain, while others are set to lose.[112] Because of **the rebalanced incentives, more equitable treatment of income and young parents and less regressive system of CTS that we recommend**, our modelling suggests **the number of families gaining from UC would increase by roughly 600,000, while the number losing out would be reduced by around 550,000.**

There is **no net change to the balance of working couples with children who gain or lose, but amongst working single parents, 50,000 more families gain and 100,000 fewer lose. Around**

[110] We assume that UC is fully rolled out by 2021 and where the tax credit system is used for comparison, we assume it was subject to the same uprating defaults as UC.

[111] This is the case where we have proposed changes in reporting periods for people with childcare costs or the self-employed because our data provides a snapshot of incomes, not flows over the year. We do not take account of the income effect of changes to entitlement for FSMs. Gains for the lowest income households from integrating CTS are likely to be underestimated because we do not capture variations in the current scheme (such as minimum payments). Similarly, gains associated with the boost in support we propose for childcare costs are understated (because the use of childcare is under-reported in our data). Our analysis is based on the DWP's Family Resources Survey 2012-13.

[112] Our interim report *Credit where it's due?* set out details of how the government's baseline UC proposals compare with the existing tax credit system.

400,000 fewer families containing a carer or disabled adult will lose out, with an increase of 350,000 seeing no change in their entitlements compared to the current system.

Table 3: Net change to gainers and losers by family type compared with the current tax credit system of our Phase I proposals over current UC proposals

	Gainers	Losers	No change	All families entitled in either system
working couple with children	0	0	0	1,300
working single parents	100	-50	0	800
workless single parents	350	-100	-250	450
workers without children	-100	0	-50	1,600
workless without children	200	0	-200	1,350
disability or caring responsibilities	0	-400	350	3,650
All	650	-550	-200	9,300

Notes: Table depicts the net change to the profile of gainers and losers of our Phase I proposals over the current UC proposals, both against a baseline of the current tax credit system. Excludes the impact of the Married Couple's Allowance on families not entitled to UC or the current tax credit system. A full analysis of the impact of the UC baseline proposals can be found in our previous report Credit where it's due?

Figure 14 details average cash gains and losses for different groups. Both the government's UC baseline and our Phase I package are compared with the existing welfare system. The difference between the bars therefore represents the extent to which our proposals change outcomes relative to the existing UC proposals.

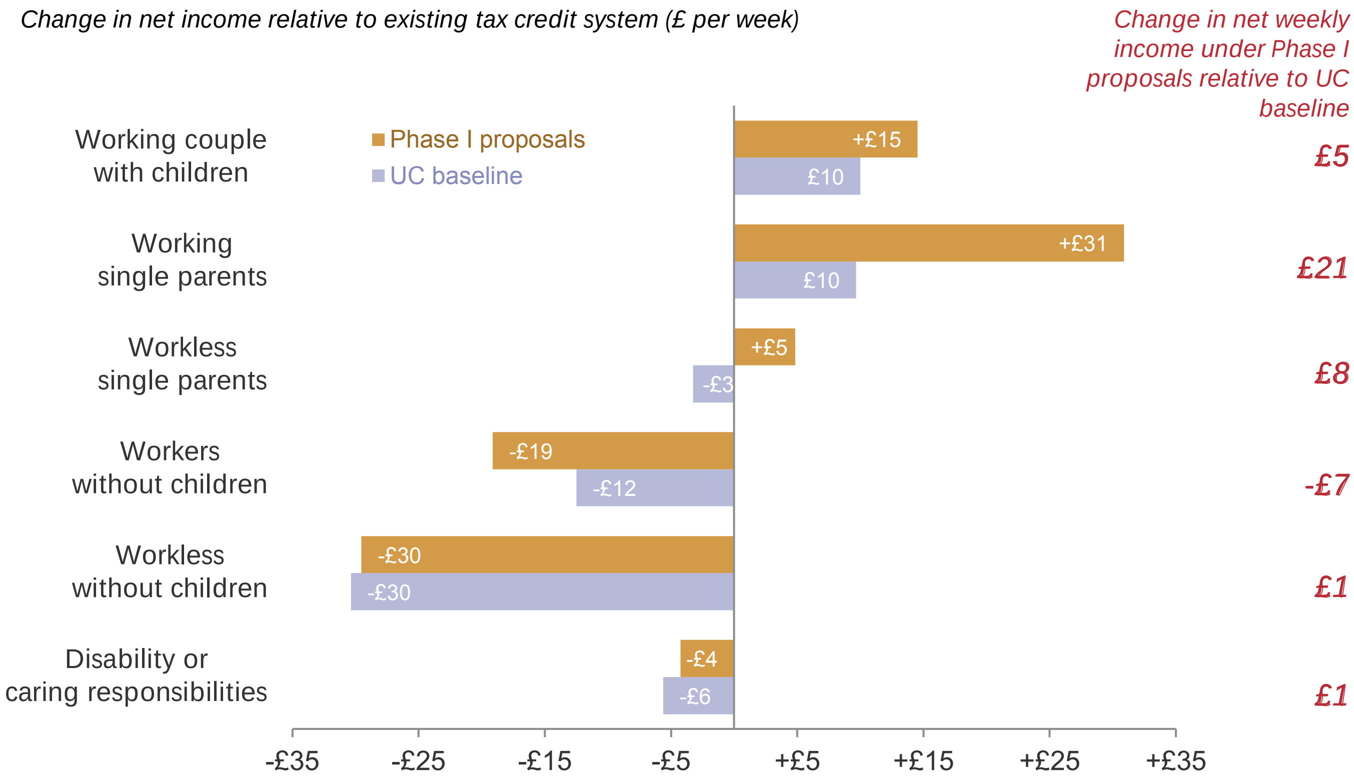
The biggest gainers are overwhelmingly working families with children

Relative to the existing tax credit system, our Phase I UC package tends to raise incomes among families with children and reduce them among non-parents. However, our proposals lead to an overall improvement in income relative to the baseline UC system for nearly all groups of recipients. The one exception is workers without children who make a clear loss compared to the government's existing proposals. Under our measures, there is a rebalancing of support towards women (the majority of single parents and second earners) from men (the majority of out-of-work singles and main earners in couples). **The biggest gainers are overwhelmingly working families with children**.

Looking across the different family types, we can identify the drivers that cause income to vary as a result of our recommendations:

- **Working couples with children**: Average weekly incomes are £10 higher under the UC baseline than in the existing system, rising to £15 higher under our Phase I proposals. Our package therefore leaves them £5 better off.
  - Relative to the UC baseline, the introduction of the second earner work allowance benefits 400,000 families in which both parents are in work, by up to £19 a week. In addition, nearly 100,000 families gain where both parents are under-25. These gains are partially offset by couples losing around £2 a week from a small reduction in the main earner work allowance, and around 500,000 families losing up to £1.50 a week from the removal of the Married Couple's

Figure 14:
Comparing the average cash impact of the government's UC baseline and our Phase I proposals against the current tax credit system



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

Allowance. There is no change to the overall balance of gainers and losers within this group.

- **Working single parents**: Average weekly incomes are £10 higher under the UC baseline than in the existing system, rising to £30 higher under our Phase I proposals. Our package therefore leaves them £21 better off (not £20 due to rounding).
- This increase is driven primarily by the enhanced work allowance for renters, which benefits 400,000 in-work single parents (a similar gain to the second earner work allowance in families where both parents work). A further 50,000 gain from the rise in the basic allowance for under-25s. Overall, compared to the UC baseline, 50,000 more working single parents now gain and 100,000 fewer lose out.

» **Single parents who are not in work**: Average weekly incomes are £3 *lower* under the UC baseline than in the existing system, but £5 *higher* under our Phase I proposals. Our package therefore leaves them £8 better off.

- This reversal of position is associated in part with the improved basic allowance for under-25 parents, which boosts the incomes of 150,000 families. Our more generous treatment of CTS is also of particular benefit to this group.

» **Workers without dependent children**: Average weekly incomes are £12 lower under the UC baseline than in the existing system, and lower still (£19) under our Phase I proposals. Our package therefore leaves them £7 worse off.

- The biggest reason this group loses out under both the baseline UC approach and our Phase I reforms (relative to the current system) is the removal of the boost to income provided at

30 hours by working tax credits. Our proposals further reduce awards for those still entitled to UC both by cutting support at lower hours of work and by lowering housing support for renters in full-time work. It is important to note that, for those entitled to UC, our proposals are still more generous than the current tax credit system – just not as generous as the UC baseline. A further 200,000 lose up to £1.50 a week from the removal of the Married Couple's Allowance. The lowest earners will gain from our improvements to CTS.

- **Out-of-work families without children**: Average weekly incomes are £31 lower under the UC baseline than in the existing system and £30 lower under our Phase I proposals. Our package therefore leaves them very slightly (£1) better off.
  - This slight improvement relative to the UC baseline is driven by 450,000 families gaining an average of £3 a week through the more generous treatment of CTS. The balance of gainers and losers is also improved with an extra 200,000 families better off under our proposals.
  - Overall losses appear high for this group largely driven by families, who would have been entitled to Pension Credit as one member is over State Pension age, becoming entitled to income-related working-age support under UC rules.
- **Families with disability or caring responsibilities**: Our review has not focused on this group because – as we set out in Section 2 – the challenges they face and the potential support that can be provided go far beyond the scope of UC. In terms of the direct effects of UC, we find that average weekly incomes would be £5 lower under the UC baseline than in the existing tax credit system and £4 lower under our Phase I proposals. Our package therefore again produces a very slight (£1) increase in income.
  - This broadly neutral outcome masks a number of changes for different parts of this population. Young parents will gain from the increased basic allowance for parents aged under-25. Renting single parents will be able to access an enhanced work allowance, as will the small number of cases where both parents in a family work. Some married couples within this group (300,000) will lose from the removal of the Married Couple's Allowance. The impact of UC and wider welfare changes on this group go beyond the remit of our study. We do expect the enhanced incentives we create to benefit them. But it is vital that the additional challenges this group face are addressed by government in future.
  - Outside of the UC population (and not captured in Figure 14), the removal of the Married Couple's Allowance leads to a further 2.8 million married couples (two-thirds of whom do not have children) losing up to £4 a week.

Again, it is important to emphasise that none of the above figures take any account of behavioural changes, which we expect to be significant. **Our proposals also make UC easier to use. This will benefit many families, but these exact gains are more difficult to quantify**. Some will gain from more flexible reporting periods for childcare. Self-employed claimants with variable earnings will gain from switching their reporting periods and the minimum income floor to an annual basis.

Broadly speaking, UC as it currently stands will reduce the number of workless households

Distributional impacts

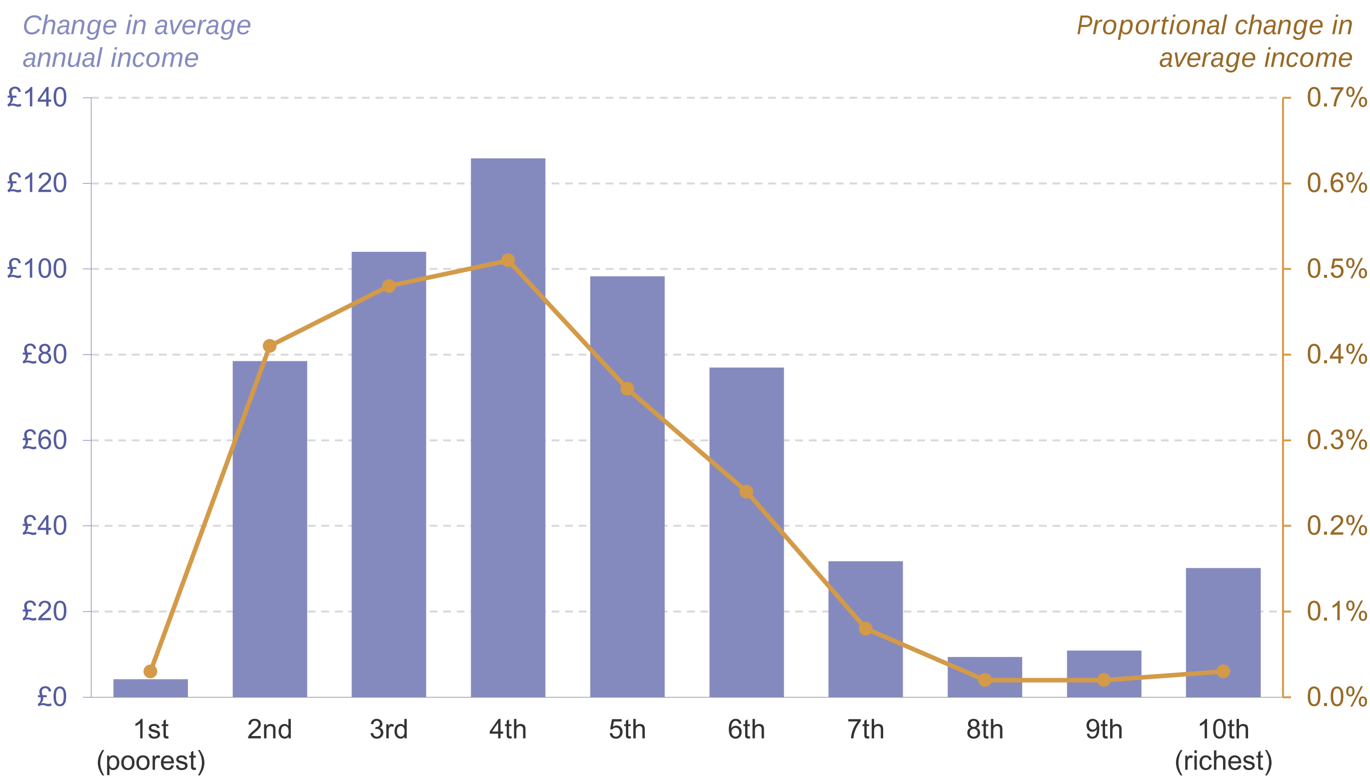
Figure 15 shows how our Phase I proposals redistribute income relative to the UC baseline across the household income distribution. Families in deciles three to five, where most workers with children on UC are concentrated, see the greatest improvements in cash terms. Those in deciles two to four do best as a proportion of their income. Gains are small in the lowest income decile because more generous treatment of CTS for this group under our proposals is offset by the removal of the work allowance for workers without children. The changes provide a boost to income in all deciles because we increase total spending on UC by recycling the savings associated with no longer administering CTS locally.

