

Universal Credit: A Preliminary Analysis

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Universal Credit: a preliminary analysis¹

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Executive summary

The government plans to redesign entirely the system of means-tested benefits and tax credits for working-age adults by replacing them all with a single benefit, known as Universal Credit, to be administered by the Department for Work and Pensions. This Briefing Note analyses Universal Credit as set out in the government's White Paper, *Universal Credit: Welfare that Works*. A Welfare Reform Bill is due to be published later in January 2011, and this should contain more details of how Universal Credit will operate.

The government hopes Universal Credit will simplify the benefit system and strengthen financial incentives to work. IFS researchers have long argued for a simpler, more integrated benefit and tax credit system to make life easier for claimants, make the gains to work more transparent, and reduce money wasted on administration and lost to fraud and error. This note concentrates on the way that Universal Credit will affect household incomes and financial work incentives.

What is Universal Credit and what is it replacing?

Universal Credit will entirely replace the system of means-tested benefits and tax credits for working-age adults, including Income Support, income-related Jobseeker's Allowance and Employment and Support Allowance, Working Tax Credit, Child Tax Credit and Housing Benefit.

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Means-tested benefits for those who are not working are currently withdrawn pound-for-pound against claimants' income, meaning that Working Tax Credit is necessary to provide a positive financial incentive to work. Universal Credit will be withdrawn more slowly against earned income, at a rate of 65% rather than 100%. This means Universal Credit will extend further up the income distribution than the current set of means-tested benefits, allowing the government to scrap Working Tax Credit. Extra benefits currently paid to those with children and those who rent through Child Tax Credit and Housing Benefit will be rolled into Universal Credit, eliminating the scope for claimants to face very weak work incentives, which can happen at present when they are subject to withdrawal of multiple benefits.

How will entitlement be calculated?

Basic entitlements to Universal Credit have been set so that the majority of workless families will receive the same amount of benefits as they do under the current regime. A 100% withdrawal rate will apply to unearned income, and earned income will be subject to a 65% withdrawal rate (applying to net earnings) after a disregard.

The withdrawal rate applying to earned income is lower than that applying under the current set of out-of-work means-tested benefits, but higher than currently applies under tax credits for those in work. A basic-rate taxpayer who is currently on the tax credit taper faces an overall marginal effective tax rate (METR) of 73%, and this will rise for most to 76.2% under Universal Credit. For the combined METR on earned income for taxpaying recipients of Universal Credit to be equivalent to that in place under tax credits, the Universal Credit withdrawal rate would have to be reduced to 60% of net earnings.

The withdrawal rate applying to unearned income is identical to that in the current set of means-tested benefits, but higher than currently applies under tax credits, and much higher for those families with more than £16,000 of financial capital, who will not be entitled to any Universal Credit at all.

Who will win and lose in the long run?

The government produced a limited analysis of winners and losers under Universal Credit; this Briefing Note presents a fuller analysis under the

same assumptions. This analysis assumes full take-up of benefits under the existing regime and under Universal Credit, ignores any behavioural impact of Universal Credit and mostly ignores the transitional protection. Under these assumptions, the analysis suggests the following:

- The long-run cost of Universal Credit will be around £1.7 billion (in 2014–15 prices). The short-run cost, including the transitional protection, will depend on how quickly the government transfers existing recipients of benefits and tax credits over to Universal Credit and on the precise details of the scheme.
- A total of 2.5 million working-age families will gain and, in the long run, 1.4 million working-age families will lose, and 2.5 million working-age families will see no change in their disposable income because their entitlements to Universal Credit will match their current entitlements to means-tested benefits and tax credits.
- Overall, Universal Credit will benefit poorer families more than richer ones. The bottom six-tenths of the income distribution will gain on average, while the richest four-tenths will lose out slightly in the long run.
- On average, couples with children will gain more (in cash and as a percentage of income) than couples without children, who will gain more than single adults without children. Lone parents will, on average, lose in the long run. But there will be winners and, in the long run, losers amongst all family types.

It is likely that Universal Credit will increase take-up, which would increase the number of families gaining and the cost to government. It is also likely that Universal Credit will encourage more people to work, which would reduce the cost to government, although it may also encourage some people to work less, increasing the cost to government. And the transitional protection will increase the cost to government, and reduce the number of families losing in the short run.

How will Universal Credit affect work incentives?

The government produced a very limited analysis of how Universal Credit will affect work incentives; this note presents a fuller analysis. Ignoring the transitional protection and assuming full take-up of benefits under the existing regime and under Universal Credit, we find the following:

- Universal Credit will strengthen the incentive to work at all, on average, particularly for those who have the weakest incentives to work under the current tax and benefit system, namely low-earning single people and primary earners in couples. It will reduce the number of individuals with participation tax rates (PTRs) of 70% or more by 1.1 million. However, it will increase the number of individuals with PTRs of 60% or more by 350,000.
- However, Universal Credit will weaken incentives to work for (potential) second earners in couples, who will see Universal Credit withdrawn more quickly if they enter work than currently happens with tax credits. This trade-off is reminiscent of the impact on the incentive to work of Working Families' Tax Credit, introduced by the previous government in 1999, although the impact of Universal Credit applies to work of less than 16 hours per week and to those without children.
- A total of 1.7 million workers will see a fall in their marginal effective tax rate and 1.8 million will see an increase. About half of those seeing a rise are workers currently paying income tax and National Insurance and facing a withdrawal of tax credits: they will see a rise in their METR from 73% to 76.2%. On average, Universal Credit will lower METRs for those on low earnings and raise them slightly for those on middle earnings.
- Universal Credit will ensure that the maximum METR on earned income faced by workers is 76.2%, so those currently facing a higher METR than that, as a result of facing the withdrawal of several benefits or tax credits simultaneously or through a 100% withdrawal of an out-of-work means-tested benefit, will see their METR reduced; these tend to be low earners who do not have a partner or whose partner does not work.
- Low earners who do have a working partner will tend to see their METR increase, because Universal Credit will have a higher withdrawal rate than tax credits do. This also means that some higher earners who do not have a working partner will see their METR increase slightly.

How will it work?

- New claimants will start to receive Universal Credit from October 2013, with all existing recipients moved across over the subsequent four years. Households will be protected from cash losses at the point of transition as long as their circumstances do not change.
- Universal Credit will be paid monthly and will be based on income in the previous month. The government hopes to measure earnings using HMRC's proposed real-time PAYE system, but it is not clear how it will measure or record other sources of income.
- Most recipients (but not the seriously disabled or lone parents with very young children) earning below a threshold will be subject to conditionality (i.e. they will be required to take steps to prepare for work, to look for work or to accept suitable job offers) under a regime similar to, but probably tougher than, that which currently applies to recipients of out-of-work benefits.
- The government has not yet announced decisions on many aspects of Universal Credit, with three of the most important design issues being whether to include Carer's Allowance within Universal Credit, how to replace the childcare element of the Working Tax Credit, and what to do about Council Tax Benefit given the government's desire to give local authorities control over its generosity. It is likely that whatever decisions are reached in these areas will either increase the cost of Universal Credit or lead to more families losing (or both).

1. Introduction

In November 2010, the coalition government published a White Paper setting out its plans for a Universal Credit.² Chapter 7 of the White Paper contained a brief analysis of the way in which household incomes might be affected in the long run and of the impact on financial work incentives. The government is planning to publish its full proposals in the Welfare Reform Bill in January 2011, along with its own fuller assessment of the impact on incomes and work incentives, and we plan to publish a revised assessment shortly after that.

The government hopes Universal Credit will simplify the benefit system and strengthen financial incentives to work. IFS researchers have long argued for a simpler, more integrated benefit and tax credit system to make life easier for claimants, make the gains to work more transparent, and reduce money wasted on administration and lost to fraud and error. This Briefing Note concentrates on the way that Universal Credit will affect household incomes and financial work incentives. It sets out our estimates of the impact of Universal Credit on household incomes and measures of financial work incentives, given the information supplied in the White Paper. However, such analysis should not be seen as definitive, both because full details of how Universal Credit will work have not yet been made available and because Universal Credit is likely to have complicated impacts on take-up and labour supply behaviour which we have not attempted to capture. However, our analysis is intended to be comparable to that provided in chapter 7 of the White Paper.

This note is structured as follows. Section 2 gives a brief overview of how Universal Credit might work and of what decisions over its design the government has yet to make. Section 3 explains in more detail how entitlement to Universal Credit will be calculated, and compares this with the current set of benefits and tax credits to give an indication of who might win or lose and how work incentives might change. Section 4 gives our quantitative assessment of the impact of Universal Credit on household incomes in the long run, but under various simplifying assumptions (assuming full take-up of Universal Credit and of the current

² Department for Work and Pensions, *Universal Credit: Welfare that Works*, Cm 7957, 2010, <http://www.dwp.gov.uk/docs/universal-credit-full-document.pdf>. Hereafter, 'the White Paper'.

set of benefits and tax credits, and ignoring any behavioural impact of Universal Credit). Section 5 gives our quantitative assessment of the impact of Universal Credit on measures of financial work incentives. Section 6 summarises and concludes.

2. Universal Credit: key features

This section gives an overview of how Universal Credit will work and outlines the design decisions the government has yet to make. Section 3 gives more detail of the structure of Universal Credit (with examples).

2.1 *What we know*

The White Paper sets out the government's plan to introduce an integrated benefit, known as Universal Credit. This subsection provides a brief description of the proposed plan; the reader may refer to the White Paper for further details.

What will and will not be replaced by Universal Credit

Universal Credit will stand in place of most of the existing means-tested benefits and tax credits for those of working age:

- Income Support (IS);
- income-based Jobseeker's Allowance (JSA);
- income-based Employment and Support Allowance (ESA);
- Housing Benefit (HB);
- Child Tax Credit (CTC) and Working Tax Credit (WTC).

Social security is a devolved matter in Northern Ireland, and it is not yet clear whether the reform will affect Northern Ireland.

The White Paper mentions the government's intention to incorporate into Universal Credit certain elements of the Social Fund, including Budgeting Loans, Sure Start Maternity Grant and Cold Weather Payment. The government is also considering reforming Community Care Grants and Crisis Loans towards a more localised system. We do not consider these benefits in our quantitative modelling.

Some benefits will not be superseded by the Universal Credit:

- contribution-based ESA and contribution-based JSA;
- Disability Living Allowance (DLA);
- Child Benefit;
- specific non-means-tested benefits, including Maternity Allowance, Statutory Maternity Pay, Statutory Sick Pay, Industrial Injuries Disablement Benefit and bereavement benefits.

The structure of Universal Credit

The structure of Universal Credit will resemble that of the existing means-tested benefits in as much as it will consist of a personal amount and additions for people in specific circumstances, reflecting differences in basic living costs.

The personal amount will be higher for couples than for single people, and lower for some young people, as in IS. There will be additions for disability, housing costs and children. The housing component will be similar to both Housing Benefit for social-sector tenants and Local Housing Allowance (LHA) for private-sector tenants. The amounts for child additions will be based on the current rates of Child Tax Credit. This structure ensures that most out-of-work benefit claimants will see their entitlements to benefits unaffected by the move to Universal Credit.

Universal Credit will have a single taper rate of 65% for earned income net of income tax and National Insurance contributions (NICs), and a taper rate of 100% for unearned income. This means that if a non-taxpayer earns an additional pound, they will lose 65p of Universal Credit, whereas if a basic-rate taxpayer earns an additional pound, they will have to pay an additional 20p in income tax and 12p in additional NICs and will then lose 44.2p in Universal Credit (65% of the 68p of additional net earnings).³ Some earnings will be disregarded before the taper applies, and the size of the disregard will depend on personal circumstances. Payments of Universal Credit will be subject to a cap of around £350 per week for single adults without dependent children and around £500 per week for other family types.