Incentives to enter work

Broadly speaking, UC as it currently stands will reduce the number of workless households because, as discussed in Section 4, the biggest improvements occur when entering work at low hours and low pay. There is, however, a trade-off. This proposed approach to UC will also worsen incentives for many to take on full-time work and weaken the incentive for second earners to work at all.

Changes to incentives to enter work are measured through what is called the 'participation tax rate' (PTR). The PTR shows how much income a person loses as they *enter* work, whether that be from paying additional tax or the amount of benefits they lose as they earn more. The higher a person's PTR, the weaker their incentive to enter work. This measure will vary depending on the shape of the benefit system and a person's earnings or hours when starting work. Modelling PTRs is therefore sensitive to the precise assumptions used about the circumstances of the individual.

Figure 15:
Distributional impact of our recommendations compared to the UC baseline



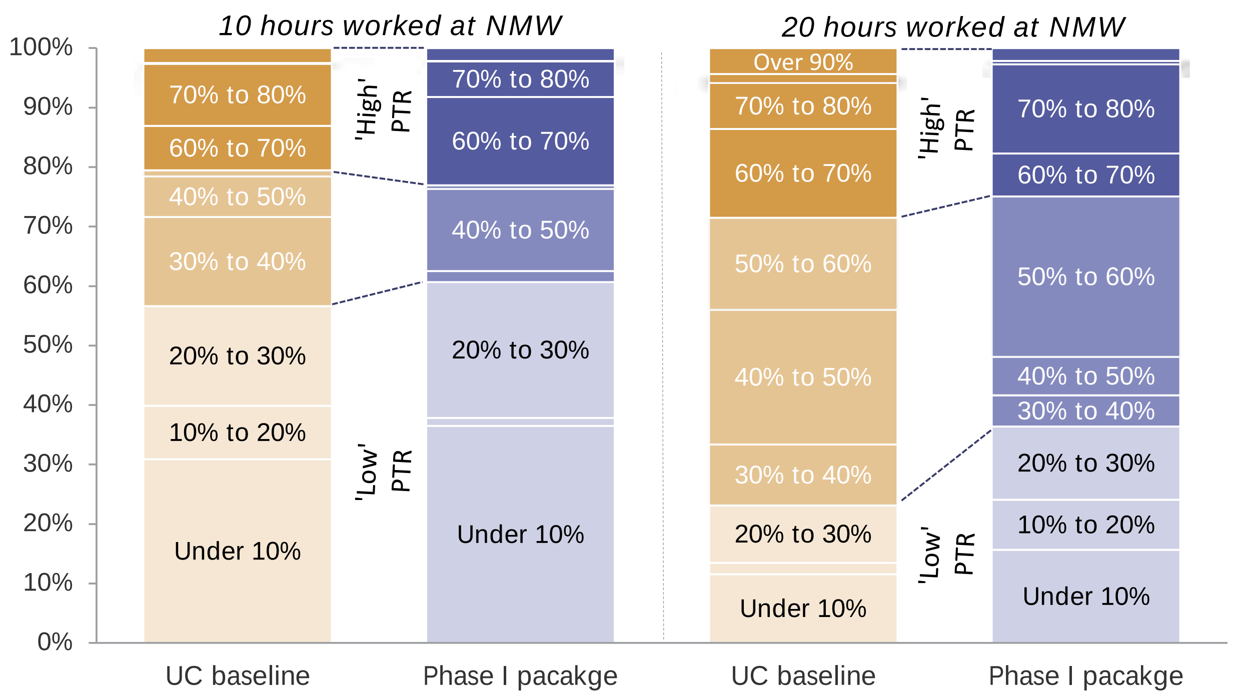
Source: Resolution foundation analysis using the IPPR tax-benefit model

Incentives to work part time under our recommendations

Figure 16 sets out the PTRs that exist under our proposed Phase I package for a person paid the minimum wage and working part-time (either 10 or 20 hours). It compares these with the PTRs under UC as it is currently envisaged.[113]

Figure 16:
Incentives to enter work at part-time hours
Participation Tax Rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate



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

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

Under our Phase I proposals, at 10 hours of work, more out-of-work recipients now face 'low' PTRs (below 30 per cent) and fewer face 'high' PTRs (over 70 per cent). However, there is also an increase in the proportion with a PTR of between 60 to 70 per cent.

At 20 hours of work, we again find more recipients facing a PTR of less than 30 per cent. In this instance, however, there is an increase in the proportion with a PTR between 70 per cent and 80 per cent (though there is a fall in the number facing 'very high' PTRs above 80 per cent).

The increase in PTRs for some is concentrated among families without children, just over 20 per cent of whom would face a PTR of 70-80 per cent under our proposals. In contrast, the big reductions in PTRs are concentrated among parents. Around 95 per cent of single parents would face a PTR of less than 20 per cent under our proposals, compared with around 25 per cent in the UC baseline. Similarly, our recommendations result in the near-complete removal of PTRs

[113] A more detailed analysis is provided in Annex D.

above 60 per cent for second earners in couples – where previously they accounted for around two-thirds of the population.

These changes are driven by:

» The introduction of a **work allowance for second earners** in couples with children and the **enhanced work allowance for single-parent renters**. These two groups can now keep more of their earnings if they enter work at lower levels of pay, reducing their PTRs from their previously high rates that made beginning work unattractive.

» The **removal of the work allowance for workers without children**. Because such individuals have their earnings tapered away as soon as they enter work, a higher proportion of their benefit is withdrawn at low hours. This in part explains why the share facing higher PTRs has grown. In practice however, we expect this group to enter work at closer to full-time hours because they face fewer barriers that would stop them seeking to do so. Our expectation is that PTRs are less influential for this group.

Our proposals will make full-time work more appealing to families without children, while reducing their incentive to work a low number of hours. At the same time, incentives to work part-time or full-time hours for single parents and second earners in couples with children are significantly improved

Put simply, **we have achieved a lower PTR where we think it matters most, at the cost of a slightly higher PTR for groups where we expect it to make less difference to working patterns**.

Incentives to work full time under our recommendations

Figure 17 shows how **incentives to work full-time hours have, overall, been improved by our proposals**. More people entering work at either 30 hours or 40 hours at the minimum wage will have a PTR of less than 50 per cent. We have also reduced the number of people facing the very highest PTRs (above 80 per cent). These changes are driven by:

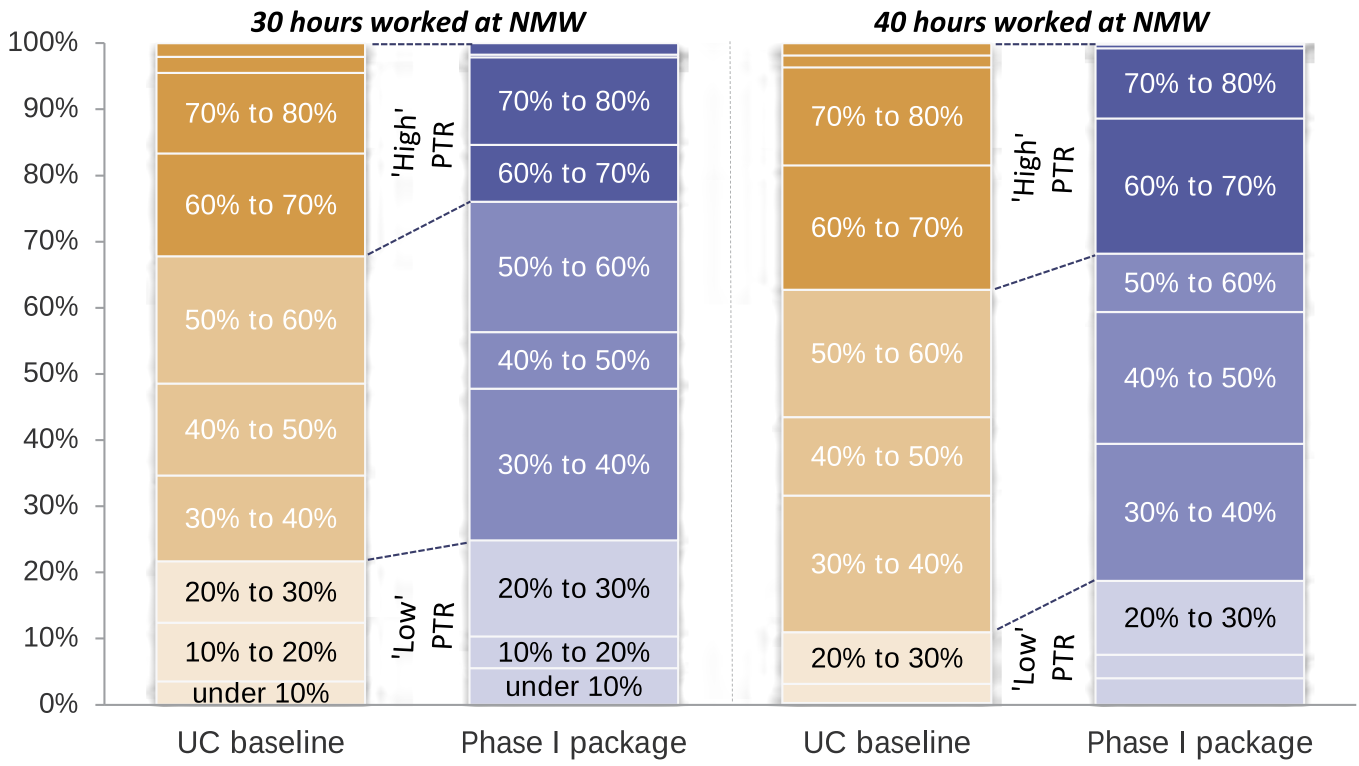
» **Faster withdrawal of UC entitlement for workers without children**. The removal of their work allowance means that, at a higher number of hours worked, many will have moved off the taper altogether and will therefore only be paying income tax or NI.

» **The new second earner work allowance and the enhanced work allowance for single parent renters**. As a result, these groups can keep more of their benefit entitlement while in work.

» **The faster withdrawal of CTS among families with children**. This is due to CTS no longer being withdrawn at higher hours of work. This occurs because the enhanced work allowances we propose mean that families with children have higher incomes and therefore have their CTS removed more quickly. (CTS is withdrawn with reference to recipients' post-tax and post-UC income.)

Figure 17:
Incentives to enter work at full-time hours
Participation tax rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate



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

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

Overall, **our proposals will make full-time work more appealing to families without children, while reducing their incentive to work a low number of hours. At the same time, incentives to work part-time or full-time hours for single parents and second earners in couples with children are significantly improved**.

Incentives to progress

Despite our Phase I recommendations not reducing the UC taper rate, some of our changes do still alter people's incentive to work more or increase their earnings. This is measured by the marginal effective tax rate (METR). The METR tells us what a person already in work pays back to the government through tax, NI *and* reduced benefits for every extra pound of earnings. While the PTR discussed above shows whether it is worth entering work, the METR lets us know how worthwhile it is for a person to boost their earnings.

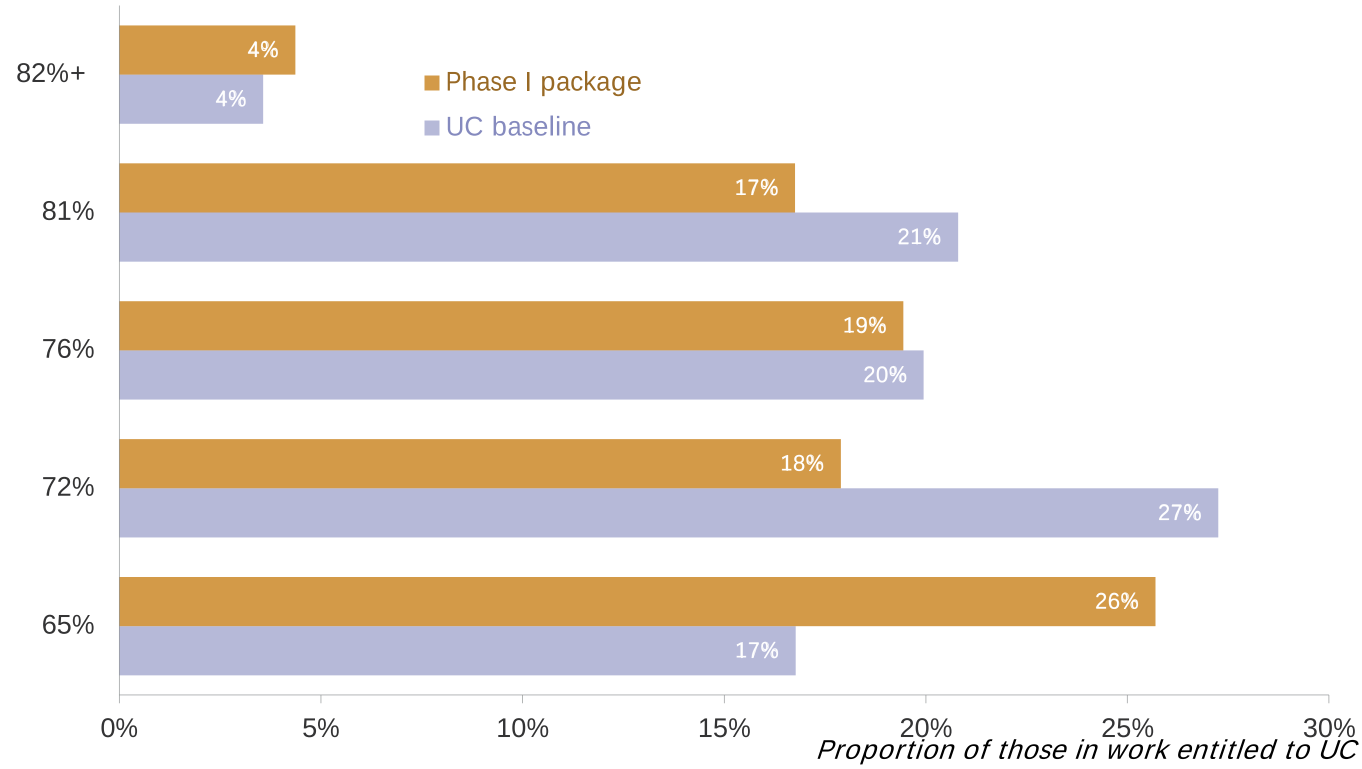
As shown in Figure 18, **our Phase I proposals lead to an increase in the proportion of the working UC population with a comparatively low METR of 65 per cent, and a reduction in the proportions with METRs of 72 per cent or 81 per cent**. In short, there is an overall improvement in the incentives to work or earn more compared to the government's UC baseline.

Two important factors have influenced this:

- **Higher work allowances for single-parent renters**, and to a lesser extent, **second earners in couples with children**. As discussed above, higher work allowances boost the net incomes of families in these groups and therefore mean that CTS is fully tapered away at lower income levels. Fewer families are therefore still in receipt of CTS as their incomes rise, meaning their METRs are reduced from 72 per cent or 81 per cent.
- **The overall composition of the working UC population has changed**, with our proposals meaning that fewer workers without children and more working couples with children are now eligible. Those leaving UC are more likely to be earning enough to pay income tax and NI – reducing the proportion with an METR of 76 per cent. Those remaining or moving onto UC are more likely to have lower earnings, so have an METR of 65 per cent.

Figure 18:
Incentives to progress for the working UC population

Marginal effective tax rate



Notes: Chart shows selected METRs at which the population is concentrated. METRs are shown for all people entitled to UC in the baseline proposal and show the percentage return from earning £1 more for all those already in work. In couples, the METR is for the household.

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

The impact on the number of people entering work

It is clear from the impact of our proposals on measures of financial incentives – PTRs and METRs – that our short-term proposals lead to significant improvements in the incentive to enter work for single parents and second earners in couples with children, with some reduction in the incentive to work part-time hours for people without children. However, although these estimates point to how much better off a person would be if they chose to enter work, they give no indication of how many more people would actually start working in response to the improved incentives.

Making such 'dynamic' estimates of how far changes to financial incentives would change behaviour is very difficult and any such estimate should be treated as an indication of the likely scale of any such impact, rather than a definitive prediction. Using a simple model (explained in further detail in Box 9), we estimate that – relative to the current tax credit system – between 110,000 to 240,000 extra people would enter work under the government's proposed baseline version of UC. We present a range to acknowledge the uncertainty surrounding such an estimate.[114]

Our Phase I package of proposals is estimated to increase the number of people in work by 150,000 to 290,000 compared to the current tax credit system. This is an increase of between one-fifth and one-third on the extra numbers estimated to enter work under the government's proposals.

The aggregate figures mask a variety of changes among different groups entitled to UC. The baseline UC system leads to an increase in the numbers of single parents and people without children entering work, but these are partly offset by a reduction in the number of second earners that work. Our proposals – with more people entering work overall – lead to a smaller increase in the extra number of people without children who start working, but improved outcomes for single parents and second earners in couples with children. These impacts reflect our intent to rebalance financial incentives towards groups more likely to respond.

It is important to note that our estimates are based on the likely impact of people entering work in line with current patterns of employment: we make no attempt to capture a change in the distribution of hours worked or earnings

It is important to note that our estimates are based on the likely impact of people entering work in line with current patterns of employment: we make no attempt to capture a change in the distribution of hours worked or earnings. If we alter this central assumption and instead consider how many extra people might work if all new jobs comprise, say, just 10 hours a week, then we find a significantly larger impact under UC relative to the tax credit model. Similarly, if we assume that all new jobs are full time, our estimate for the numbers of people entering work falls sharply.

It is, of course, extremely difficult to predict precisely how people will respond to such a radical change to incentives. We therefore weight our employment effect estimates to account for the likely hours profile of the new jobs. For that reason, we present no additional estimates here. However, this exercise does highlight the extent to which UC (under both the government's baseline approach and to some extent our Phase I package) increases the relative attractiveness of shorter-hours working. In the former case, this is particularly driven by the work allowance for workers without children. This reinforces the need to focus simultaneously on earnings progression.

[114] DWP has estimated that between 100,000 to 300,000 more people would enter work under their design for UC compared to the current tax credit regime, with a central estimate of 145,000 people. The OECD estimated a reduction in the number of workless households of between 45,000 and 240,000.

Box 9: Estimating employment response to a change in financial incentives

In estimating the employment impact of our proposed Phase I UC reforms, we have taken a simple approach, broadly in line with OECD and DWP modelling.[1] More detailed approaches are possible, but would rest on strong assumptions about how far people weigh financial considerations against other factors. The unique nature of the UC reforms – in which some people move from one extreme of facing practically no return at all when entering work to another, keeping all of their benefits as they start work – also makes estimating how people may respond to the new incentives particularly difficult to determine.

Given the uncertainty that surrounds these estimates, we prefer a more straightforward, indicative (rather than definitive) approach designed to give a sense of the likely scale of employment response to our proposals.

Our method requires three key pieces of information. A range of estimates for each of these factors is used to provide a range of potential outcomes, and to test the sensitivity of our results:

- the average change in the financial return from entering work for different groups;
- the average hours those groups currently work (and which we assume new entrants to the labour market replicate); and
- how responsive a given group is to a change in their financial incentives.

The IPPR tax-benefit model is used to estimate average PTRs and average hours worked for sub-groups of the UC population, split by whether people are single or in a couple, have children, rent their homes, and are male or female.

Estimates of how responsive different groups are to financial incentives to enter work – 'elasticities' – are used to provide lower and upper estimates of the potential responsiveness of different groups.[2] In general, the literature[3] suggests that men and women without children are less responsive to financial incentives, while women with children are likely to be more responsive. People in lower-income families are more likely to be responsive than those with higher incomes. There is clearer evidence of people responding to incentives to enter work, than to incentives affecting the decision to work more.

[1] See JK Pareliuseen *Work Incentives and Universal Credit*, OECD and DWP (2012) Universal Credit Impact Assessment, 2013

[2] O Bargain, et al *Labour Supply Elasticities in Europe and the US*, Institute for the Study of Labour, OEC, 2011 and S Adam *Measuring the marginal efficiency cost of redistribution in the UK*, IFS, 2005

[3] C Meghir and D Philips *Labour Supply and Taxes*, IFS, 2008

Summary

In this section, we have presented the overall impact of our Phase I policy proposals. They are designed to ensure that, in the short term, UC meets its goals of being a simpler, more reliable system that incentivises people to enter work and creates strong incentives where they are likely to be most effective. But the ambition of these proposals has been necessarily limited by our insistence on any changes to UC being cost-neutral to government.

In the following section we set out our Phase II package, which seeks to shape the longer-term future of UC. This package builds on our short-term Phase I proposals, under the assumption that spending on UC will remain within OBR projections.

Section 9

Phase II – UC in the next decade

In the previous section, we summarised our Phase I proposals which aimed to ensure UC has the maximum impact on employment and incomes in the short term. Here we set out our Phase II proposals that complete the rebalancing of work incentives and look to secure the long-term success of UC. They seek to extend UC's scope in order to better meet the needs of low to middle income households in the next decade and beyond.

This section details our longer-term vision for UC, taking a more ambitious, and slightly less fiscally constrained, approach (though still growing only in line with expected spending on welfare). We turn our focus to the lack of financial incentives to progress once in work, build on incentives for dual-earning families and remove further inequities in the treatment of unearned income. Our blueprint will provide a clear path for low to middle income families to improve their standard of living into the next decade.

Long-term ambitions and further reform

To fulfil its original objective, UC will need to support families to enter and progress in work. This should lead to these households seeing their living standards rise as well as chipping away at the extent of low pay in the UK. Over time, there will be opportunities to further align and integrate other elements of the working-age benefit system. This should be possible once UC is in place and proving to be effective, and will lead to an increase in its scope and potential impact.

We propose a 'triple-lock', so that that the value of work allowances keep pace with the higher of growth in the minimum wage, growth in average earnings or CPI inflation

Overleaf are the recommendations we feel address key design features and longer-term challenges for UC as we move into the next decade. **These measures focus on removing some of the remaining inequities in the treatment of different forms of income, providing equal opportunities to start working for everyone entitled to UC and strengthening the incentives to progress once in work**. Our proposals for the near term dealt with what we felt to be the most pressing problems. They stemmed from issues with the current design, in how people would use and interact with UC on a day-to-day basis. It is difficult to tell until greater numbers of families migrate onto UC whether further action will be necessary. However, it will be crucial that as problems arise (as they inevitably will), the government take an open and adaptable approach to the system.

Phase II: Summary of recommendations for UC beyond this parliament	Illustrative cost in 2020
1. Incentives to start working	
Increase work allowances to a minimum value of 15 hours of work at the minimum wage for all parents and disabled people	£3,500m
Uprate work work allowances with a 'triple lock' - the higher of minimum wage growth, average earnings growth and CPU inflation to preserve incentives to enter work	
Maintain a gap between work allowances for home-owners and renters to recognise the extra help to which renters are entitled.	
Reduce the single UC taper to the most effective rate as funds allow (modelled here as at 55 per cent but it may be lower)	£3,000m
4. Interactions with UC: A system that is easy to use	
Treat occupational pension income and spousal maintenance for those in work as earned income	£400m
Longer term design challenges	
Continue to move to a more integrated working-age benefit system, gradually bring potentially	
Implement a coherent long-term strategy to reduce the cost and increase the availability of childcare to working parents, with greater alignment between the different government schemes	
Explore the ability to pay childcare providers direct through the UC system	
Total (assuming 55 per cent taper)	£6.9bn

Table 4 considers possible work allowances for different family types under three UC regimes: the government's baseline; our near-term (Phase I) recommendations; and longer-term (Phase II) proposals.

Table 4: Evolution of work allowances between proposals, 2015-16 minimum wage terms

	Current plans		Phase I: *(This parliament)*		Phase II: *(Beyond this parliament)*	
	Annual limit	Hours at NMW	Annual limit	Hours at NMW	Annual limit	Hours at NMW
Higher work allowance - without housing costs						
Single parent	£7,500	22	£7,500	22	£7,500	22
Couple with children						
Main earner	£5,400	16	£5,400	16	£5,400	16
Second earner	None	0	£1,500	4	£5,100	15
No dependent children	£1,100	3	None	0	None	0
Disability	£6,600	20	£6,600	20	£8,200	20
Lower work allowance - with housing costs						
Single parent	£2,700	8	£5,100	15	£5,100	15
Couple with children						
Main earner	£2,300	7	£2,300	7	£4,500	13
Second earner	None	0	£1,500	4	£4,500	13
No dependent children	£1,100	3	None	0	None	0
Disability	£2,000	6	£2,000	6	£5,100	15

To ensure there is a strong incentive to enter work, we set work allowances for single parents and second earners[115] **– two groups we would expect to be more responsive to work incentives – equal to 15 hours a week at the minimum wage**. We also choose to maintain a gap (though narrowed) between the value of work allowances for homeowners and renters to reflect the extra generosity UC would otherwise provide to renters. Here, we have maintained **work allowances in line with the minimum wage for main earners in couples with children**. Work allowances play an important role for parents in this group too, but we would expect them to be much less sensitive to significant additional financial incentives to work.

[115] The second earner allowance would only apply once both members of a couple with children are working and then only to the earnings of the lesser-paid spouse.

Over time, **we propose a 'triple-lock', so that that the value of work allowances keep pace with the higher of growth in the minimum wage, growth in average earnings or CPI inflation**. This is to prevent the value of work allowances being eroded relative to the (typically) low earnings of UC recipients. If work allowances rose by less than the growth in earnings or the minimum wage, increases in hourly pay would be withdrawn through the UC taper. This would greatly limit the extent to which additional earnings boost the incomes of UC recipients and therefore their incentive to work more. Uprating in this way will also prevent working fewer hours from becoming more attractive over time.