Means-tested benefits for those who are not working are currently withdrawn pound-for-pound against claimants' income, meaning that Working Tax Credit is necessary to provide a positive financial incentive to work. The slower rate of withdrawal in Universal Credit means it will extend further up the income distribution than the current set of means-

³ The existence of employer National Insurance contributions and of indirect taxes also weakens the incentive for individuals to work, since these taxes also create a wedge between the cost of employing an individual and the value of goods and services they are able to purchase with their wages. However, for reasons of simplicity, and since these taxes will not be affected by the introduction of Universal Credit, we do not take employer NICs or indirect taxes into account in this Briefing Note.

tested benefits, allowing the government to scrap Working Tax Credit. The fact that Housing Benefit will be rolled into Universal Credit eliminates the scope for claimants to face very weak work incentives, which can happen at present when they are subject to withdrawal of multiple benefits.

These issues are discussed further in Section 3, where we also compare the structure of Universal Credit to that of the existing set of means-tested benefits and tax credits.

*Conditionality*⁴

The government intends that out-of-work recipients receiving Universal Credit will have to undertake various activities, backed up with the threat of sanctions if they do not comply. The White Paper says that the conditionality regime of Universal Credit will be based on the conditionality regime that will exist in the current benefit system by 2013–14 and confirms that the government plans to alter the conditionality regime in the current benefit system at some point between now and 2013–14.⁵

One complication about imposing conditionality on Universal Credit recipients is that it is not exclusively an out-of-work benefit: it will be payable to recipients both in and out of work (with the aim of making it easier, compared with the current system, for benefit recipients to understand the impact on their benefits when they move into or out of work). This means that the government has to devise a test to determine which recipients of Universal Credit will and will not be subject to the conditionality regime.⁶ The White Paper proposes that this test be related to claimants' weekly earnings: essentially, those earning above a certain limit will not be subject to conditionality and those earning below that limit will be subject to conditionality. The White Paper also says (chapter 3, paragraph 21)

To begin with, we intend to set the threshold at broadly the same point at which people lose entitlement to the current out-of-work benefits. However,

⁴ These issues are discussed in chapter 3 of the White Paper.

⁵ See figures 7 and 8 in the White Paper for more information.

⁶ Under the current system, conditionality is applied to recipients of certain out-of-work benefits, namely JSA, IS and the work-related activity component of ESA.

once Universal Credit is established we will be able to raise or lower this threshold and apply conditionality to a greater [sic] number of recipients.

People lose entitlement to the current out-of-work benefits at earnings between £62.20 (for a single adult aged under 24) and £118.40 (for a couple) per week, corresponding to 10.4 and 19.7 hours a week at a wage of £6 per hour.

There are attractions to basing such tests on the number of hours worked a week by claimants, but an attraction of linking it to weekly earnings is that this information will already be used in the Universal Credit means test.

The government also has to decide how much of Universal Credit to sanction. At present, sanctions never apply to Child Tax Credit, Housing Benefit or Council Tax Benefit, and the government has said that it does not intend to sanction their equivalents under Universal Credit.⁷ However, combining all benefits into a single payment will make it easier for a future government to extend the severity of Universal Credit sanctions by sanctioning all Universal Credit payments, not just those corresponding to basic adult elements.

The way that this and future governments will apply conditionality to Universal Credit may be one of the more important aspects of the reform. However, it is beyond the scope of this note to discuss it further, and we ignore conditionality in our quantitative analysis.

Administration

Universal Credit will be administered by the Department for Work and Pensions (DWP), in contrast to the current system where HM Revenue and Customs (HMRC) manages tax credits and DWP administers most means-tested benefits.

Having a single body in charge of a single benefit should make reporting easier and simpler for households (saving them time, and possibly reducing error and increasing take-up) and make benefit claims easier to check (reducing error and fraud).

⁷ The June 2010 Budget announced plans to cut HB awards by 10% for claimants who have been unemployed for more than a year; it is not clear whether a similar policy will apply to the housing element of Universal Credit.

Of course, moving from the current system of benefits and tax credits to a single benefit will require major administrative and IT changes. It is beyond the scope of this note to assess the risk involved, but it is worth noting that the government does not plan a large-scale shift of benefit recipients from the current regime to Universal Credit; instead, the move across will be gradual, and this should mean that relatively few families will be affected by any early problems.

Period of assessment and frequency of payments⁸

The government is proposing that the period of assessment for Universal Credit will be a month and that payments will be monthly. This means, in broad terms, that families will receive Universal Credit monthly, based on their circumstances in the previous month or the most recent month for which information is available: Universal Credit will be a retrospective system. To implement this, the government proposes to make use of data on income captured by HMRC in a real-time information system that will be introduced in 2013–14. This will require employers to inform HMRC each month about the amounts paid to each employee and the amounts of income tax and NI deducted.

Such a system will be quite different from the way that tax credits currently work. At present, entitlement to tax credits is based on income in the current financial year and on current family circumstances. But HMRC currently has no way of knowing a family's joint income or family situation in real time, and so it has to base its calculations of tax credit entitlement on information supplied by claimants. If claimants are slow to report changes to HMRC, then over- or under-payments can – and do – result.⁹

The advantage of the system proposed by the government is that it should involve far fewer under- and over-payments than the current system of tax credits because payments will always be based on historic, verifiable information on income and family circumstances. This should increase certainty amongst Universal Credit recipients, and save the government money (because it loses money at present when it is unable to recover tax credit overpayments in full). The flip side is that payments may not reflect

⁸ See chapter 4, paragraphs 12–13 of the White Paper.

⁹ Overpayments can sometimes arise even when claimants report all changes as soon as they happen.

the claimant's most recent changes in circumstances. For example, it is not clear how quickly Universal Credit payments will respond if a claimant loses their job.

Reform timetable and transitional arrangements¹⁰

The government intends to have Universal Credit running from October 2013, and has a plan to complete the transfer to Universal Credit by October 2017. The timetable has various stages:

- From October 2013, there will be no new claims for out-of-work benefits: families will have to claim Universal Credit instead. Families leaving out-of-work benefits will also have to claim Universal Credit (and not tax credits).
- From April 2014, no new claims for tax credits will be made: families wishing to start a claim for CTC or WTC will thereafter need to claim Universal Credit instead.
- April 2014 to October 2017: remaining claimants of out-of-work benefits and tax credits will be transferred onto Universal Credit over time.

The government has not given full details of the transition yet. The October 2010 Spending Review allocated the DWP a total of £2 billion over the current spending review period to pay for the set-up costs of Universal Credit and the higher benefit payments that might arise when families are moved across. It seems likely that the government will determine the speed of transfer to fit within that budget.

As we show in Section 3, some families' entitlement to Universal Credit will be lower than their entitlement to current benefits and tax credits. The government has said that those households whose circumstances remain unchanged and who would otherwise lose will receive protection in cash terms. It is not entirely clear how this transition will work for households that subsequently do see a change in circumstances, and for how long the protection will last; these details should be published with the Welfare Reform Bill.

¹⁰ See chapter 4 of the White Paper for full discussion of these issues.

2.2 *What the government has yet to decide*

There are a number of design issues that the government has yet to make decisions about. We discuss the main ones below; this is not an exhaustive list.

Childcare

The government has not decided what to do about the childcare element of Working Tax Credit, which currently subsidises some parents' spending on formal childcare. The way that the current scheme is administered has been criticised for being overly complicated, and thus leading to less-than-full take-up, and being liable to fraud and error. The government has stated (chapter 2, paragraph 46 of the White Paper) that it wishes to extend help with childcare costs to parents who are in work of less than 16 hours a week (who currently cannot claim the childcare element of WTC) but without increasing spending. Sensibly, therefore, the government is considering both how much support to give to parents and the way in which it is delivered and administered.

Without any further constraints on what options the government is considering, there are too many options to permit any meaningful analysis. However, IFS researchers have previously recommended the government consider adopting one of the following options for administering the scheme:¹¹

- to base any childcare subsidy on verifiable receipts which parents should have to send to the relevant government department;
- to replace cash payments to parents subsidising childcare spending with a form of discount voucher scheme, where the government would send parents an entitlement to a certain 'discount' on their childcare spending (the discount could be a fixed fraction, or a fixed sum per week, or a fixed sum per hour, and could have ceilings if necessary); parents would then take the discount to a provider, who would charge parents the fee less the discount and be responsible for claiming the subsidy back from the government.

¹¹ See 'The Childcare Tax Credit', presentation given by Mike Brewer at seminar held by the Daycare Trust, 16 September 2010, <http://www.ifs.org.uk/publications/5280>.

Either option should reduce fraud and overpayments, and increase transparency and certainty. However, the first could cause a cash-flow problem for families (because they would have to meet the first month of childcare costs themselves before receiving any subsidy) and the second option would merely pass that problem on to providers.

Carer's Allowance

The government has not decided what to do about Carer's Allowance, which is a non-means-tested benefit for those who care full-time for a disabled adult or child. Although not means-tested against family income (like Income Support), it cannot be paid to those who earn more than £100 a week. It currently interacts with other means-tested benefits (such as IS) in complicated ways.

Carer's Allowance therefore has aspects of both non-means-tested and means-tested benefits. In essence, the government needs to decide whether it sees Carer's Allowance as a means-tested benefit designed to replace the forgone earnings of people who cannot work because they are caring – in which case, consistency suggests it should be rolled into Universal Credit – or whether it sees it as a non-means-tested benefit that compensates for higher needs, like DLA – in which case, it could remain outside. Rolling Carer's Allowance into Universal Credit would – unless new complexities were also added to Universal Credit – mean means-testing it against the combined income of a family, and this could lead to losers amongst existing recipients of Carer's Allowance whose partners have sufficiently high earnings or other income.

Council Tax Benefit

The October 2010 Spending Review announced that Council Tax Benefit (CTB) will be localised from 2013–14, but so far there are no concrete details on how this will be implemented in practice. This reform will affect Great Britain but not Northern Ireland, which still has a system of domestic rates and an associated rebate scheme that is unaffected by this reform.

It is difficult to see how a localised form of CTB could work alongside Universal Credit without undermining the government's aims of a simpler benefit system with more transparent and stronger incentives: a fully localised CTB could lead to a complicated and opaque benefit system, if the

hundreds of authorities that currently administer CTB each have their own rules for its replacement; and giving local authorities the ability to determine the withdrawal rate of CTB (or its replacement) could undermine any strengthening of work incentives that might arise when Universal Credit is introduced.

Perhaps the option that would do least harm to the government's aims of a simpler benefit system with stronger incentives to work would be to include CTB within Universal Credit (in a similar way to the proposed housing element), but to give local authorities the power to determine the basic entitlement to this council tax element. For example, local authorities could be given the power to determine what fraction of a household's council tax bill can potentially be rebated (it is currently 100%), or set caps on the amount that can potentially be rebated in cash terms or relating to the Band of a property, and where these limits could vary by family type (but not by income; the means-testing would arise through Universal Credit). Under such a scheme, CTB would become an integrated part of Universal Credit, but with certain parameters under the control of local authorities. However, such a benefit system would still be more complicated than one where DWP was responsible for policy on CTB, and it is not clear to us that the advantages (if any) of localising CTB policy offset this.

In our quantitative analysis, we have assumed that CTB will become a part of Universal Credit in a way similar to Housing Benefit;¹² this allows us to focus on the impact of Universal Credit per se, rather than the complication of future CTB reform.