Having secured an incentive to start working, our longer-term proposals also reduce the UC taper to boost the incentive to *increase earnings* and *progress* in work. For illustrative purposes, in the modelling that follows we have used a **taper rate of 55 per cent**. We consider this a probable minimum starting point and, as proposed in Section 4, would test the appropriate long-term level for the taper to maximise progression and help reduce the incidence of low pay.

Our second phase of proposals also completes the process of reversing inequities created by applying out-of-work benefit rules to in-work support. To recap, our short-term package:

» sought to prevent the exclusion of UC recipients from the generous saving incentives provided to the rest of the population;

» restored basic allowances for young parents (under-25), matching the levels enjoyed by older parents; and

» treated income support during maternity in the same way whether through Statutory Maternity Pay or maternity allowance.

In the longer term, we go further and propose that **occupational pension income (where the recipient is disabled or has left work due to long-term sickness) and spousal maintenance should also be treated as earned income**.

An affordable package of reforms for the longer term

In the longer term, the level of spend allocated to UC is likely to rise in line with economic growth: beyond 2020, the OBR's long-term projections assume that the allocation of government spending on working-age benefits remains constant as a proportion of GDP. Taken in this context, **we expect our proposals to remain affordable and within the projected long-term path of spending for working-age welfare**. In cash terms, **we estimate our second phase of reforms to cost an extra £7 billion a year if, for illustrative purposes, they were implemented in 2020**.

Importantly, two-thirds of this cost is attributable to a 10 percentage point reduction in the taper (costed to account also for its interactions with the improvements to work allowances we propose). We have already said that, by definition, this move should, in part, fund itself. That is, the final taper rate will have been set – following extensive trialling – at a level designed to maximise the chances of people increasing their earnings. Consequently, they will be paying more tax and receiving less UC, reducing the cost to the Exchequer.

Our £7 billion estimate takes no account of any potential 'dynamic' savings associated with this move, or with the improved incentives created by our significant increases in work allowances. We expect these savings to be sizeable.

Impacts of the package

As with the assessment of our Phase I proposals, we set out a range of measures below that are designed to test the impact of our Phase II package. We consider incentives to enter work or earn more and the distributional effects of the combined policies. It is important at this stage to reiterate the caveat mentioned above: we model only a *snapshot* of the expected impact, with no attempt to capture the savings arising from behavioural changes.

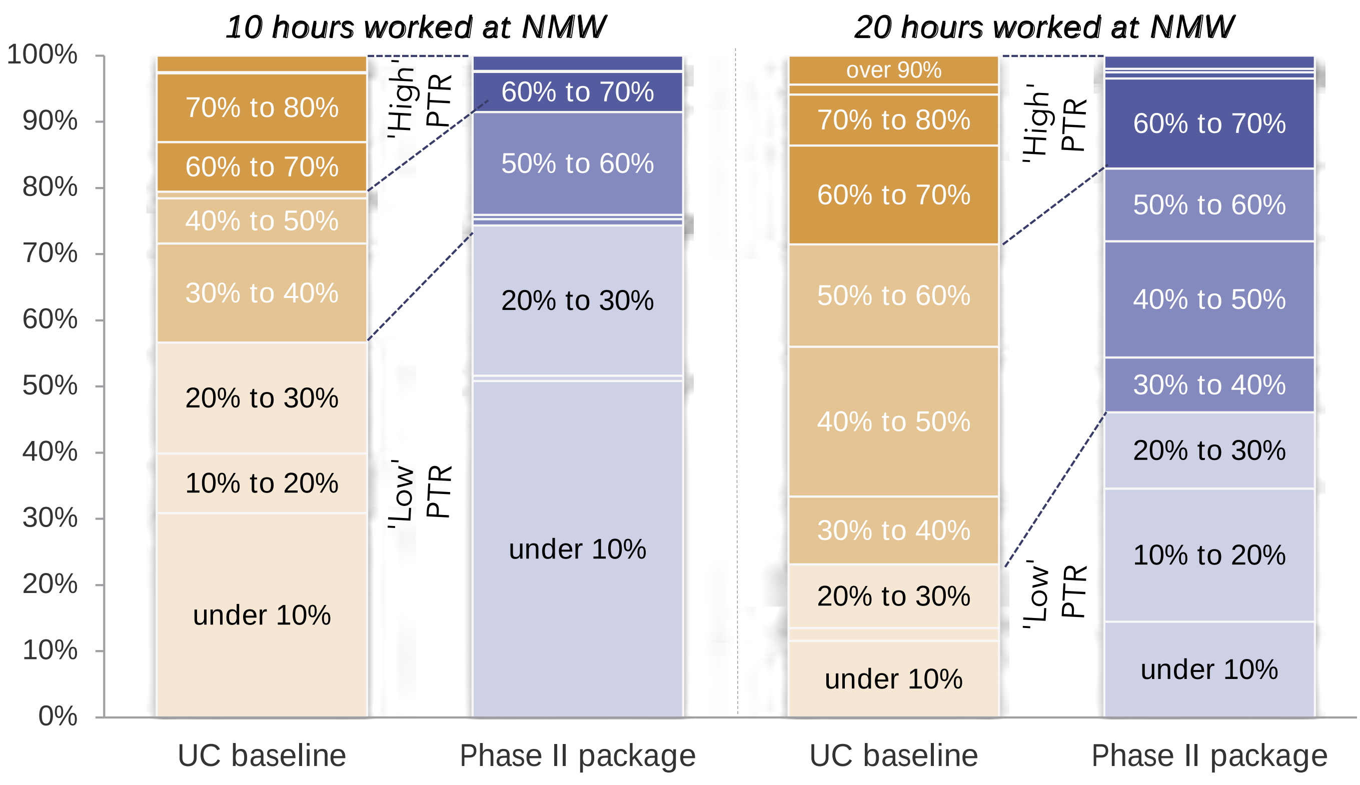
Incentives to enter part-time work

Our Phase II proposals significantly improve the incentive to enter work at part-time hours. This is because they enhance the value of work allowances for second earners and single parent renters. As shown in Figure 19, the proportion of UC recipients facing a 'low' PTR (less than 30 per cent) if starting work at 20 hours on the minimum wage rises from 25 per cent in the government's UC baseline to 45 per cent under our Phase II proposals. For those entering work at 10 hours, the proportion facing a 'low' PTR rises from 55 per cent to 75 per cent.

The improvement in PTRs (at 20 hours of work) is most dramatic among second earners in couples with children. Under our Phase II proposals, 95 per cent face a PTR of less than 20 per cent. This is in contrast to the government's baseline UC proposals in which almost two-thirds face a PTR above 60 per cent.

Figure 19:
Incentives to enter work at part-time hours
Participation tax rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate



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

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

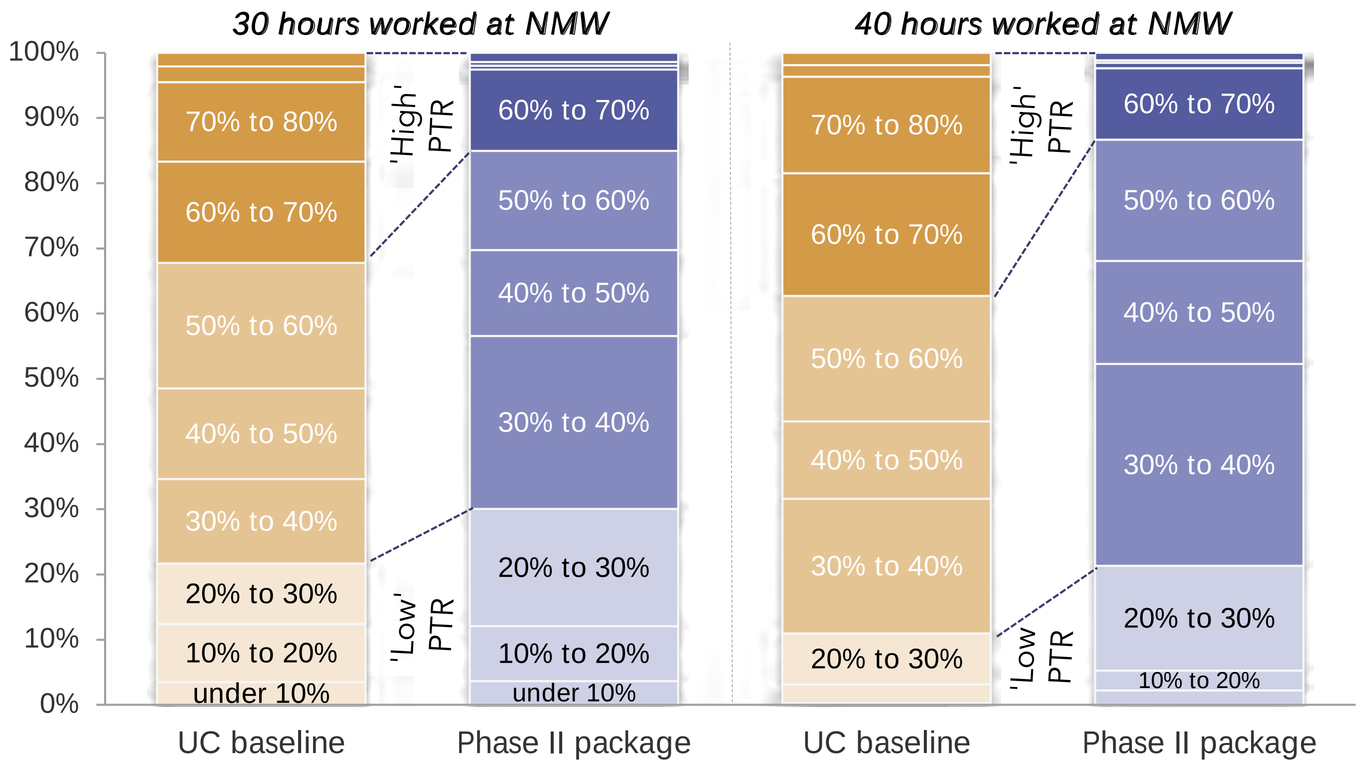
Around one-quarter of workers will still have a PTR of between 50 per cent and 70 per cent (although there is a fall in the proportion with PTRs above this). Workers *without* children drive this change. Because they do not have a work allowance under our reforms, they face the withdrawal of CTS alongside UC, income tax and NI. They will, however, still be gaining from the lower taper rate.

Incentives to enter full-time work

Incentives to enter full-time work are also significantly improved on average. Figure 20 illustrates the case of a person entering work at the equivalent of 30 or 40 hours at the minimum wage. Under our reforms, PTRs are less than 40 per cent for more than half of those who are out of work and entitled to UC. PTRs fall significantly because of the higher work allowances and lower taper rates in our proposals.

Figure 20:
Incentives to enter work at full-time hours
Participation tax rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate



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

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

Overall, **our long-term proposals will provide strong incentives to enter work at part-time and full-time hours of work and help ensure that the reality of UC lives up to the rhetoric.** Work allowances equivalent to 15 hours at the minimum wage will provide a powerful incentive to start work at part-time hours, with a lower taper rate providing an improved incentive to progress.

Maintaining the value of work allowances in line with the expected growth of the minimum wage will prevent incentives to enter work from deteriorating over time. This is crucial in terms of meeting UC's objectives over time.

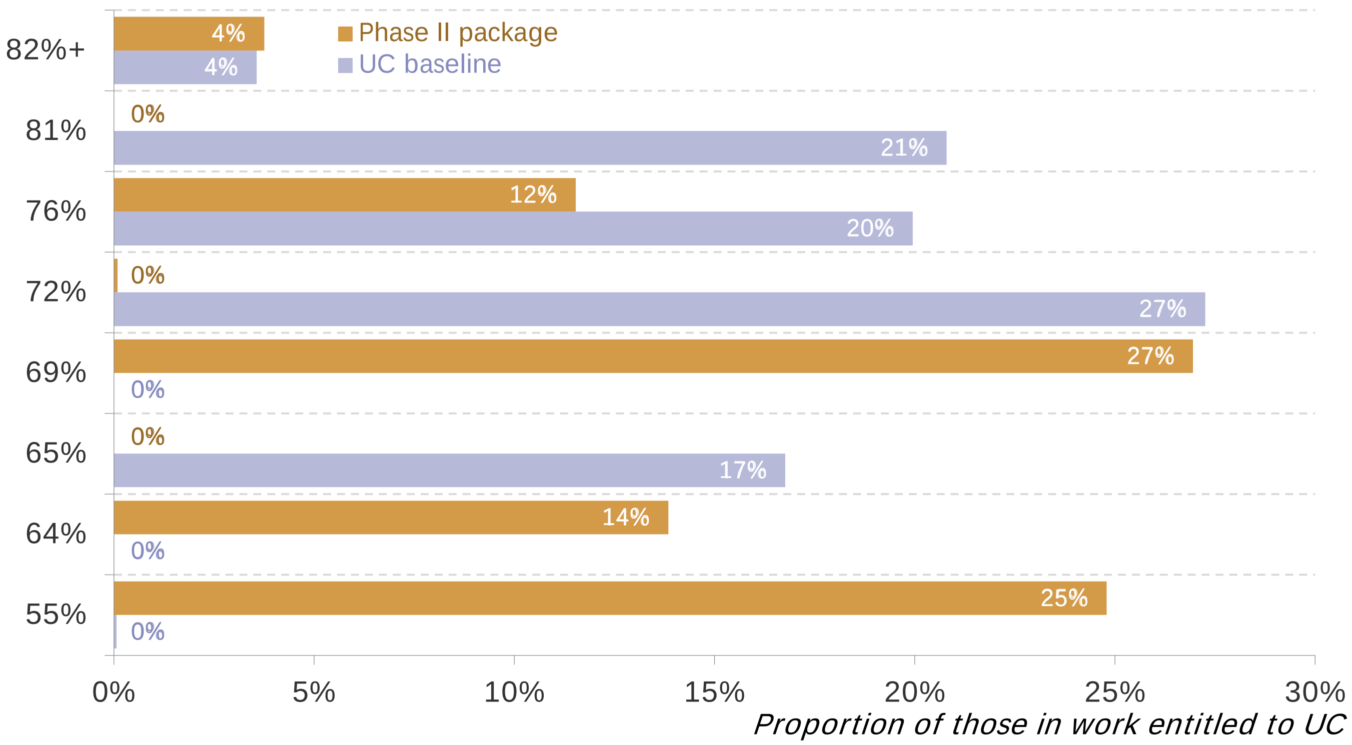
Incentives to progress

Our Phase II proposals seek to provide the foundations for a system that will not only encourage people to enter employment but also enable workers to progress rather than finding themselves stuck on low pay. The 10 percentage point reduction in the taper rate that we model achieves two goals. It represents both a symbolic first step towards a system that promotes progression and an illustration of the impact that a lower taper rate could have. Conducting a systematic set of trials over this parliament would help to identify an appropriate taper rate for the longer term.

Not surprisingly, reducing the taper rate to 55 per cent has a significant impact on incentives to progress. As shown in Figure 21, a**lmost two-thirds of workers entitled to UC would have a taper rate of no more than 69 per cent under our proposals, in contrast to only 17 per cent in the current baseline**. More generally, workers entitled to UC are clustered at 55 per cent (reflecting the reduced UC taper rate) and 69 per cent (capturing those who are also paying income tax and NI) under our Phase II package. The corresponding levels under the UC baseline are 65 and 76 per cent.

Figure 21:
Incentives to progress for the UC population

Marginal effective tax rate



Notes: Chart shows selected METRs at which the population is concentrated. METRs are shown for all people entitled to UC in the baseline and show the percentage return from earning £1 more for all those already in work. In couples, the METR is for the household.

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

If we consider those UC recipients who are simultaneously facing withdrawal of CTS, we find that our Phase II package creates METRs that cluster around 64 per cent and 76 per cent (for those paying income tax and NI as well). Under the UC baseline, these METRs are higher, at 72 per cent and 81 per cent respectively. By establishing more generous work allowances and a reduced taper, our proposals mean that that **only one-quarter of UC workers (26 per cent) have their METR affected by CTS, compared to almost one-half (48 per cent) under the current UC system**.

We estimate that implementation of our proposals would lead to an extra 180,000 to 460,000 people entering work relative to the current tax credit system

It would be possible to go further. Withdrawing CTS at the same rate as the UC taper could remove these additional METRs altogether but, as discussed in Section 6, this would come at a significant additional cost to the Exchequer. Over the longer term, government will be able to make a more informed decision as to whether such a move is cost-effective.

The impact on the number of people entering work

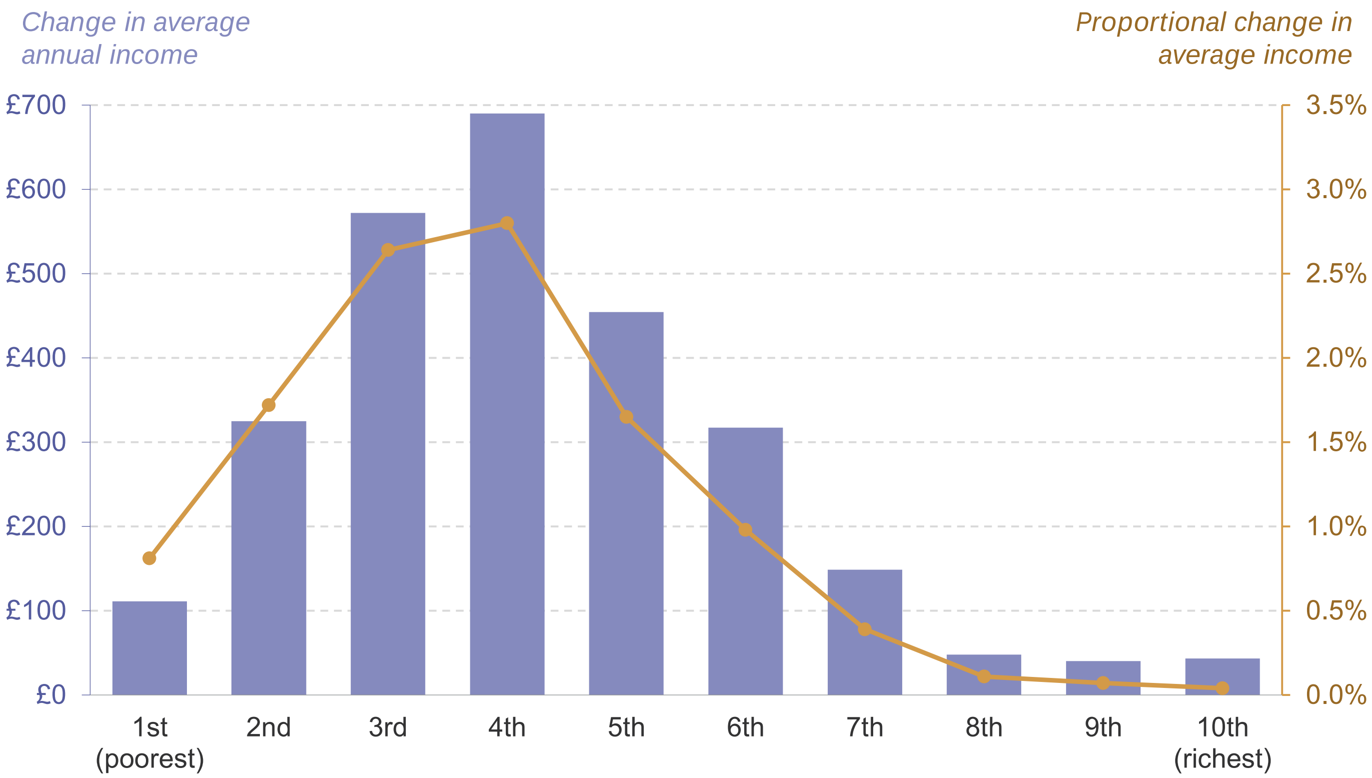
The further increases to work allowances and the reduction in the taper rate that are contained in our Phase II package result in large improvements in the financial incentive to enter work. In line with the methodology described in the previous section, **we estimate that implementation of our proposals would lead to an extra 180,000 to 460,000 people entering work relative to the current tax credit system**. This is a further improvement on our short-term proposals (150,000 to 290,000) and compares an estimated increase of between 110,000 and 240,000 under the baseline version of UC.

It must be reiterated that, as with any such estimate, there is considerable uncertainty as to the precise employment impact. Nonetheless, these estimates provide a helpful indication of the relative scale of the impact of our proposals. In this case, we would expect our proposals to increase the number of people entering work by between 50 and 130 per cent above the government's UC baseline – potentially doubling the impact of the new system.

Distributional impacts

Figure 22 presents the distributional impact of our Phase II proposals, as if they occurred in 2020-21, compared to the baseline UC design. This allows for a direct comparison with the effect of our Phase I proposals against the same baseline (Figure 15). In practice, **we would not expect our longer-term proposals to be implemented in full by this date, but the shape and scale of the impacts are likely to be similar**. Once again though, this all assumes no behavioural change.

Figure 22:
Distributional impact of our long-run proposals compared to current UC baseline



Notes: The estimated Phase I baseline scenario includes the impact of abolishing the Married Couple's Allowance and reinvesting savings from the delivery of CTS into extra support with council tax. Our Phase II scenario includes the impact of further improvements to work allowances, tapers and the treatment of unearned income.

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

Similar to **our short-term reforms, our recommendations would have the largest impact for families at the third, fourth and fifth deciles**. This is because changes to work allowances and tapers boost incomes for working families with children who make up a considerable share of this part of the distribution. A combination of the reduced taper and fairer treatment of occupational pension income and spousal maintenance also provide a more significant boost to the incomes of the poorest 20 per cent of families than was the case in Phase I.

These changes would mean that the total population entitled to UC would increase to 8.8 million families, a relatively modest rise of 450,000. With most single parents (90 per cent) already entitled to UC, the vast majority of this increase comes from couples with children gaining entitlement through further increases to the second earner work allowance. As a proportion of the total working-age population, it is a relatively small change (from 33 per cent to 35 per cent).

Compared with the effects of the higher work allowances for families with children, the reduced taper does relatively little to extend entitlement at higher levels of income for families without children.

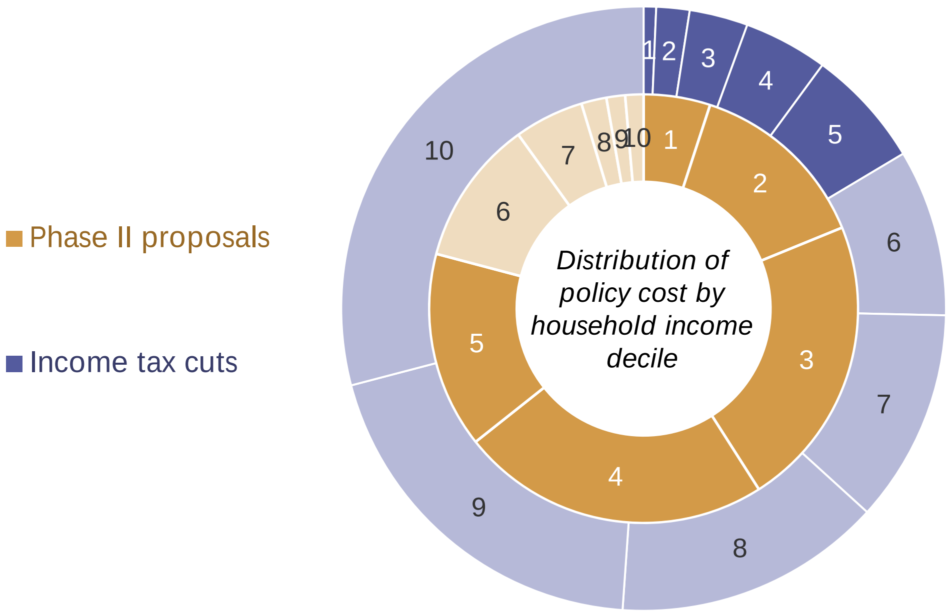
Comparing investment in UC with further income tax cuts

As noted above, if expenditure on working-age welfare is kept constant as a proportion of GDP as the economy grows, **our Phase II package of proposals would imply no 'new' spending over existing OBR projections**. In cash terms, we estimate the cost of the precise package we set out here (for the purpose of modelling) to be around £7 billion if, for illustrative purposes, it were delivered in 2020. By way of context, it is also worth noting that this is less but similar in magnitude to the additional £7 billion required in 2020 to implement the pre-election Conservative pledges to increase the personal allowance to £12,500 and the basic upper threshold to £50,000.

Clearly, these two approaches differ in timeframe and targeting, but it is interesting to note the variation in gains across the income distribution (shown in Figure 23) associated with these policies. **The planned tax cuts would focus the extra £7 billion on higher-income families**. Almost half of all gains go to the richest 20 per cent of families; and over three-quarters go to the top half of the income distribution. This occurs not just because of the cut in the higher rate threshold, but also due to higher-income families being more likely to be dual earning, therefore gaining twice from tax cuts.[116]

Low and middle income households are less likely to have two beneficiaries – indeed, many will have none. This applies not just to the out-of-work, but to lower earners too: the ever-increasing number of workers with earnings below the tax threshold – over 5 million currently find themselves in this position – receive no benefit from further income tax cuts. And, as discussed in Section 4, UC recipients have improvements in their post-tax incomes absorbed by the UC taper. As such, **they receive as little as 35 per cent of a given tax cut**. This effect is why, more widely, we recommend that low to middle income working families entitled to UC have future income tax cuts passed onto them in full through adjustments to work allowances.

Figure 23:
Distribution of gains across household income deciles in 2020-21: Phase II UC proposals compared with Conservative income tax cut pledges



Notes: Distribution of gains per £1 spent on the different proposals, as modelled in 2020-21.

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

[116] All income tax cuts tend to benefit the top half in this way.

In contrast, in Figure 23 we see that **over three-quarters of the benefit of our proposals would go to families in the bottom half of households**. In this scenario, only around 5 per cent of gains would go to the richest 30 per cent. There is a stark difference in who will benefit from further tax cuts and from further investment in UC.

Summary

The further changes to UC that we propose for the longer term seek to ensure the provision of strong incentives to enter and then progress in work, while allowing a better work-life balance and supporting improvements in living standards.

Although the reforms we modelled in the previous section will have a more immediate impact, we believe it is crucial for the long-term success and sustainability of UC that the recommendations outlined in this section are implemented in due course.

While this second phase of proposals will require some additional funding, it is well within the expected sustainable level of spend as projected by the OBR. Given the time, thought and expense that have already been dedicated to UC, ensuring its long-term future is secured through the reforms outlined is essential.

Section 10

Conclusion

Our review has brought the focus back to the impacts that UC will have on people's incomes and, just as importantly, their work and life choices. In doing so, we have looked beyond the debate surrounding the implementation problems that have beset UC to date. In this report, **we have outlined our ambitious, but achievable, vision for UC both in the short- and long-term**.