Other

The housing component in Universal Credit will have different formulas for people who rent and people who need help with mortgage costs, and the government has not decided on the precise rules determining who is entitled to mortgage support, nor how much support they should receive.

The government will need to create new rules determining eligibility for in-kind benefits such as free school meals and exemption from

¹² We assume that CTB will form a part of the maximum entitlement to Universal Credit, and then be tapered in the same way as all other components of Universal Credit.

prescription charges. Currently, such entitlements are based on receipt of certain benefits, including IS, income-based JSA and income-related ESA, which are to be replaced by Universal Credit. The government has said that it will base entitlements on a family's income or earnings, and that it intends that broadly the same number of people will qualify under Universal Credit as do under the current system.

The government is considering whether to abolish the In-Work Credit and Job Grant. Both of these are payable to claimants of out-of-work benefits who move into work, and are intended to encourage and help with the transition into work.¹³

2.3 Summary

- The Universal Credit will combine the main means-tested benefits and tax credits, and be paid alongside the non-means-tested and contributory benefits.
- A family's basic entitlement will mirror that under the current set of out-of-work means-tested benefits, meaning most non-working families currently receiving benefits will be entitled to the same amount through Universal Credit. A 100% taper will apply to unearned income, and earned income net of income tax and NICs will be subject to a taper of 65%, with an earnings disregard.
- Recipients earning below a certain threshold will be subject to conditionality, in a similar way to recipients of current out-of-work benefits.
- Universal Credit will be administered by DWP. It will be paid monthly, and will be based on income in the previous month, which the government hopes to measure using HMRC's proposed real-time PAYE system.

¹³ An evaluation by IFS researchers found that IWC did encourage more lone parents to move into work, and that the extent of deadweight was lower than for other welfare-to-work programmes and comparable to that for other in-work tax credits. See M. Brewer, J. Browne, H. Chowdry and C. Crawford, *The Lone Parent Pilots after 24–36 Months: The Final Impact Assessment of In-Work Credit, Work Search Premium, Extended Schools Childcare, Quarterly Work Focused Interviews and New Deal Plus for Lone Parents*, DWP Research Report 606, 2009, <http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep606.pdf>.

- New claimants will start to receive Universal Credit from October 2013, and the government plans to move all existing recipients across over the subsequent four years. Households will be protected from cash losses at the point of transition if their circumstances do not change.
- The government has not yet announced decisions on many aspects of Universal Credit. Three of the most important design issues are whether to include Carer's Allowance within Universal Credit, how to replace the childcare element of Working Tax Credit, and what to do about Council Tax Benefit given the government's desire to give local authorities control over its generosity. It is likely that whatever decision is reached in each of these areas will either increase the cost to the taxpayer or involve a loss of income for some families (or both).

3. The structure of the Universal Credit and key differences from existing means-tested benefits and tax credits

This section discusses the structure of Universal Credit – by which we mean the rules that determine different families’ entitlements – in more detail. We also compare this with the structure of the existing means-tested benefits and tax credits to draw some general conclusions about which sorts of families are likely to win or lose or see work incentives strengthen or weaken; Sections 4 and 5 then present quantitative analysis of the winners and losers and of the impact of Universal Credit on work incentives across a representative sample of families in Great Britain.

In this section, we focus on four different family types: single adults with no children, lone parents, couples with no children and couples with children.

3.1 The structure of Universal Credit

A family’s basic or maximum entitlement

A family’s basic (or maximum) entitlement to Universal Credit will consist of a personal amount and additions for families in specific circumstances.

The personal amount will be higher for couples than for single people (but not twice as high), and be lower for some young people, similar to the personal allowance in Income Support.¹⁴

The additions will be for disability, housing costs and children. The disability additions will work in a similar way to disability premiums in means-tested benefits (although the government has said, in paragraph 22 of chapter 2 of the White Paper, that it is reviewing the number and nature of disability premiums in means-tested benefits). The housing component will be similar to Housing Benefit for social-sector tenants and Local Housing Allowance for private-sector tenants. The amounts for child additions will be based on the current rates of Child Tax Credit. This structure ensures that out-of-work benefit claimants are unlikely to be affected by the introduction of Universal Credit. The combination of the

¹⁴ Using the Office for Budget Responsibility’s latest (November 2010) forecasts for annual changes in the consumer price index (of 3.1%, 3.1%, 1.8% and 2.0% in September 2010, 2011, 2012 and 2013 respectively), the personal allowance in 2014 will be £113.40 for couples, £72.25 for single adults aged 25 or over and for lone parents, and £57.20 for younger single adults.

earnings disregards and the 65% rate of withdrawal against earned income in Universal Credit means it will extend further up the income distribution than the current set of out-of-work means-tested benefits, allowing the government to scrap Working Tax Credit.

Box 3.1 illustrates how to work out a family's maximum entitlement to Universal Credit.

Box 3.1. An example of calculating maximum entitlement to Universal Credit

In all cases, maximum Universal Credit entitlement = personal amount + child additions^a + disability addition^a + housing element^a.

For example, consider a couple with two children and no disability. If they rent from the local authority at £80 a week, their maximum Universal Credit entitlement consists of:

- a personal amount for a couple of £113.40 per week;
- child additions worth £119.90 per week;
- a housing element of £80 per week.

Thus their maximum weekly amount of Universal Credit = £113.40 + £119.90 + £80 = £313.30.

^a *If applicable.*

Taper and disregards

Universal Credit will have a taper rate of 65% for earned income (net of income tax and NICs), and a taper rate of 100% will apply to unearned income, with special rules for imputing investment income. Box 3.2 explains the difference between a taper applying to net earnings and one applying to gross earnings.

Some earnings will be disregarded before the taper applies. The size of the disregard will depend on personal circumstances, as set out in Table 3.1. The disregards will be reduced for families claiming help with rental costs or mortgage interest support (i.e. the equivalent to Housing Benefit and Support for Mortgage Interest), but subject to a 'floor', which also depends on the characteristics of the claimant and their family. Specifically, a family's disregard will be reduced by 1.5 times the value of that family's housing element; this prevents Universal Credit from extending far up the earnings distribution for those entitled to a large housing element. Box 3.3 gives an example of how the disregards work.

Unearned income will not be subject to a disregard at all, and will instead reduce Universal Credit entitlement pound-for-pound.

Furthermore, special rules will apply to investment income (mirroring the current treatment of investment income in means-tested benefits): instead of taking into account the actual amount of investment income, a claimant's financial capital will be used to calculate an imputed income. If total savings exceed £16,000, then a family will not be entitled to any Universal Credit. For savings between £6,000 and £16,000, an income of £1 a week will be imputed for every £250 of savings in excess of £6,000. So savings of £7,000 will lead to an imputed income of £4 per week. Box 3.3 also shows how unearned income reduces entitlement to Universal Credit.

Box 3.2. An example of a taper applying to net earnings

The main withdrawal rate in Universal Credit will be 65%, but it will apply to earnings *net* of income tax and National Insurance. By contrast, the main withdrawal rate in tax credits will be 41% from April 2011, but it will apply to earnings *gross* of income tax and National Insurance.

To see the difference, consider someone earning enough to be liable for income tax and National Insurance, and subject to a withdrawal of tax credits or Universal Credit, and whose income rises by £1 a week. Currently, 41p of tax credits will be withdrawn, 12p will be lost through National Insurance contributions and 20p through income tax. Thus 41p + 12p + 20p = 73p overall will be lost. Under Universal Credit, first 12p and 20p will be deducted through NICs and income tax, then 65% of the remaining 68p (i.e. 44.2p) will be withdrawn. The total amount lost will be 12p + 20p + 44.2p = 76.2p. For the combined marginal effective tax rate (METR) under Universal Credit to be equivalent to that under tax credits, the Universal Credit withdrawal rate would have to be set at 60% of net earnings. For working adults receiving tax credits but who do not pay income tax or NICs (this would apply to some low-earning lone parents and to some low-earning adults in two-earner couples), the METR would be 65% under Universal Credit and 41% in the current system.

In both cases, current recipients of tax credits (who are earning above the tax credit earnings threshold and who are not entitled to any means-tested benefits) will face a higher METR under Universal Credit than under the current regime.

Table 3.1. Maximum and minimum earnings disregards (per year)

| <i>Claimant type</i> | <i>Maximum disregard</i> | <i>Minimum disregard</i> |
|---|--------------------------|--|
| Single adult | 0 | 0 |
| Couple without children | £3,000 | £520 |
| Couple with at least one child | £5,700 | £1,040 + £260 for each of the second and subsequent children |
| Lone parent | £7,700 | £2,080 + £260 for each of the second and subsequent children |
| Disabled person (if a claimant or either partner in a couple is disabled) | £7,000 | £2,080 |

Box 3.3. An example of how disregards and the taper will work

The amount of Universal Credit payable is the maximum amount that is applicable to the family less unearned income (including imputed income from capital) less 65% of {net earned income less the applicable disregard}.

If a family has no earned or unearned income, it will receive the maximum amount of Universal Credit. (An example is provided in Box 3.1.)

We now give an example to illustrate how different types of income will reduce Universal Credit entitlement.

Suppose a couple with two children and no disability rent at £80 a week from the local authority. As explained in Box 3.1, their maximum entitlement to Universal Credit is £313.30 per week.

From Table 3.1, their maximum annual earnings disregard is £5,700 and their disregard floor is $£1,040 + £260 = £1,300$.

They receive housing support of £80 per week (£4,160 per year). Deducting $1.5 \times £4,160 = £6,240$ from the maximum disregard of £5,700 gives a negative amount, so the disregard floor of £1,300 per year (£25 per week) applies to this family.

Suppose the couple have savings of £10,000. This is considered to generate a weekly income of $(£10,000 - £6,000)/250 = £16$.

Suppose one partner earns £400 per week before income tax and National Insurance (corresponding to net earnings after income tax and NICs of £322.31 per week).

The amount of Universal Credit they will actually receive is $£313.30 - £16 - 0.65 \times (£322.31 - £25) = £104.05$ per week. This is because the £16 imputed unearned income reduces their Universal Credit entitlement by £16; their after-tax (or net) employment income is partially disregarded and then reduces their Universal Credit entitlement at the 65% taper rate.

This treatment of investment income and other unearned income is identical to the way that means-tested benefits currently operate. But it is different from the treatment of such income in tax credits, as we now explain:

- In tax credits, there are no mechanical limits on the level of financial capital that families can own and still receive tax credits. Investment income below £300 per year is ignored altogether, and investment income above £300 per year, as well as all other unearned income, is subject to, at most, a 41% taper. The most extreme difference between this and the Universal Credit treatment of investment income and capital is for families with financial assets in excess of £16,000: such families will never be entitled to any Universal Credit, but currently could be entitled to tax credits; indeed, with an interest rate of 3%, savings of £16,000 would reduce tax credit entitlement by £1.42 a

week,¹⁵ but the same level of savings would mean that a family will lose all entitlement to Universal Credit. Having capital limits in Universal Credit limits the payment of Universal Credit to those who have both a low income and low levels of savings. But the mechanism will give some families a strong incentive to lower their financial capital to below £16,000 and will give others a strong incentive not to accumulate more than this amount.

- In tax credits, many types of unearned (non-investment) income are completely or partly disregarded in the current system. Some income, such as maintenance payments from former partners (which are particularly important for lone parents), currently does not count as income for the purpose of tax credits. This income will be considered as income under the system of Universal Credit, and therefore will reduce entitlement pound-for-pound. Other types, such as widows' pensions and private pensions, count as income for both existing out-of-work benefits and Universal Credit. Such income will be tapered at 100% under Universal Credit, instead of the 41% in Child Tax Credit for some workless families.