Our two-phase approach provides appropriate **action on UC in the near term to ensure that, at a minimum, incentives to enter work are improved and a simpler, easier to use system is put in place**. We do this against a backdrop of tight fiscal constraint.

Our **longer-term vision sets out the additional investment and reform necessary to refocus UC on progression and provide the opportunity for families to find an appropriate work-life balance**. Our aim is to meet the changing social and economic challenges – in the labour market, housing and in relation to the demographics of our population – of the coming decades.

Through analysing the evidence, it became apparent to us that **the policy focus in UC must shift from reducing worklessness to encouraging and supporting all members of a household into decent, sustainable work**. Simply being in work is not enough; the objective must be to tackle endemic low pay. To do so, we make recommendations that would improve incentives and provide effective practical support to help people progress. It is our hope that this approach will improve the living standards of millions of low to middle income families, helping them find a better balance between work and other commitments.

UC must learn the lessons of the current tax credits regime, particularly in relation to simplicity. The existing system successfully supports many people into work. However, its highly complicated structures and interactions can mean those who could stand to benefit most do not do so. The withdrawal of multiple benefits at the same time (and at varying rates) fails to provide workers with a clear incentive to progress and increase their earnings. **A better-integrated and simpler-to-navigate working-age benefit system – which we have made suggestions to develop – can help to achieve these aims**.

Simplifying the system will not be enough on its own however. To reach the targets set for UC, **it is imperative that incentives to enter work are rebalanced**. Those most in need of support to start working – single parents, second earners with children and the disabled – should have their incentives strengthened. Those with fewer barriers to work – people without dependent children – must not have their work choices distorted. Government must improve incentives to progress in work. People will feel little impetus to do so if 76 pence of every additional pound earned is lost through reduced benefits and payment of income tax and NI. Along with getting the financial incentives to progress right, **effective practical support can help people improve their earnings via the route most appropriate for them**.

With significant numbers of families set to start claiming UC next year – many of whom will have more complicated circumstances than those who are already receiving it – the start of the new parliament provides a perfect opportunity to reflect on the current design of UC. We hope that the new government finds our review to be a constructive and practical guide as it decides how to proceed. The warning our report makes is that a **failure to revisit and revise policies now, and**

overlooking the changes needed to make UC a success, would represent a missed window of opportunity that may not present itself again once the system becomes fully bedded in.

Annex A: The evolving design of UC

The original conception of UC, set out by the Centre for Social Justice, had significantly different features to the version of UC being implemented today. In part, this reflects inevitable changes associated with development by government. More accurate modelling and a fuller consideration of practical delivery issues meant that certain ideas were modified or dropped. Related to this, the introduction of real-time information (RTI) by HMRC provided new opportunities. This RTI generates monthly earnings information on which in-work support can be calculated on a more timely basis.[117] Aside from structural changes, UC has also evolved in reaction to the tight fiscal backdrop of recent years. Both the existing working-age welfare system and the UC budget have been subject to repeated reductions in generosity in this period.

Below, we set out a timeline of some of these changes.

Stage 1: 'Dynamic Benefits', 2009

The Centre for Social Justice published proposals for a system of 'Universal Credits'. Instead of a single benefit, there would be two; one if out-of-work or on low levels of pay, one covering additional living expenses such as childcare costs or costs associated with disability. The system would integrate a large number of existing benefits:

- 'Standard allowances' would reflect current out-of-work entitlements;
- Council Tax Benefit and Disability Living Allowance[118] would be incorporated;
- Passported benefits, like free school meals, would be provided as monetary payments, tapered away on earnings; and
- Conditionality would only apply to those receiving out-of-work benefits. But an earnings disregard could apply for second earners engaging in work-related activity.

Universal Credits would establish a large earnings disregard and a single taper rate of support for in-work families:

- Withdrawing 55 per cent of post-tax earnings;
- Maximum earnings disregards[119] for:
  - singles over-25 – £5,750;
  - single parents with two children – £9,550;
  - couples with two children – £6,150; and
- Earnings disregards reduced by the value of housing and council tax entitlements.

Stage 2: Autumn Statement 2013

The parameters detailing the generosity of the scheme were set out in time for UC to begin roll-out in 2014 (with an end date of 2017). It was less generous than the scheme envisioned in 2009:

[117] R Sainsbury, *Talking Universal Credit: In conversation with Lord Freud, Minister for Welfare Reform*, 2014

[118] Disability Living Allowance is being replaced for people of working age by Personal Independence Payment https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/422328/timetable-for-pip-replacing-dla-may-2015.pdf

[119] CPI inflation uprated value of disregards in : Brien, S et al. (2009) Dynamic benefits: towards welfare that works, The Centre for Social Justice

- The taper on post-tax earnings was set at 65 per cent;
- Maximum 'work allowance' (i.e. earnings disregard) for:
  - singles – £1,330;
  - single parents with two children – £8,800;
  - couples with two children – £6,450; and
- Each family type with housing costs has a single lower work allowance, no longer dependent on their specific housing costs.

The system is a single benefit whether in- or out-of-work, but key working-age benefits are excluded:

- Council tax support is localised and Disability Living Allowance kept as a separate benefit;
- There is no confirmed policy on passported benefits, it is still under review; and
- In-work conditionality is introduced for those earning less than the equivalent of full-time National Minimum Wage.

Stage 3: May 2015 onwards

Implementation is taking longer than planned, with few cases currently entitled and full roll-out now expected in 2020 at the earliest. Further cuts to the generosity of UC have already been made:

- 'Elements' (i.e. standard allowances) are increased by only 1 per cent a year until April 2016 and then frozen until April 2018;
- Work allowances are frozen in cash terms until April 2018; and
- Passported benefits set to be withdrawn at earnings thresholds and not integrated as cash elements of UC.

Annex B: Free school meal work allowances

As set out in Section 6, we recommend incorporating free school meals (FSMs) into UC by means of moving recipients onto temporary lower work allowances. Standard allowances are then restored beyond the earnings limit at which FSM receipt is stopped. As such, recipients are compensated for the loss of FSMs by a corresponding boost to their post-UC income.

To achieve a balance between maximing the extent to which families can receive FSMs, costs and simplicity, the earnings limit is set at the lowest threshold possible which for most family types is £424 a month or 15 hours at the minimum wage.

For the purposes of simplicity, the FSM work allowance is set to compensate for the financial loss of up to three school meals. Table B.1 sets out the full range of potential FSM and standard work allowances for different family types with children. Our recommendation that work allowances are introduced for second earners is not affected by these proposals.

Table B.1: Adjusted work allowances for families with school children

	Without FSM allowance		With FSM allowance	
	Monthly cash amount	Weekly hours at NMW	Monthly cash amount	Weekly hours at NMW
Higher work allowance (no housing costs)				
Single with dependent children	£734	26	£367	13
Couple with dependent children	£508	18	£141	5
Lower work allowance (has housing costs)				
Single with dependent children	£424	15	£141	5
Couple with dependent children	£222	8	£0	0

It should be noted that those with more than three children will find themselves slightly worse off without free school meals even after reverting to the standard work allowance. However, the cliff-edge is small and occurs at a low level of earnings. Most of these families are couples, in which we would anticipate the main earner to be less responsive at such a low level of earnings.

Based on 2015 UC rates, renting couples with three children would also find themselves slightly worse off. But over time, if work allowances are increased in line with growth in the minimum wage (as recommended in Section 4 of the main report), and the cost of school meals increases at the rate of inflation (as would be expected over the longer term), this will no longer be the case. The relative growth in generosity of the work allowance will increase the boost to income when FSMs are withdrawn.

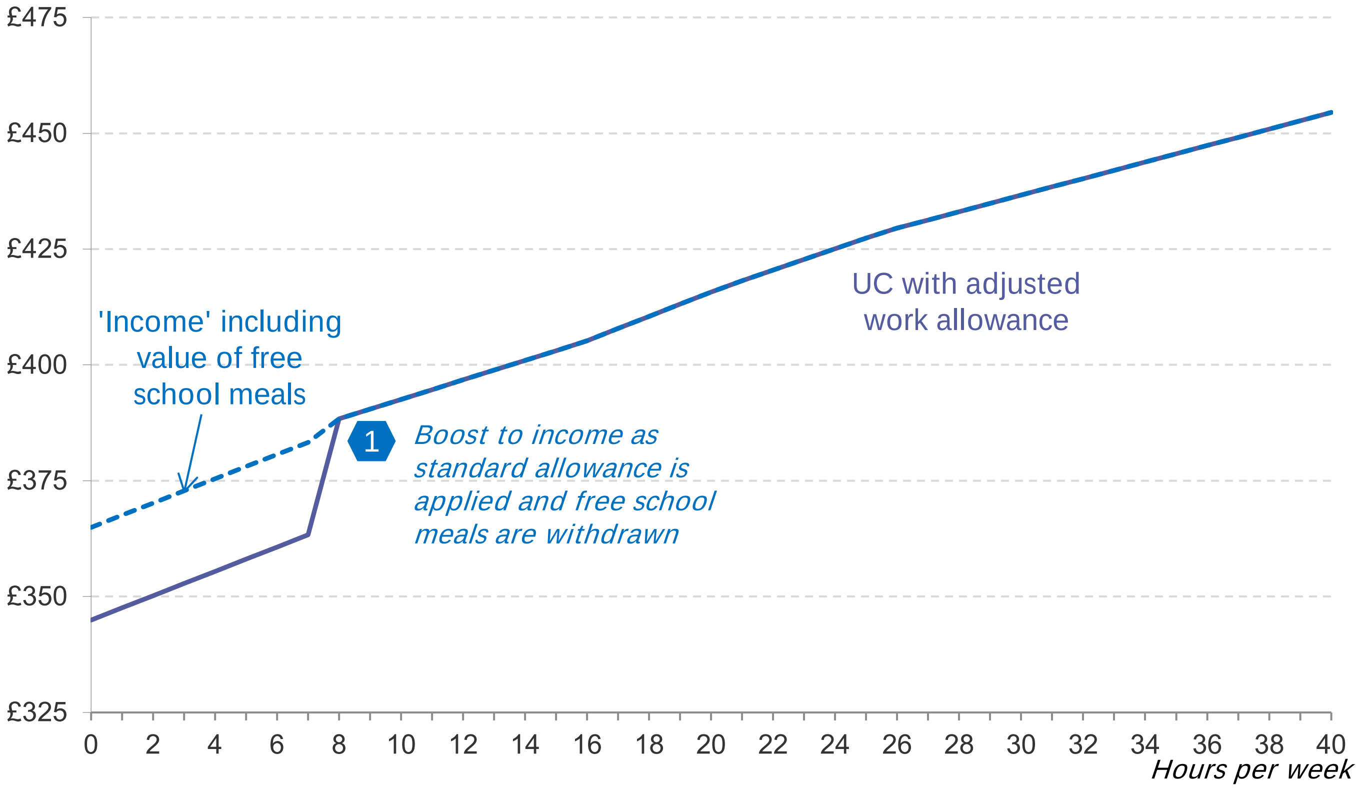
A further increase in entitlement to FSMs, most likely to all primary school-aged children, may mean that our recommended approach should be reviewed. However, it would still be important to have a mechanism to determine entitlement for children at secondary school.

Figure B.1 shows the impact of our proposal on a renting couple with children. This family has the lowest standard work allowance among parents in UC. Ensuring they receive a sufficient boost to income when their FSM entitlement is withdrawn (in this instance it occurs at the point at which their standard work allowance runs out) necessitates an FSM-adjusted work allowance of zero.

All other family types would have FSM entitlement removed at higher earnings thresholds and, therefore, would maintain *some* work allowance at low levels of earnings. It is worth re-iterating that we do not expect FSMs to have a significant impact on the decision of a main earner in a couple to enter work, because they are unlikely to do so at such a low level of earnings.

Figure B.1:
Determining free school meal entitlement for a couple with children who rent
Couple with two children, one earner at 7.50 an hour and rent of £100 per week

Net income as weekly hours worked increase



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

Annex C: Treatment of unearned income

	Income source	Universal Credit	Existing system: Income-related out-of-work benefits	Existing system: Housing Benefit	Existing system: Tax credits
Out-of-work benefit entitlement and tax credits	Bereavement Allowance	£1 for £1 reduction	£1 for £1 reduction	Paid in full if entitled to income-related out-of-work benefits, otherwise income is subject to 65 per cent taper	Contributory benefit subject to 41 per cent taper, income-related benefit is ignored
	Carer's Allowance				
	Employment and Support Allowance				
	Incapacity Benefit				
	Industrial Injuries Benefit*				Ignored
	Jobseeker's Allowance				Subject to 41 per cent taper
	Maternity Allowance				Ignored
	Retirement Pension				Treated as pension income
	Severe Disability Allowance				Ignored
	Widows Pension, widowed mothers allowance, widowed parents allowance			First £15 a week ignored then subject to 65 per cent taper	Treated as pension income
	Statutory Sick pay, Statutory Maternity Pay and other forms of Statutory parental payments	Treated as earnings		Subject to 65 per cent taper	Treated as earnings
	Working Tax Credit	N/A	N/A		Ignored
	Child Tax Credit		Ignored		
Maintenance payments	Child maintenance	Ignored	Ignored	Ignored	Ignored
	Spousal maintenance	£1 for £1 reduction, in-kind support, such as mortgage payments are ignored	£1 for £1 reduction	First £15 ignored if children present	Ignored
Pension income	Occupational pension	£1 for £1 reduction	£1 for £1 reduction	Subject to 65 per cent taper	First £300 a year of income from pension and capital is ignored, then income is subject to 41 per cent taper
	Personal pension				
	Income from annuities or trusts**				
	Overseas pensions				
Capital and Savings	Below £6,000	Ignored	Ignored	Ignored	Only *taxable income* from savings are subject to 41 per cent taper
	£6,000.01 to £16,000	Each £250 above £6,000 adds £4.35 a month of assumed income to earnings	Each £250 above £6,000 adds £1 a week of assumed income to earnings	Each £250 above £6,000 adds £1 a week of assumed income to earnings	
	£16,000 plus	No UC entitlement	No UC entitlement	No UC entitlement	

* Except for constant attendance allowance and exceptionally severed disability allowance
** ignored if from personal injury compensation

Notes: This list is not exhaustive, here we highlight the rules for main sources of unearned income. Further, more detailed information can be found in the Welfare Benefits and Tax Credits handbook published by Child Poverty Action Group.