The earnings disregards are very important parameters in Universal Credit. In general, the generosity of Universal Credit for a family with a given income depends on three aspects of Universal Credit:

- the basic entitlement for that family
- and, if that family has positive earnings,
- the size of the earnings disregard and
 - the withdrawal rate.

The government has said it will set the basic entitlement to Universal Credit at levels that match entitlement to the current set of out-of-work benefits, maximum entitlement to Child Tax Credit (for child additions) and Local Housing Allowance or its equivalent for those in social housing (for the housing element), and that the disability additions will be broadly similar to the disability premiums in means-tested benefits. This will ensure that the vast majority of workless families receiving Universal Credit will be entitled to the same amount of benefits as they are under the

¹⁵ $\{(0.03 \times 16,000) - 300\} \times 0.41 = \text{£}73.80/\text{year}$ or $\text{£}1.42/\text{week}$.

current system. The government has also decided that there will be only one withdrawal rate for earnings in Universal Credit, of 65% (of after-tax earnings), across all family types and all ranges of earnings. Given these two decisions, the only way in which the government can vary Universal Credit entitlements across different family types for a given level of earnings is through the earnings disregards.¹⁶ As we show in the next subsection, the government has suggested values for the disregards that mean that working families currently entitled to tax credits will receive broadly the same level of support through Universal Credit as they do under the existing system, but there are important differences between family types.

One reason for this variation between family types is that it is impossible for Universal Credit to replicate the way in which the current system treats lone parents. Under the current system, the basic entitlement to Working Tax Credit for a lone parent is greater than their basic entitlement to out-of-work benefits. For a lone parent who is not entitled to Housing Benefit or Council Tax Benefit, and whose earnings are below the income tax personal allowance and the point at which tax credits start to be withdrawn, this means that the government can pay out more benefits and tax credits to them when they are working than when they are not working. (This can occur for lone parents working at least 16 hours a week but who have sufficiently low earnings, and is reflected in an example in Figure 3.2b later.) This situation is possible because entitlements to WTC can be set separately from entitlements to the out-of-work means-tested benefits. Such a situation cannot arise under Universal Credit, with its much simpler structure of just a basic entitlement, a single withdrawal rate and an earnings disregard. Inevitably, therefore, some working lone parents will lose out (ignoring transitional protection) from the move to Universal Credit.

¹⁶ Although, clearly, families that have earnings below the disregard do not benefit from a rise in that disregard (unless it induces them to change their behaviour); the only way for Universal Credit to be more generous to such families is through a rise in the basic entitlement for that family type.

3.2 *A comparison of Universal Credit entitlements against the existing system*

This subsection directly compares entitlements to Universal Credit with entitlements to the current set of means-tested benefits and tax credits using four examples, each of a different family type. The aim is to highlight some of the key differences and how they affect both net incomes and incentives to work.

Single adult

Figure 3.1a shows the budget constraint for a single adult aged over 25, with no children and no disability, earning £6.50 an hour, with no unearned income and with Local Housing Allowance of £60 per week.

Such a person will be better off under Universal Credit if he works for less than 30 hours a week as a result of the lower withdrawal rate in Universal Credit than in the current out-of-work means-tested benefits. He will be worse off under Universal Credit if he works between 30 and 39 hours a week (and is currently entitled to Working Tax Credit).

If this adult works for more than 39 hours a week, he will be unaffected by the reform. The convergence comes at the point where the person's income would be too high for him to receive any benefit payments in either system.

The key point above which this individual loses from the reform (up to 39 hours a week and under these particular assumptions) is 30 hours a week. This is because the current system produces a sharp increase in net income when the number of working hours reaches 30, the minimum hours needed to be eligible for Working Tax Credit for those without children.

This has an implication for work incentives. One measure of the incentive to work at all is the participation tax rate (PTR), which measures the percentage of earnings that are lost in tax or withdrawn benefits when an individual moves into work.¹⁷ As seen in Figure 3.1b, a lower proportion of earnings will be lost through tax and withdrawn benefits if this individual takes a part-time job of between 2 and 30 hours a week under Universal Credit than under the current system. Thus the incentive to take such a job

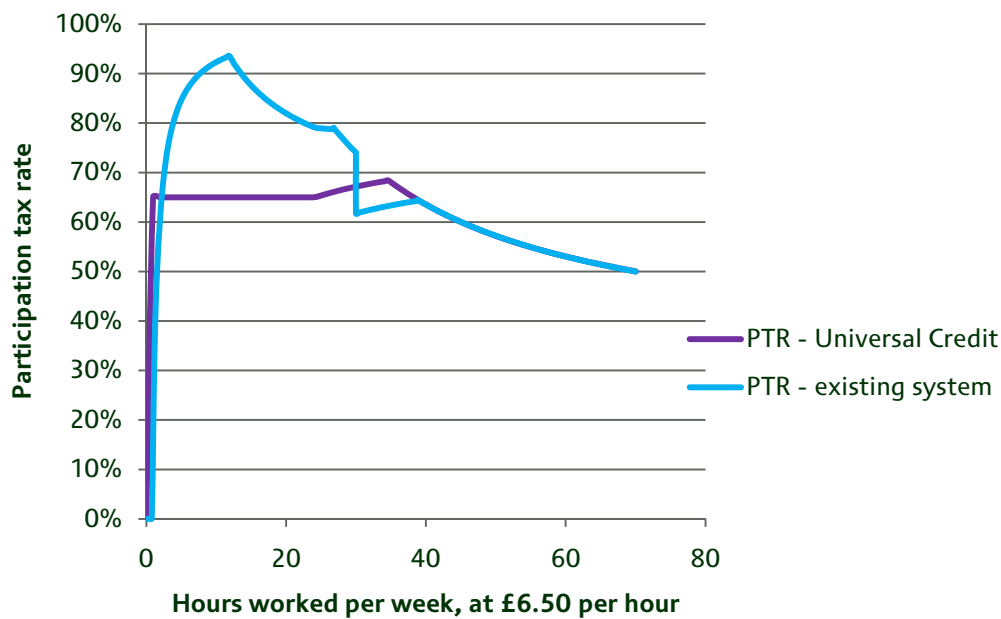
¹⁷ See Section 5 for more details.

as opposed to remaining unemployed will be stronger under Universal Credit. However, the incentive for this person to work between 30 and 39 hours a week is weaker under Universal Credit, as a greater proportion of his earnings will be lost in tax and withdrawn benefits than under the current system.

Figure 3.1a. Budget constraint under Universal Credit for an example single adult



Figure 3.1b. Work incentives under Universal Credit for an example single adult



Notes: Both figures are based on an assumed single adult: he can choose how many hours to work at a given wage rate, £6.50 per hour; his eligible rent is £60 per week; and he has no disability and no unearned income.

Lone parent with two children

Figure 3.2a shows the budget constraint for a lone parent with two children and no disability, earning £6.50 per hour and with no housing costs and no unearned income.

The graph illustrates how Universal Credit removes many of the kinks in the existing system that result from the hours rules in WTC, the interaction between different benefits and the simultaneous withdrawal of benefits. As a result, the net impact of the reform depends on the current working hours in a complicated way.

If the lone parent works for less than 16 hours a week, she will be better off under Universal Credit than under the current system. This is mainly a result of the substantial earnings disregard in Universal Credit, at about £150 per week. As reflected in Figure 3.2b, the lone parent can keep all her earnings if she works 23 hours a week or less under Universal Credit. In contrast, she faces a 100% marginal effective tax rate (after a £20 a week disregard) if she works for less than 16 hours a week in the current system. On the other hand, the current regime gives a strong incentive for lone parents to work for 16 hours a week through the generous WTC.¹⁸ Overall, Universal Credit clearly improves the lone parent's incentive to work less than 16 hours a week.

If the lone parent works for more than 30 hours a week, however, she will be slightly worse off under Universal Credit. This appears to be the result of the removal of WTC, which has a higher personal amount than Universal Credit. Also, the combination of Universal Credit, income tax and NICs gives rise to a marginal effective tax rate of 76.2%, which is higher than the combined rate of 73% from tax credits, income tax and NICs under the current system. This means that the losses for this lone parent increase the more hours she works above 30 hours per week.

¹⁸ The minimum number of weekly hours required for lone parents to claim WTC is 16. The relative generosity of WTC for lone parents leads to the lone parent receiving more from the state when working 16 hours a week than when not working at all, which gives her a negative PTR at this point.

Figure 3.2a. Budget constraint under Universal Credit for an example lone parent with two children

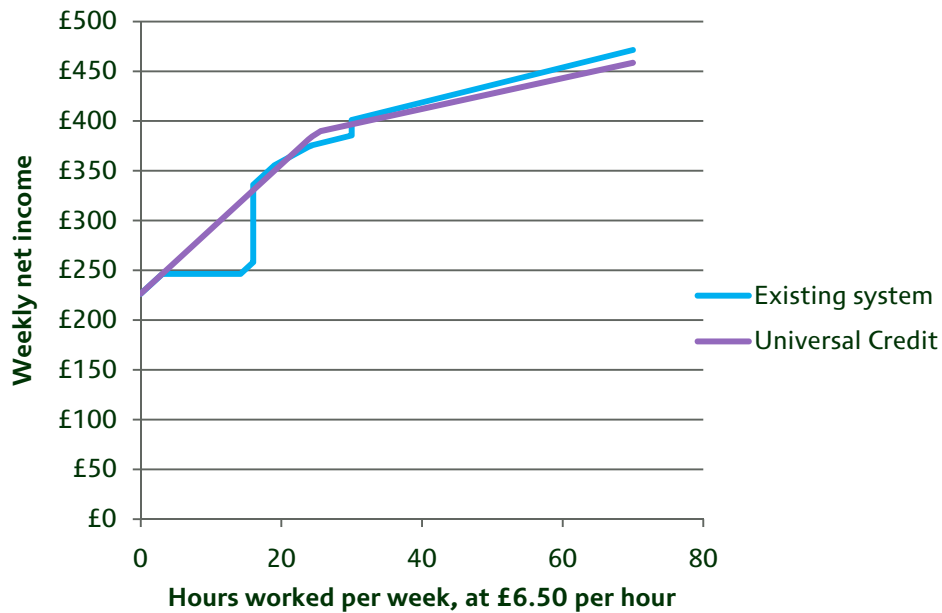
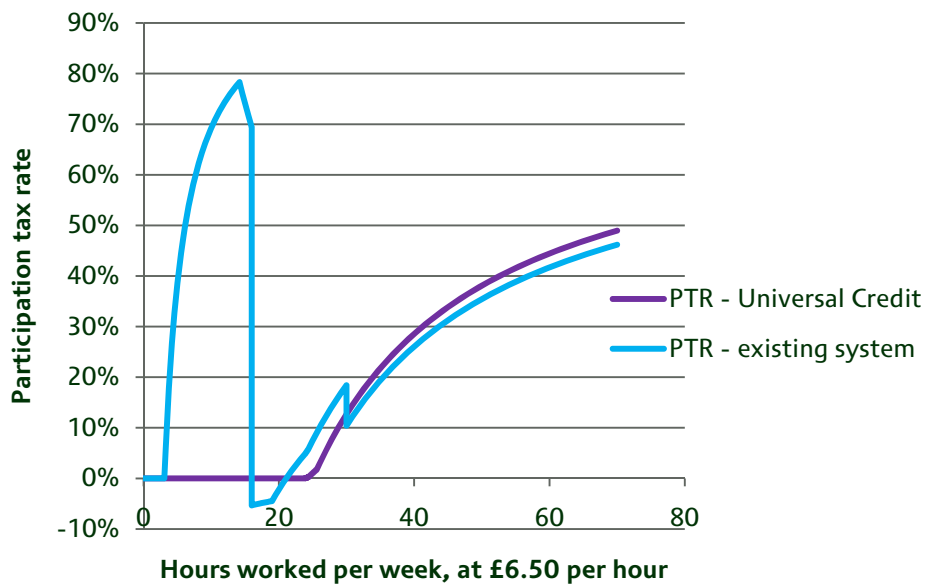


Figure 3.2b. Work incentives under Universal Credit for an example lone parent with two children



Notes: Both figures are based on an assumed lone parent with two children: she can choose how many hours to work at a given wage rate, £6.50 per hour, and she has no housing costs, no disability and no unearned income.

Couple with two children

Figure 3.3a shows the budget constraint for an adult in a couple with two children who earns £10 per hour. We assume that the spouse is out of work and that neither partner is disabled. They have no unearned income and their Local Housing Allowance is assumed to be £100 per week.

For any positive number of working hours, the family will be better off under Universal Credit than under the current system; and its net income will be no different under Universal Credit if both partners are out of work.

The gains are attributable to the lower withdrawal rate of Universal Credit compared with the combined withdrawal rate of WTC and Housing Benefit in the current system. The Universal Credit system will create a marginal effective tax rate that is stable around 65% to 76.2% for most working hours. The current system, however, involves a 100% rate as Income Support is withdrawn at low hours, and an approximately 90% rate due to the combination of WTC and Housing Benefit withdrawal at higher levels of hours worked.

The gap between the two budget constraints translates to significant differences in participation tax rates. As seen in Figure 3.3b, the incentive to work for any positive number of hours will be higher under Universal Credit than under the existing system. The difference is particularly pronounced at low hours of work, because of the pound-for-pound withdrawal of Income Support under the current system.

Figure 3.3a. Budget constraint under Universal Credit for an example couple with two children

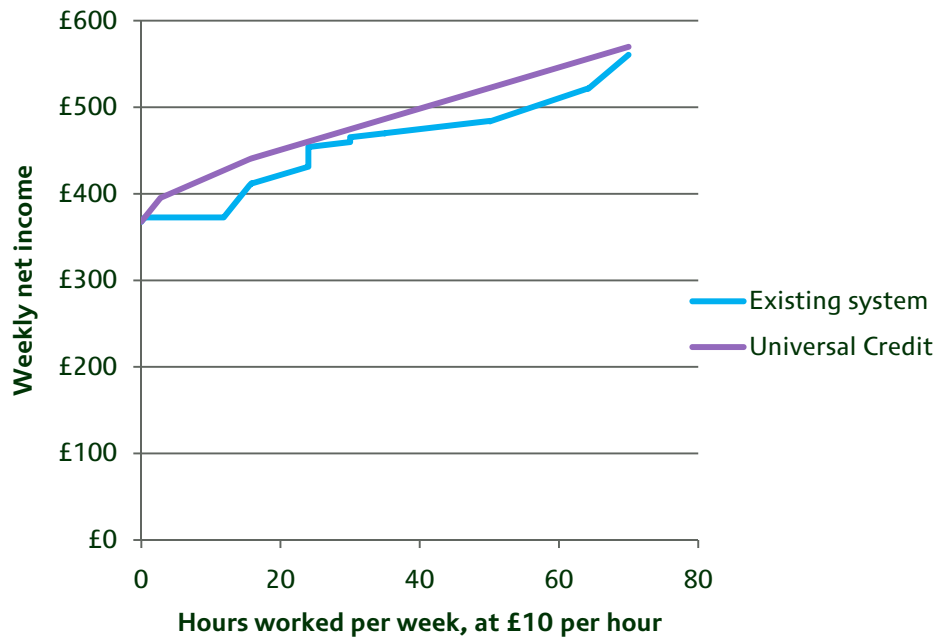
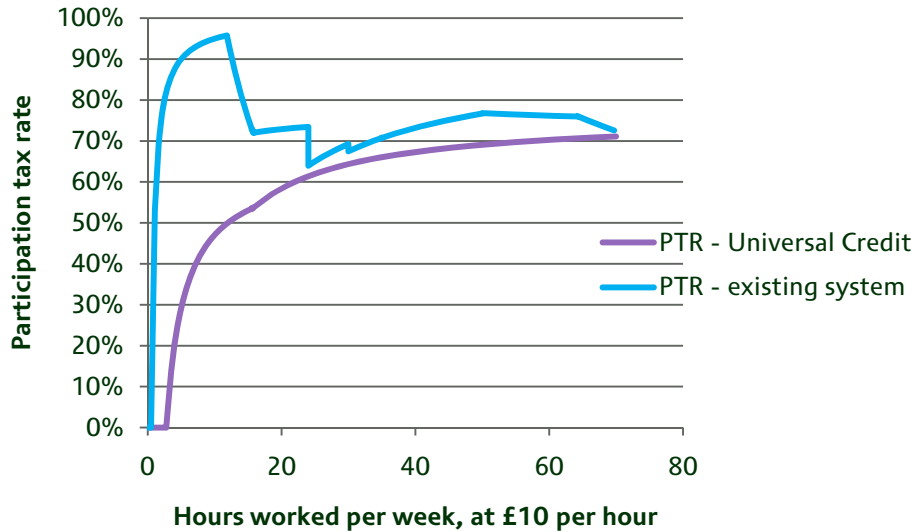


Figure 3.3b. Work incentives under Universal Credit for an example couple with two children



Notes: Both figures are based on an assumed couple with two children: one partner can choose how many hours to work at a given wage rate, £10 per hour; the other is out of work; their LHA is £100 per week; and they have no disability and no unearned income.

Second earner in couple with no children

Figure 3.4a shows the budget constraint for the second earner in a couple with no children who is assumed to earn £6.50 per hour. The first earner is assumed to work for 35 hours a week at £7 per hour, neither is disabled, both have no unearned income and the applicable LHA rate is £80.

If the spouse does not work, then the family will be better off under Universal Credit than under the current system (just as the single-earner couple with children was better off): such a family's entitlement to Universal Credit will be higher than its entitlement to Working Tax Credit under the current system. In fact, the family will be better off provided the second earner works no more than about 10 hours a week. Essentially, this is because of the higher personal allowance for couples in Universal Credit than in WTC. As the second earner's working hours rise, their entitlement to Universal Credit will fall gradually to the point at which the higher maximum entitlement to Universal Credit will be outweighed by its higher withdrawal rate.

As Figure 3.4a shows, the budget constraint is flatter under Universal Credit than under the existing system for short working hours. At that range (approximately 1 to 14 hours a week), the marginal effective tax rate is 65% under Universal Credit, and 41% under the existing system due to WTC. In this sense, the incentive for the second earner to work a little more is weaker under Universal Credit than under the current system.

Figure 3.4b illustrates the differences in PTRs between the current system and the Universal Credit system. In both, the disincentive to work is generally higher for shorter hours of work than for full-time work. This is mainly because means-tested benefits start to be withdrawn as one starts work, at a (combined) rate much higher than the effective tax rate (32%) for basic-rate taxpayers (and there would be no more benefits to be withdrawn when both adults work long hours). Moreover, Figure 3.4b suggests that the second earner's incentive to start work is generally weaker under Universal Credit (unless the second earner is to start a job that takes less than 3 hours a week). The primary reason is that Universal Credit treats the couple more favourably than the current system when only one partner is in work, and it treats them the same as the current system when both partners work long hours.

Figure 3.4a. Budget constraint under Universal Credit for an example couple without children

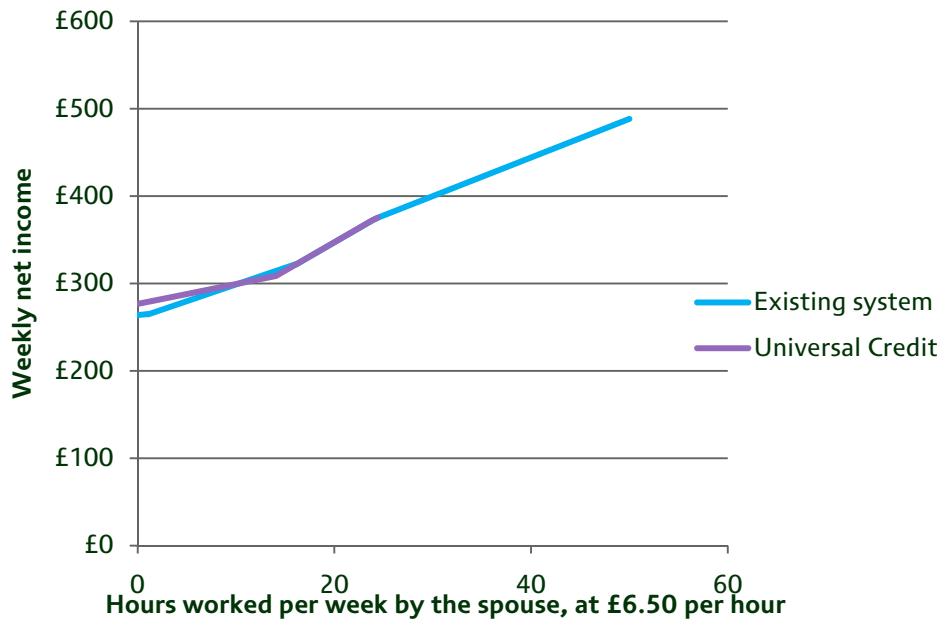
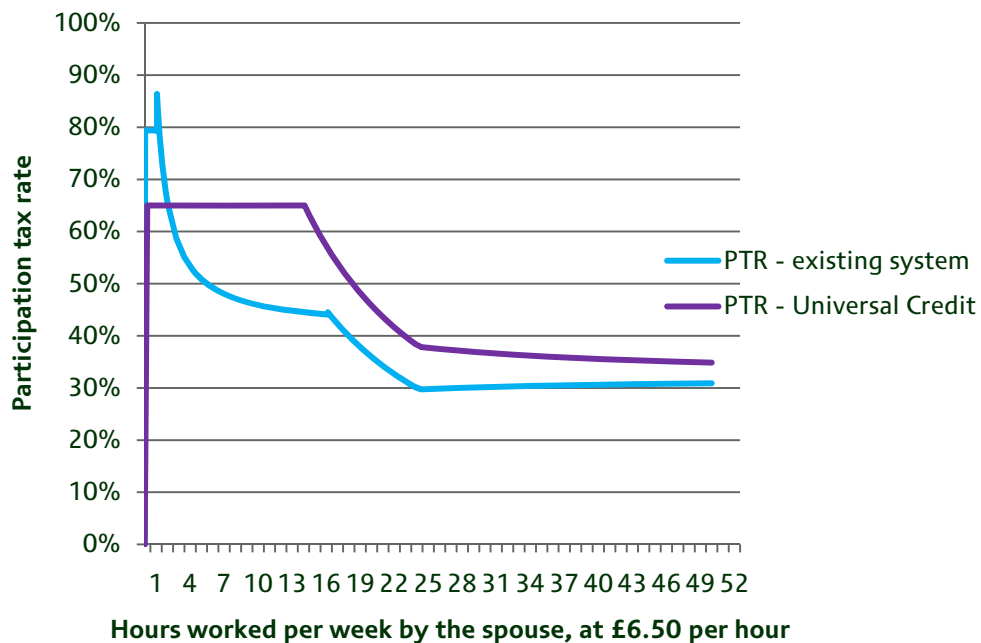


Figure 3.4b. Work incentives under Universal Credit for an example couple without children



Notes: Both figures are based on an assumed couple without children: one partner can choose how many hours to work at a given wage rate, £6.50 per hour; the other works 35 hours a week at £7 per hour; their LHA is £80 per week; and they have no disability and no unearned income.