Annex D: Rebalancing incentives to enter work

In this annex, we set out the detailed impact on Participation Tax Rates (PTRs) – a measure of how strong the incentive to enter work is – of our proposals, and consider how they affect different family types. This analysis provides a more detailed account of the impacts set out in Sections 8 and 9 of the main body of the report, comparing PTRs under our proposals with PTRs under the UC system as currently envisaged.

Phase I: Re-balancing work incentives in this parliament

Incentives to work part time hours under our recommendations

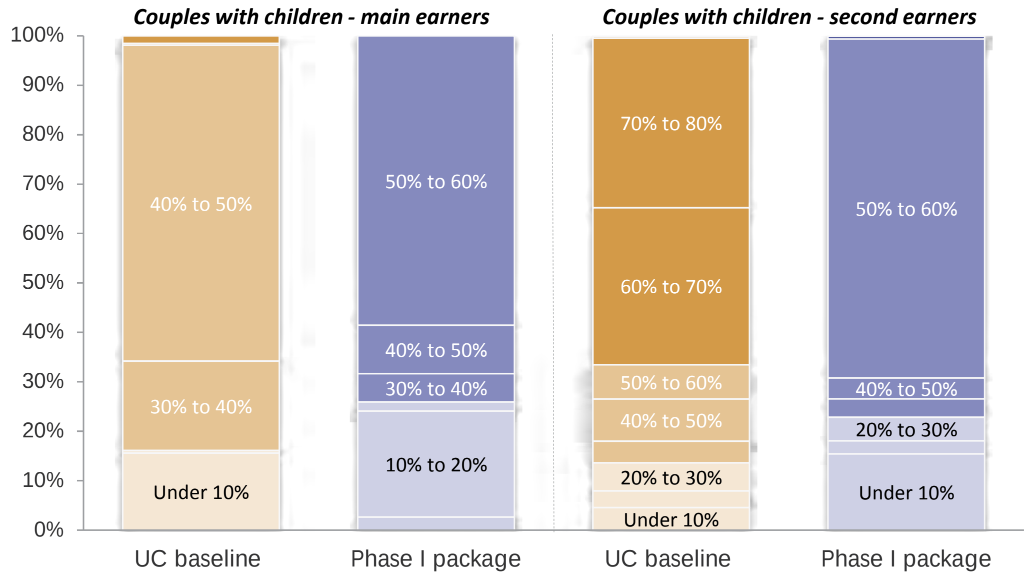
Figures D.1 and D.2 set out the PTRs that exist under our proposed Phase I package for a currently out-of-work person assumed to be paid the minimum wage and working 20 hours a week, split by their position in a family.

Under our Phase I proposals, at 20 hours of work for **couples with children**:

- PTRs for the **main earner** are made slightly worse, with PTRs for many increasing from between 40 to 50 per cent to between 50 to 60 per cent. This is driven by the **small reduction in the work allowance for non-renters**.
- For the **second earner** PTRs are much improved with two-thirds of second earners having their PTR capped at less than 60 per cent and almost a fifth with a PTR of under 10 per cent. This is driven by the **introduction of a second earner work allowance**.

Figure D.1:
Incentives to enter work at 20 hours – couples with children
Participation Tax Rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate

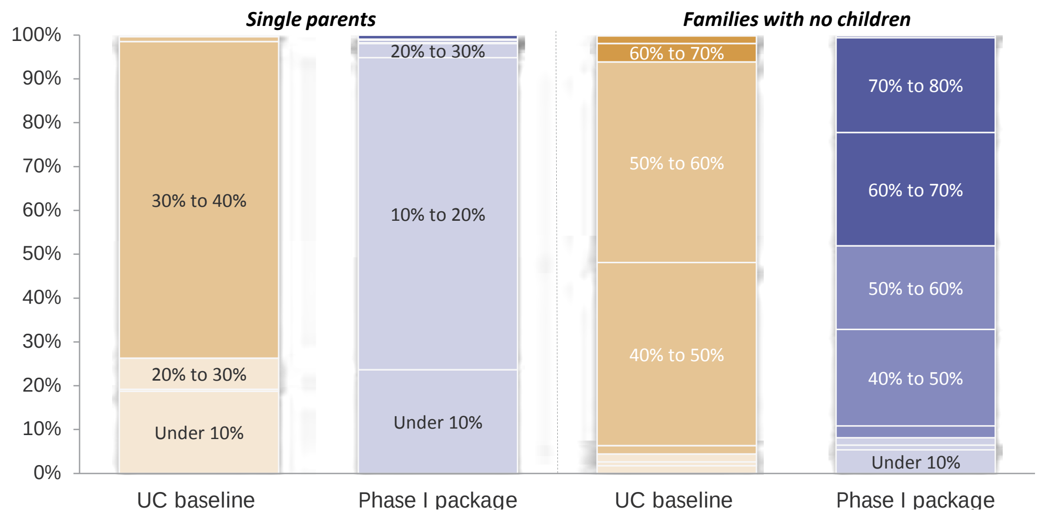


Notes: In couple households if both members are out of work only the head is assumed to enter; if there is already a single earner, the second earner enters work.

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

Figure D.2:
Incentives to enter work at 20 hours – single parents and people without children
Participation Tax Rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate



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

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

In comparing the change in PTRs under our Phase I proposals for single parents and families without children (we directly re-invest the work allowance for the latter in an improved work allowance for the former) it is clear that:

- There is a **significant improvement in the PTR for single parents**: only 5 per cent of this group are left with a PTR greater than 20 per cent under our proposals. This change is driven by an **enhanced work allowance for single parent renters**. It should be noted that our proposal seeks to **reduce the risk that single parents who rent become trapped at a low levels of earnings**.
- **Families without children** see a worsening of their PTRs at 20 hours a week. In the current design of UC over 90 per cent of this group had a PTR of less than 60 per cent. Our proposals reduce this to just over half, with the remainder facing a PTR of up to 80 per cent. These changes are driven by **the removal of the work allowance for this group**. Those with the highest PTRs under our proposals are likely to rent, have high council tax bills and be in a couple – all these factors increase entitlement to UC at part-time hours, increasing the amount that can be withdrawn as earnings rise.

Incentives to work 40 hours a week under our recommendations

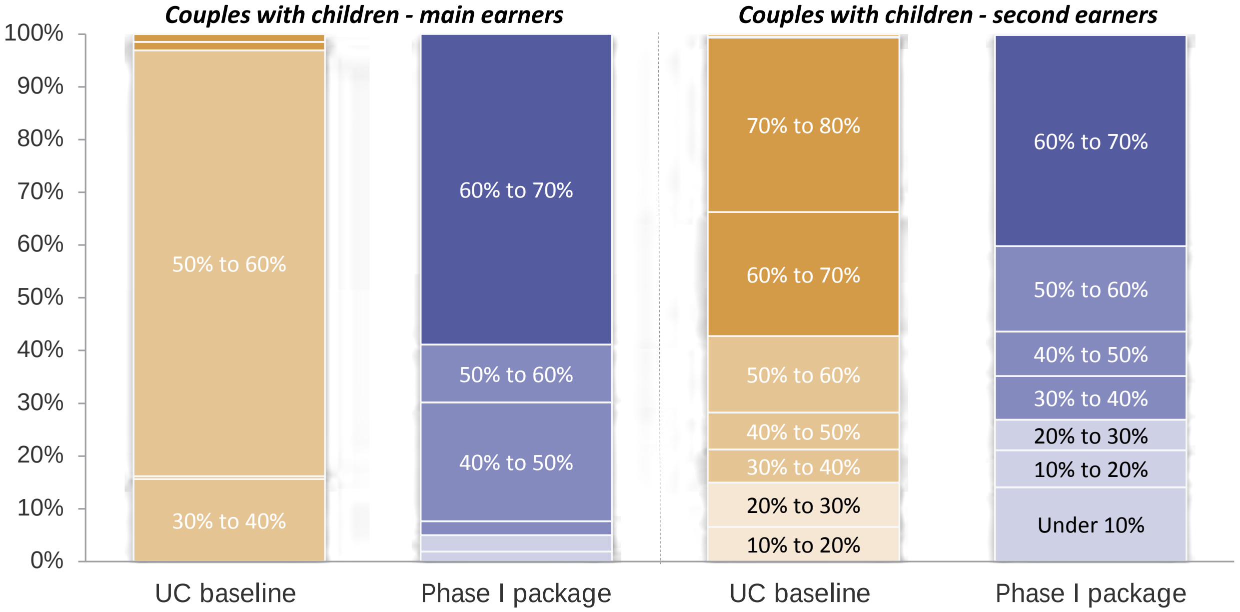
Figures D.3 and D.4 set out the PTRs that exist under our proposed Phase I package for a currently out-of-work person assumed to be paid the minimum wage and working 40 hours a week, split by their position in a family.

Under our Phase I proposals, **at 40 hours of work at the minimum wage** for **parents in a couple with children**:

- PTRs for the **main earner** are again made slightly worse with PTRs for almost 60 per cent of this group increasing from no more than 60 per cent to between 60 to 70 per cent. As with part-time hours this is driven by the **small reduction in the work allowance for non-renters**.
- For the **second earner** PTRs are once again improved with no-one facing a PTR of more than 70 per cent under our proposals. 45 per cent of this group have a PTR of less than 50 per cent under our proposals, compared to less than 30 per cent under the current UC system. This improvement is driven by the **introduction of a second earner work allowance**.

Figure D.3:
Incentives to enter work at 40 hours – couples with children
Participation Tax Rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate

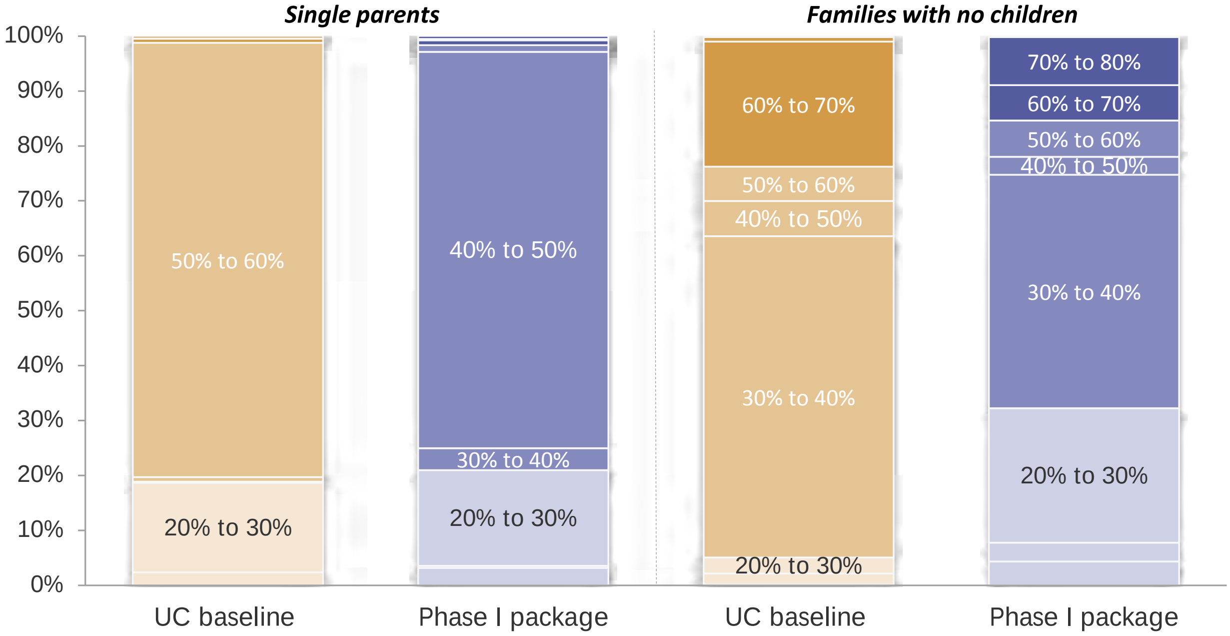


Notes: In couple households if both members are out of work only the head is assumed to enter; if there is already a single earner, the second earner enters work.