3.3 Summary

This section has shown the following:

- Basic entitlements to Universal Credit have been set so that the majority of workless families receiving means-tested benefits will receive the same amount of benefits as they do under the current regime. But families in work and currently receiving means-tested benefits or tax credits are likely to see entitlements change under Universal Credit (ignoring transitional protection).
- A 100% withdrawal rate will apply to unearned income, but earned income will be subject to a 65% withdrawal rate (applying to net earnings) after a disregard. This treatment of unearned income is identical to that under the current set of means-tested benefits but harsher than currently applies under tax credits. In particular, the fact that Universal Credit will have capital rules based on those currently in means-tested benefits means that working families with earnings low enough to receive Universal Credit will have a strong incentive to keep their savings below £16,000.
- The 65% withdrawal rate applying to earned income will lead to a lower marginal effective tax rate for people in work currently facing withdrawal of an out-of-work benefit, or withdrawal of both tax credits and Housing Benefit. It will lead to a slightly higher METR for people in work who currently pay basic-rate income tax and National Insurance and face a tax credit withdrawal, and it will mean a higher METR for people in work who earn too little to pay income tax or National Insurance but currently face a tax credit withdrawal.
- Whether a working family wins or loses from the reform depends crucially on its number of working hours.
- Universal Credit will typically improve the incentive for couples to have one person in work, particularly if they only wish to work part-time, but will typically worsen the incentive for both members of a couple to work rather than just one.

4. Winners and losers, and the cost to government

The government presented some preliminary analysis of the impact of Universal Credit on family incomes and financial work incentives in chapter 7 of the White Paper. In this section, we present our own preliminary analysis of Universal Credit as it might operate in 2014–15, conducted on a similar basis.

This analysis should not be taken as definitive, for many reasons:

- We have assumed full take-up of all existing benefits and of Universal Credit (consistent with the analysis in chapter 7 of the White Paper).
- We have assumed no behavioural response to Universal Credit (consistent with the analysis in chapter 7 of the White Paper).
- We have had to make a number of assumptions about the operation of Universal Credit. These were necessary partly because the government has not yet reached final decisions on many aspects of Universal Credit's operation (Section 2 referred to some of these), but also because there are some technical issues, such as the precise definition of 'income', where we suspect the government has made final decisions but which are not reported in the White Paper.
- To avoid our results being overly affected by our assumptions, we have deliberately simplified the existing benefit system in some areas and deliberately excluded certain types of families from our analysis.

Our reform system is our best guess of how Universal Credit might operate in 2014–15, and our comparison system (i.e. the system representing a world without Universal Credit) is our estimate of what the tax and benefit system would look like in 2014–15 were Universal Credit not to be introduced, reflecting all announcements in the June 2010 Budget and the October 2010 Spending Review, and reflecting the forecasts of inflation and earnings growth published by the Office for Budget Responsibility (OBR) on 29 November.¹⁹ All cash changes are in 2014–15 prices.

We have modelled the introduction of Universal Credit with and without transitional protection. The analysis without transitional protection can be thought of as the long-run impact of the reform (but assuming full take-up and no behavioural responses). The analysis with transitional protection

¹⁹ <http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html>.

provides an upper bound on the cost or generosity of the reform, because it simulates a world where all families are transferred to Universal Credit in 2014–15 and no family has experienced a change in circumstances. In reality, the government has said it will move existing recipients of benefits and tax credits to Universal Credit by October 2017 and that transitional protection will not apply when a family's circumstances change.

Full details of our modelling are given in Box 4.1.

Box 4.1. Modelling Universal Credit: details

The system with Universal Credit is constructed as follows:

Basic entitlements to Universal Credit for most family types are set equal to the value of Income Support / Jobseeker's Allowance and Child Tax Credit that they would be entitled to in a counterfactual 2014–15 tax and benefit system.

The values of the Universal Credit thresholds are taken from appendix 3 of the White Paper, updated to 2014–15 values with the forecast of the consumer price index (CPI) given by the OBR.

Earned and unearned income are defined in the same way as for current means-tested benefits.^a

Earned income reduces Universal Credit awards after a disregard and with a withdrawal rate of 65%. Unearned income reduces Universal Credit awards with a withdrawal rate of 100% and no disregard.

The housing component of Universal Credit is set equal to households' eligible rent (if in social housing) or our estimate of their applicable LHA rent (if in private rental housing).

Universal Credit is assumed to have a component replacing Council Tax Benefit, which means that each family's maximum entitlement of Universal Credit is increased by its liability to council tax; this is assumed not to affect the earnings disregard.^b

This modelling means that most families that have no income of their own and are receiving out-of-work means-tested benefits will not be affected by a move to Universal Credit.

The following simplifications are made:

Sure Start Maternity Grant and Cold Weather Payment are turned off in the base and reform systems.

Entitlement to free school meals and other in-kind benefits is turned off in the base and reform systems.

Support for childcare (through tax credits and HB/CTB) is turned off in the base and reform systems (by assuming that no family spends any money on formal childcare).

Support for Mortgage Interest is turned off in the base and reform systems.

The following families are excluded from the analysis:

- those containing a full-time student;
- those whose members are all aged under 18;
- those where any adult is aged 60 or over.

Continues

Box 4.1 continued

As the text states,

We assume full take-up of all existing benefits and of Universal Credit (consistent with the analysis in chapter 7 of the White Paper) and we assume no behavioural response to Universal Credit (consistent with the analysis in chapter 7 of the White Paper). We model the introduction of Universal Credit with and without transitional protection. The analysis without transitional protection can be thought of as the long-run impact of the reform (but assuming full take-up and no behavioural responses). The analysis with transitional protection provides an upper bound on the cost or generosity of the reform, because it simulates a world where all families are transferred to Universal Credit in 2014–15 and no family has experienced a change in circumstances.

^a As Section 3 noted, this will be different from the definition of income currently used in tax credits.

^b The Spending Review announced that Council Tax Benefit will be localised from 2013–14, but neither the White Paper nor the Spending Review gave any more concrete details on how this would work. We discuss in Section 2 how a localised form of CTB could work with Universal Credit without undermining the government's aim of a simpler benefit system with stronger incentives.

4.1 Preliminary analysis

Overall, 2.5 million working-age families will gain from the introduction of Universal Credit, 1.4 million working-age families will lose out in the absence of transitional protection,²⁰ and 2.5 million working-age families will see no change in their disposable income because their entitlements to Universal Credit will match their current entitlements to means-tested benefits and tax credits.²¹

As mentioned earlier, the government plans to provide transitional amounts to all potential losers so that they will not be worse off in cash terms. Over time, however, as their benefit payments are frozen while other people's are uprated in line with inflation, the real value of their disposable income will inevitably be lower than under the existing system.²²

²⁰ And in the long run, when the transitional top-ups run out, assuming no behavioural response and no changes in personal circumstances.

²¹ A further 13.6 million families will not be affected by the reform because their incomes are too high to qualify for any means-tested welfare payments in either system.

²² Assuming positive inflation, no change in personal circumstances and no behavioural responses.

On average, families that stand to gain will see a 7.8% increase in their disposable income, which amounts to £27.82 per week in 2014–15 for each family. In the absence of transitional protection, the average family that loses will be worse off by 6.7% (or £26.09 per week). Overall, and ignoring transitional protection, Universal Credit will lead to a 0.3% average increase (i.e. £1.64 per week) in income across all working-age families. With transitional protection, the average increase in income in 2014–15 will be 0.6% or £3.48 per week.

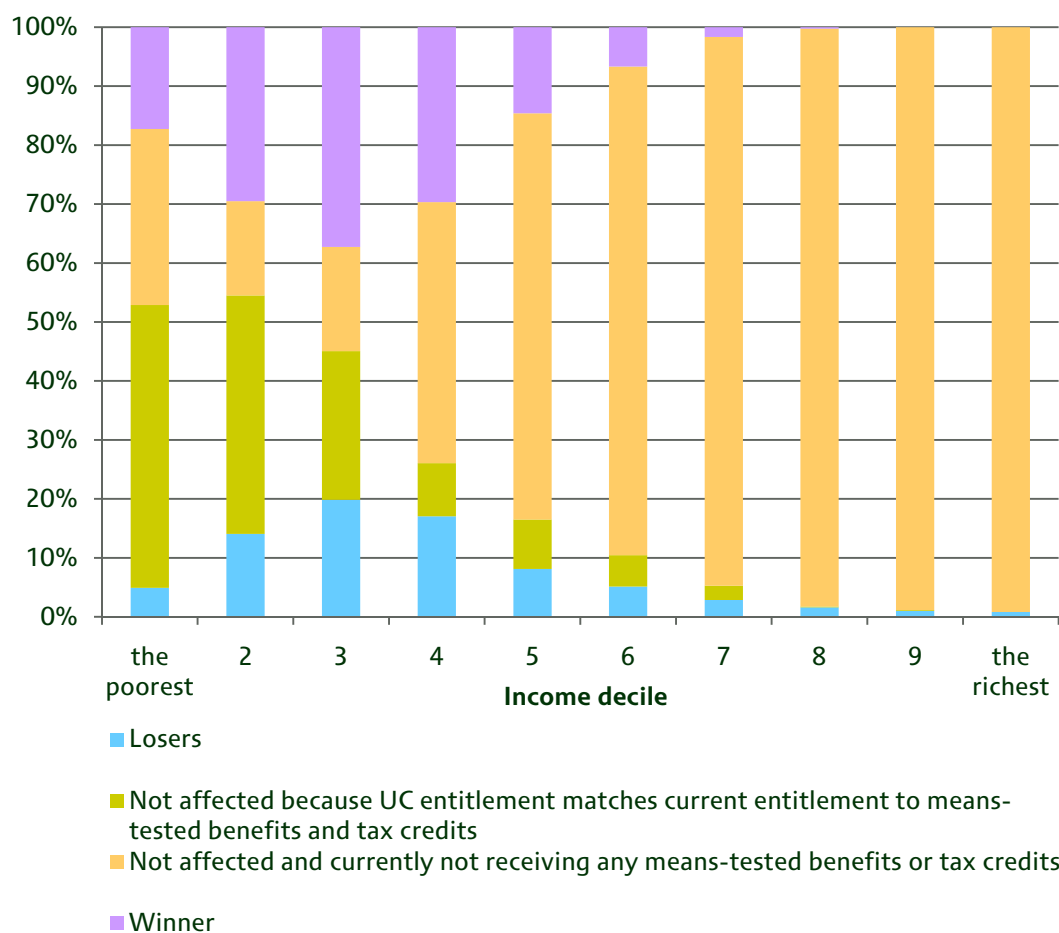
Under our assumptions, the new system of Universal Credit will be more expensive than the existing regime by £1.7 billion per year in the long run (i.e. ignoring transitional protection). Note that this assumes full take-up in both the existing and Universal Credit systems, and therefore does not include the cost of any increase in take-up arising from Universal Credit.

If no family lost out from the move to Universal Credit, then the cost would be £3.6 billion. But this is not a sensible estimate of the short-run cost of Universal Credit with transitional protection, for several reasons. First, the government is not planning a ‘big bang’ introduction of Universal Credit, but will instead move existing claimants across to Universal Credit over a three-and-a-half-year period. Second, transitional protection only applies to claimants of Universal Credit who are claiming benefits or tax credits at the instant they are moved across; and, as time goes on, a greater fraction of Universal Credit recipients will be ‘new’ claimants who were not previously receiving benefits or tax credits. Finally, the number of families eligible for transitional protection will fall because the transitional protection for existing recipients applies only while claimants’ circumstances are unchanged, and the protection applies only in cash (rather than real) terms. However, in what follows, we also present analysis where no family loses from the move to Universal Credit (in other words, we set families’ Universal Credit entitlement to the greater of their entitlement to benefits and tax credits and their entitlement to Universal Credit) and we refer to that as ‘with transitional protection’.