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

Figure D.4:
Incentives to enter work at 40 hours – single parents and people without children
Participation Tax Rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate



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

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

Comparing the change in PTRs if **entering work at 40 hours at the minimum wage** under our Phase I proposals to current UC proposals (Figure D.4) for **single parents** and **families without children** shows that:

- There is an **improvement in PTRs for single parents**, with around three quarters having their **PTR capped at less than 50 per cent** under our proposals, compared to **less than 60 per cent** under UC as currently proposed. This change is driven by an **enhanced work allowance for single parent renters**.
  - Overall our proposals improve PTRs for families wihout children at full-time hours:
  - **Three-quarters of families without children have a PTR of less than 40 per cent** – for 30 per cent of this group it is less than 30 per cent – under our proposals. Around two-thirds have a PTR of less than 40 per cent – for only 5 per cent of the group it is less than 30 per cent – under current UC proposals.
  - Around 10 per cent of **families without children** will face a higher PTR of between 70 to 80 percent under our proposals.
- These changes are driven by faster withdrawal of UC entitlement under our proposals. The highest PTRs are faced by those with the greatest entitlement to UC (through a combination of housing support, CTS and being in a couple) who still receive UC at, or close to, full-time hours of work.

Phase II: Reinforcing incentives to start working

Incentives to enter part-time work

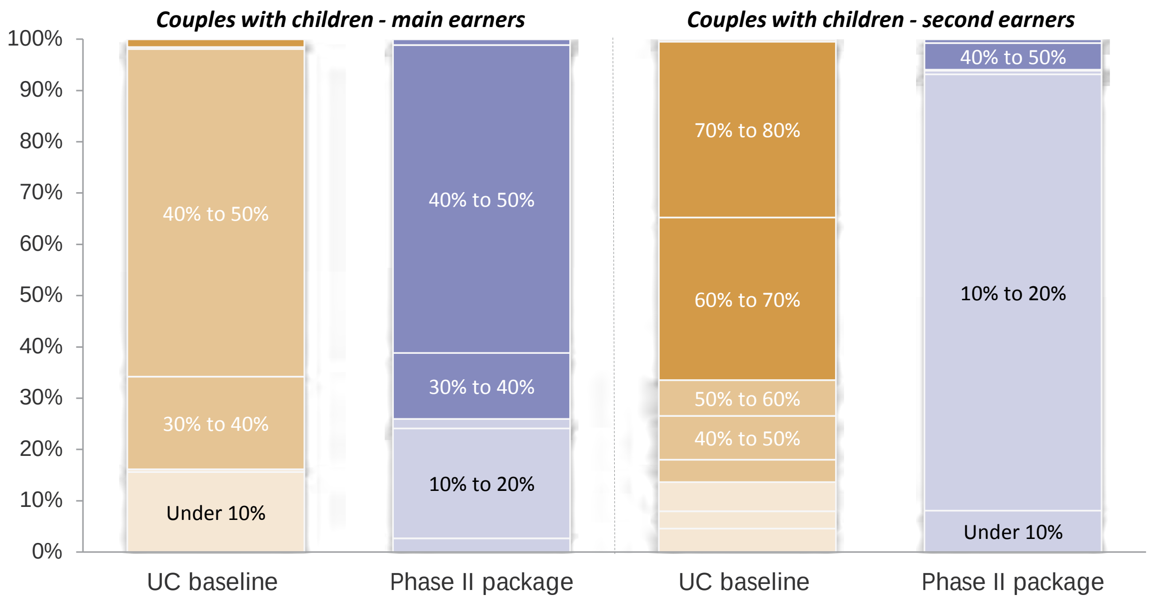
Our Phase II proposals significantly improve the incentive to enter work at part-time hours compared to current UC proposals. This is because they enhance the value of work allowances for second earners and single parent renters, and increase them, relative to our shorter term Phase I proposals, for main earners in a couple.

As shown in Figure D.5 for couples with children entering work at 20 hours a week earning the minimum wage:

- Main earners have their PTRs largely unchanged. The vast majority have their PTR capped at less than 50 per cent in either scenario. Our proposals do increase the proportion with a slightly higher, though still low, PTR.
- There are significant improvements to the PTRs faced by second earners. Under our proposals 95 per cent have a PTR of less than 20 per cent, with the remaining 5 per cent facing a PTR of between 40 to 50 per cent. Under current UC proposals almost two-thirds have a PTR of between 60 and 80 per cent, only 10 per cent face a PTR of less than 20 per cent.

Figure D.5:
Incentives to enter work at 20 hours – couples with children
Participation Tax Rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate

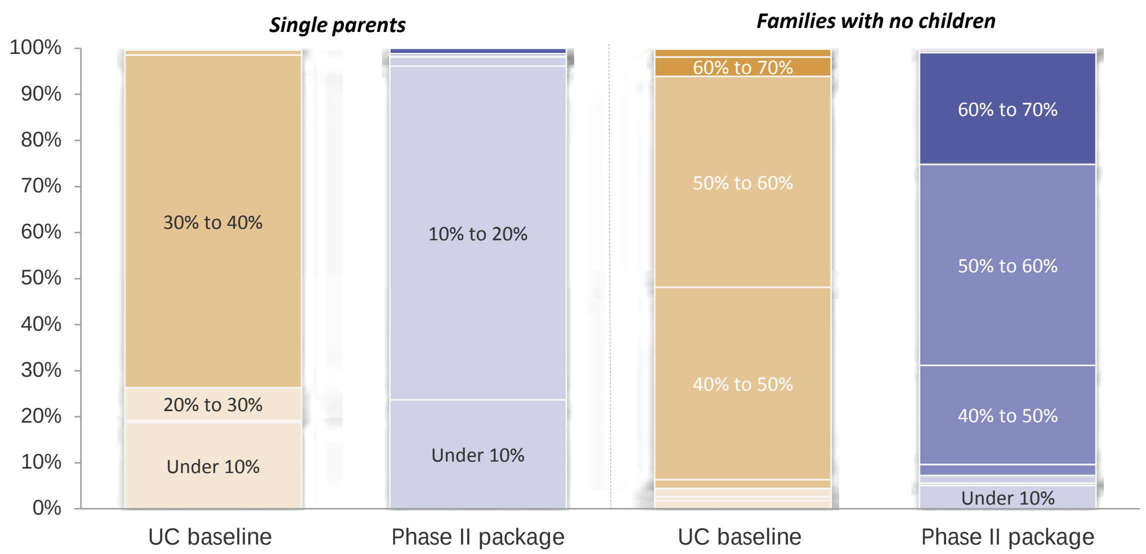


Notes: In couple households if both members are out of work only the head is assumed to enter; if there is already a single earner, the second earner enters work.

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

Figure D.6:
Incentives to enter work at 20 hours – single parents and people without children
Participation Tax Rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate



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

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

As shown in Figure D.6 for single parents and families without children entering work at 20 hours a week earning the minimum wage:

» Single parents **have a significant reduction in their PTRs**. The vast majority have their PTR capped at less than 20 per cent, half of the PTR under the current system.

Overall there is a slight worsening in the position for families without children, although the highest PTR remains at 70 per cent it applies to a further 20 per cent of the group. This is driven by the removal of their work allowance, but these incentives are improved compared to the short-term due to the lower taper rate.

Incentives to enter full-time work

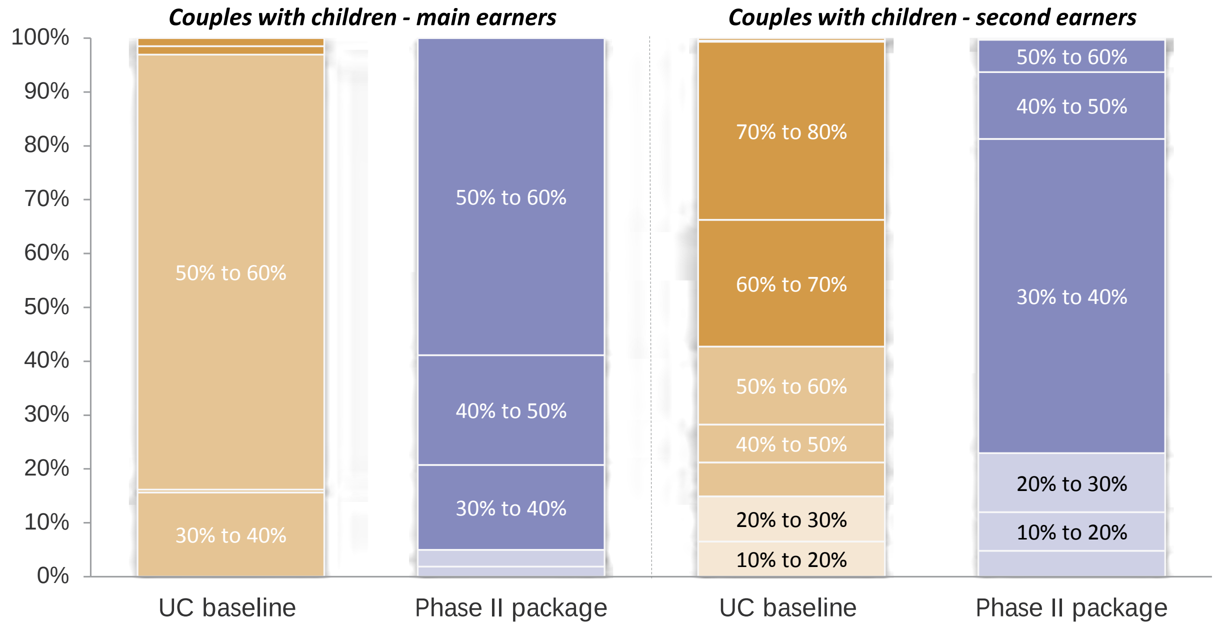
Figure D.7 illustrates the case of either the main earner or a second earner in a couple with children entering work at 40 hours on the minimum wage. It shows that:

» For the main earner in a couple with children the incentive to enter work at full-time hours is capped at 60 per cent under our longer term proposals and in the current UC baseline, however the lower taper rate leads to around 25 per cent of main earners having a lower PTR.

» Second earners clearly experience more significant impacts on their PTRs. First, PTRs are capped at 60 per cent, compared to 80 per cent under the current UC design. Second 80 per cent of second earners have a PTR of less than 40 per cent, compared to less than 30 per cent of second earners in the UC baseline system.

Figure D.7:
Incentives to enter work at 40 hours – couples with children
Participation Tax Rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate



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

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

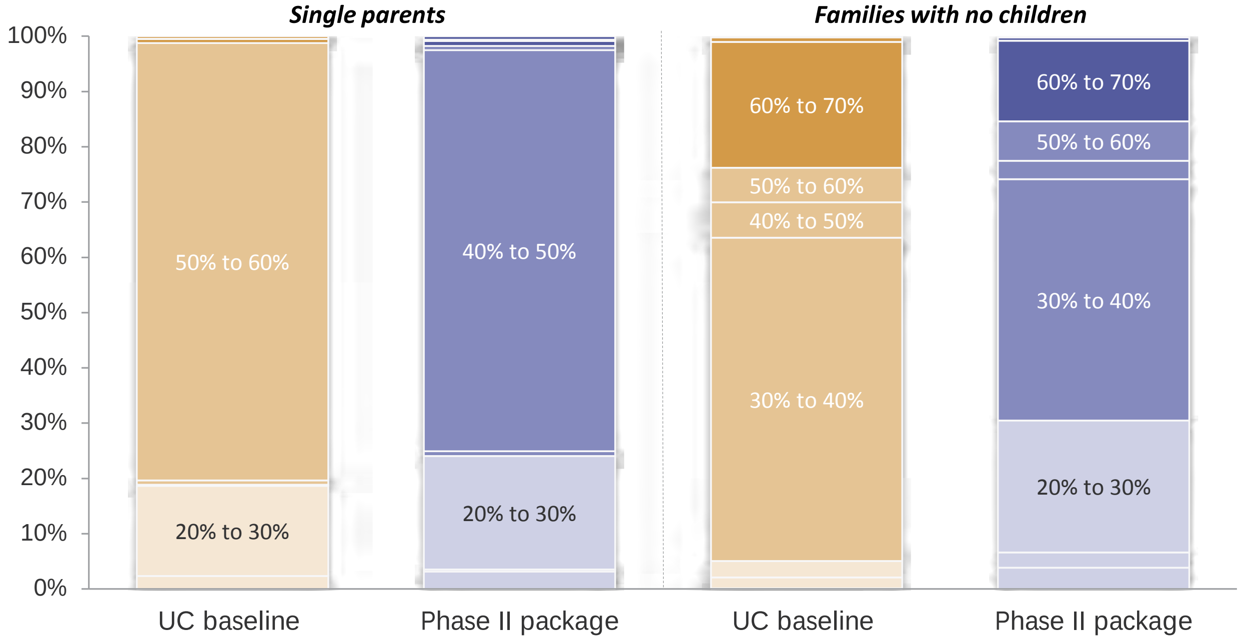
Figure D.8 illustrates the case of either a single parent or a family without children entering work at 40 hours on the minimum wage. It shows that:

» For single parents the PTR is capped at 50 per cent under our longer term proposals compared to 60 per cent under the current UC baseline. This is driven by the improvement in the work allowance for renters and the reduced taper rate.

» Some families without children still have a PTR of between 60 and 70 per cent, but the proportion is reduced from around 25 per cent in the UC baseline to 15 per cent under our longer-term proposals. Over 70 per cent of this group will have a PTR of no more than 50 per cent under our proposals, compared to 60 per cent under the current UC design. A quarter will have a PTR of less than 30 per cent, when less than 5 per cent do so in the current design of UC.

Figure D.8:
Incentives to enter work at 40 hours – single parents and people without children
Participation Tax Rates if entering work when earning the minimum wage

Proportion of people out-of-work by Participation Tax Rate



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

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

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.*

For more information on this report, contact:

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