4.2 Across the income distribution

Figure 4.1 illustrates the proportions of winners and losers in the long run from the reform by income decile.²³ In each of the bottom six income decile groups, there are more winners than losers. The richest 40% are unlikely to be affected because they do not receive any means-tested benefits or tax credits under the current regime; when they are affected,

Figure 4.1. Winners and losers by income decile group, without transitional protection

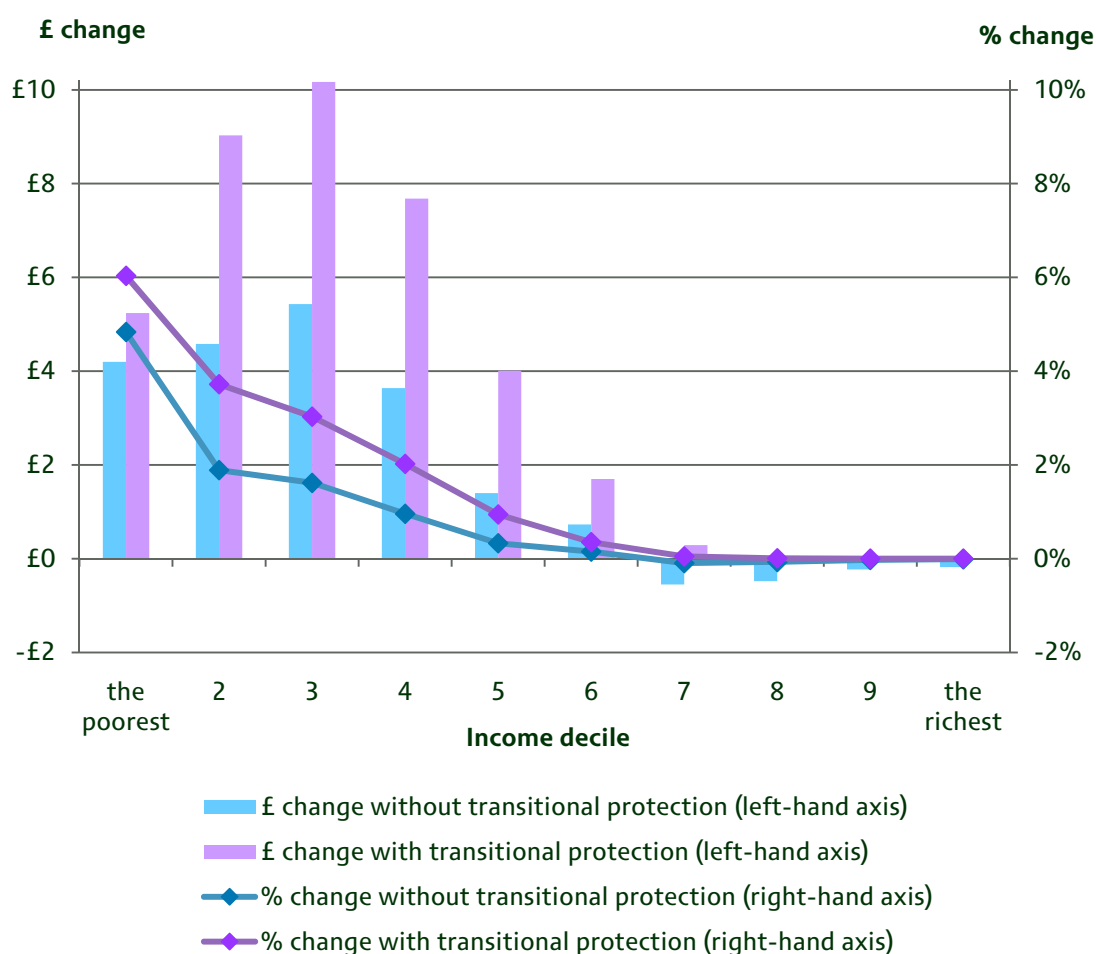


Notes: Excludes families with a full-time student, those in which all members are aged under 18 and those with someone aged 60 or over. Assumes full take-up and ignores behavioural response. See Box 4.1 for other details. Income decile groups are based on equivalised family income using the McClements equivalence scale.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2008–09 Family Resources Survey.

²³ The income deciles are based on families' income relative to the whole Great Britain population. But the sample used here does not include, among others, those aged 60 or over.

Figure 4.2. Average impact on disposable income by income decile group



Notes: As for Figure 4.1.

Source: As for Figure 4.1.

they are more likely to lose in the long run rather than gain. A substantial proportion of current welfare recipients in the bottom three deciles are not affected, because Universal Credit is designed to be as generous as the current system of means-tested benefits for workless families.

As a fraction of income, Universal Credit will benefit poorer families more than richer ones in the long run, in a pattern that is progressive (see Figure 4.2).²⁴ Ignoring transitional protection, the poorest 10% of families will see a 4.8% increase in their income, on average. The percentage gain then falls gradually from 1.9% in the second decile to 0.2% in the sixth decile,

²⁴ This uses the strict definition of ‘progressive’, being where the benefit as a fraction of income declines as income rises, but we note that this word now seems to mean many different things in current political discourse.

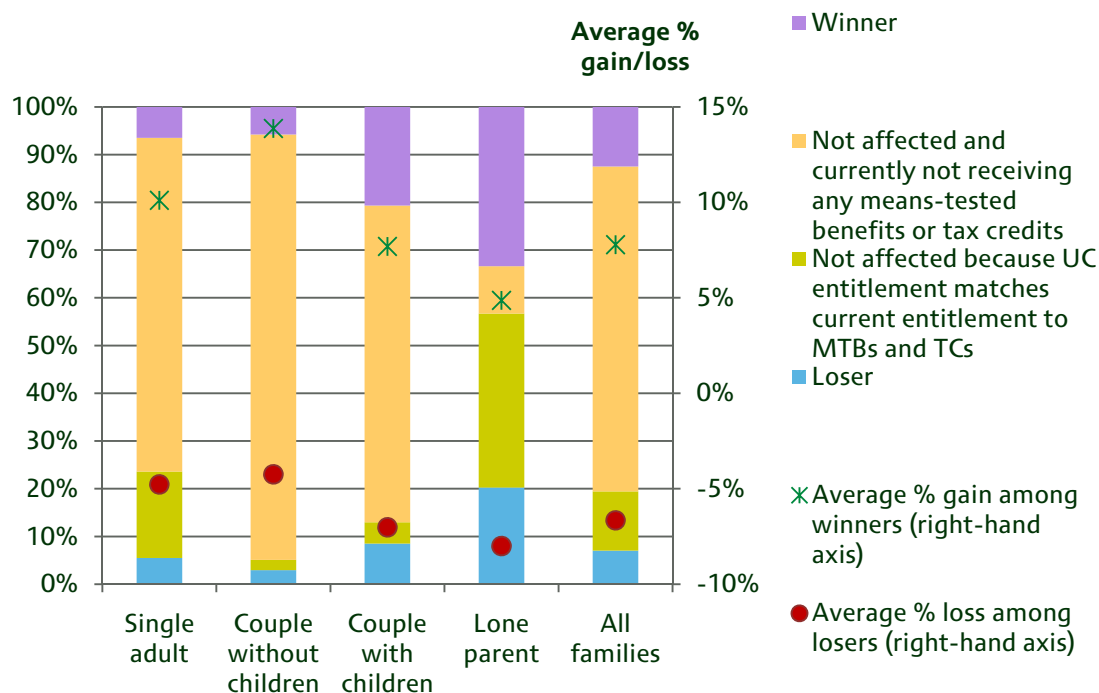
while the richest 40% will see some small losses on average in the long run. In absolute terms, the average weekly gains will be highest for families in the third decile.²⁵

The overall picture in Figure 4.2 (without transitional protection) is quite similar to the long-run impact analysis in the White Paper (figure 11 in its chapter 7). There are significant differences over the impact on the bottom decile, but this income group includes many families in unusual circumstances or with unstable or miscellaneous incomes.

4.3 Across different types of families

Figure 4.3 shows the proportions of winners, losers and non-affected by family type in the long run. In the long run, families with children are much more likely to be affected than those without, both positively and negatively; and single-adult families are more likely to be affected than

Figure 4.3. Winners and losers by family type, without transitional protection



Notes: As for Figure 4.1.

Source: As for Figure 4.1.

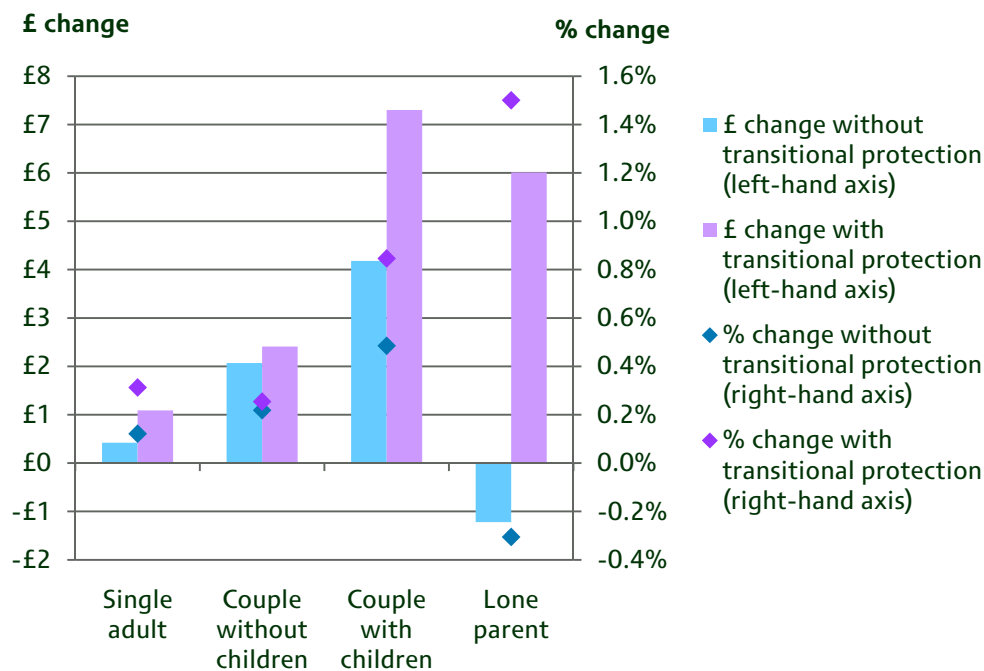
²⁵ It turns out that within all four of the family types analysed in Section 4.3, the cash gains are highest in the bottom decile group. However, there are few couples in the bottom decile group, and, as will be discussed later, couples tend to benefit more than single people from the introduction of Universal Credit.

couple families, both with and without children. Lone parents are the most affected group: about 610,000 lone parents (33%) will benefit from the introduction of Universal Credit, and, in the long run, around 370,000 (20%) will lose, and about 670,000 (36%) will not be affected because of the similarity between Universal Credit and the current system (rather than because they are too rich).

As shown in Figure 4.3, the average percentage gain among the winners ranges from 4.9% of net income for lone parents to 13.9% for couples without children. Among the losers, the average percentage loss in the long run ranges from 4.2% of net income for childless couples to 8.0% for lone parents.

Figure 4.4 illustrates the long-run changes in disposable income in both cash and proportional terms, averaged across all families for each type. Single adults will gain little on average: a small proportion of them will gain and a similar proportion will lose (in the absence of transitional protection). In the long run, couples without children will tend to gain the most, and lose the least, when affected, but they will be the least likely to be affected, and so the average impact on them will be a small gain. These families will also benefit little from transitional protection because they

Figure 4.4. Average impact on disposable income by family type



Notes: As for Figure 4.1.

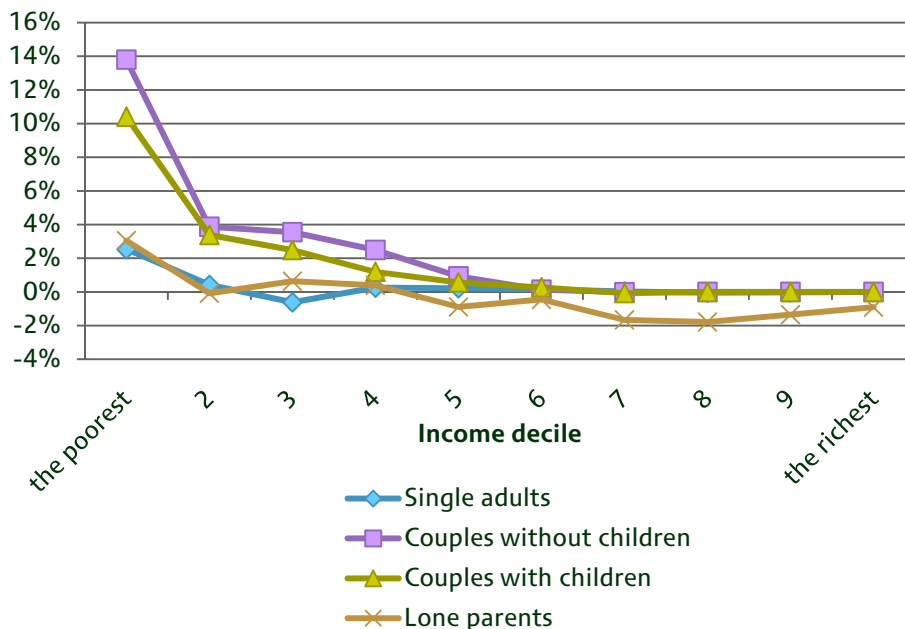
Source: As for Figure 4.1.

are very unlikely to lose out anyway. In the long run, couples with children will gain the most, on average, gaining an average of £4.18 per week (0.48% of their income). Lone parents will lose the most, on average, in the absence of transitional protection, but will also have the highest proportional gain in the presence of it, because a larger proportion of lone parents will be eligible for transitional protection than of any other family type (as seen in Figure 4.3).

Ignoring transitional protection, Figure 4.4 suggests that, in the long run, single people will fare worse than couples, with or without children. This is true in all deciles in the bottom half of the income distribution, as shown in Figure 4.5. The couple-favouring pattern is a result of the interplay of a few factors, including:

- the relative generosity of the current benefit and tax credit systems towards lone parents relative to couples with children, and towards single adults relative to couples without children;
- the structure of Universal Credit;
- the differences in employment status across families.

Figure 4.5. Average percentage impact on disposable income by family type and income decile, without transitional protection



Notes: As for Figure 4.1.
Source: As for Figure 4.1.

An important component in explaining the pattern of gains and losses under Universal Credit by family type is the relationship between maximum WTC entitlement under the current system compared with entitlement to Universal Credit for working families. Entitlement to Universal Credit for working families will, in turn, depend upon the Universal Credit personal allowance, the size of the earnings disregard and the withdrawal rate.²⁶ As the withdrawal rate is common to all family types, it does not help explain the pattern of gains and losses by family type, so we do not discuss it further. There are significant differences between the size of maximum WTC and the size of the personal allowances in Universal Credit (which are based on the personal allowances in out-of-work benefits): for single adults, maximum WTC entitlement will be £37.69 (in 2014–15) but the Universal Credit personal allowance will be £72.25. For couples with and without children, maximum WTC entitlement will be £77.79 but the Universal Credit personal allowance will be £113.40. For lone parents, maximum WTC entitlement will be £77.79 but the Universal Credit personal allowance will be £72.25. On its own, this factor would suggest that working single adults and working couples with and without children would do better than working lone parents. However, the earnings disregard in Universal Credit also affects Universal Credit entitlement for working families, and also varies by family type, being the highest for lone parents, then couples with children, couples without children and finally single adults (who have no disregard). It is the combination of these two factors that leads to the patterns in Table 4.1, which shows average impacts on disposable income by family type and number of adults in work. There are particularly large gains for couples where one adult works and the other does not, as such families are typically tax credit claimants.

Of course, the government could have chosen not to increase the amount of support received by working couple families by using lower earnings disregards for these families.²⁷ This would have reduced the amount of

²⁶ We are not discussing the child or housing elements of Universal Credit as they are identical to maximum entitlements to CTC and HB for all family types.

²⁷ The earnings disregards in Universal Credit are already lower for couples than for lone parents. The maximum disregard for a childless couple is £3,000 per year, compared with £5,700 for a couple with at least one child and £7,700 for a lone parent.

Universal Credit received by working couple families without affecting the amount received by those not working. Presumably, therefore, this government has made a deliberate decision to increase the amount of support for working couple families. Indeed, the Conservative Party's manifesto for the 2010 General Election contained a pledge to increase support for this group by 'end[ing] the couple penalty for all couples in the tax credit system as we make savings from our welfare reform plans'.²⁸

Table 4.1. Average impact on disposable income by family type and employment status (without transitional protection)

| <i>Family type</i> | <i>Number of adults in work</i> | <i>Change in income, £</i> | <i>Change in income, %</i> | <i>Fraction of that family type</i> |
|--------------------------|---------------------------------|----------------------------|----------------------------|-------------------------------------|
| Single adults | 1 | 0.38 | 0.09% | 72.5% |
| | 0 | 0.54 | 0.35% | 27.5% |
| Couples without children | 2 | 0.28 | 0.03% | 75.6% |
| | 1 | 9.34 | 0.96% | 18.7% |
| | 0 | 1.89 | 0.47% | 5.7% |
| Couples with children | 2 | 0.4 | 0.04% | 61.2% |
| | 1 | 12.66 | 1.72% | 32.9% |
| | 0 | -3.79 | -0.85% | 5.9% |
| Lone parents | 1 | 0.52 | 0.11% | 55.9% |
| | 0 | -3.43 | -1.06% | 44.1% |

Notes: As for Figure 4.1.

Source: As for Figure 4.1.

Employment status is also crucial in explaining the different effects on families. As seen in Table 4.1, families with no adults in work will generally (with the exception of single adults) benefit less from the introduction of Universal Credit than those with one adult in work, because the latter will

The minimum disregard is also lower for childless couples than for couples with children, which in turn is lower than that for lone parents.

²⁸ See page 41 of Conservative Party, *An Invitation to Join the Government of Britain*, 2010,

http://media.conservatives.s3.amazonaws.com/manifesto/cpmanifesto2010_lowres.pdf. We understood from private communication with Conservative Party officials that they wished to increase the maximum amount of WTC for couples with children. This would primarily benefit single-earner couples with children.

benefit from earnings disregards and the lower withdrawal rate in Universal Credit than currently exists in the out-of-work benefits. Families in which both adults work will also gain little, but this is mainly because they earn too much to be entitled to much benefits or tax credits in either system. Thus Table 4.1 helps to explain the pattern of losses and gains across family types shown in Figure 4.4: the biggest winners (on average) – couples with children – will gain because few of them have no adults in work; lone parents will lose out (after the transitional relief expires), as almost half of them are out of work.

Another notable point from Table 4.1 is that workless families with children (including lone parents) are the only groups to lose out, on average. This is attributable to two factors:

- Some workless families currently have unearned income, such as maintenance payments from former partners (which are particularly important for lone parents), income from savings and widows' pensions. Most of these unearned income sources will be treated more harshly under Universal Credit than under tax credits.²⁹ This difference plays an important role because out-of-work families with children currently get some of their income through tax credits, as Child Tax Credit is payable to families both in and out of work.
- Some families with a large number of children currently claim high levels of Housing Benefit and CTC, and such families are more likely to be bound by the cap on total benefit receipt, which will be introduced in 2013.³⁰

Both factors mean that a few workless families with children will stand to lose substantially in the long run, something which is uncommon in the other types of families.

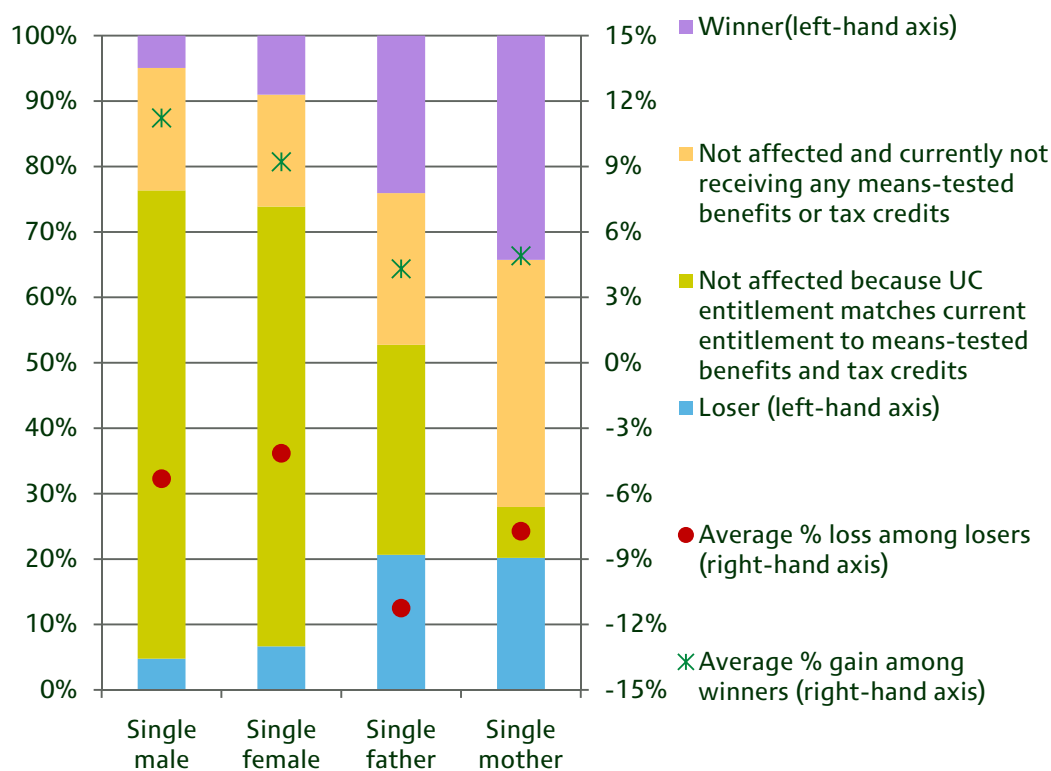
²⁹ Except for child maintenance, which will not count as income in either system. The rules on the treatment of unearned income are explained in Section 3.

³⁰ As we have assumed no cap in the base system, the actual losses that are due to Universal Credit per se should be smaller for these families.

4.4 By sex among single people

Among single adults and lone parents, women will fare better than men upon the introduction of Universal Credit. As Figure 4.6 shows, women are more likely to benefit from the reform, and tend to lose less if they do lose (in the absence of transitional protection). The female-favouring pattern is confirmed in Figure 4.7, which shows the average effects on income by sex and whether the single person has children. In both absolute and proportional terms (and with or without transitional protection), single women will benefit more on average than single men. Similarly, single mothers tend to lose less (ignoring transitional protection) or benefit more (in the presence of transitional protection) than single fathers.

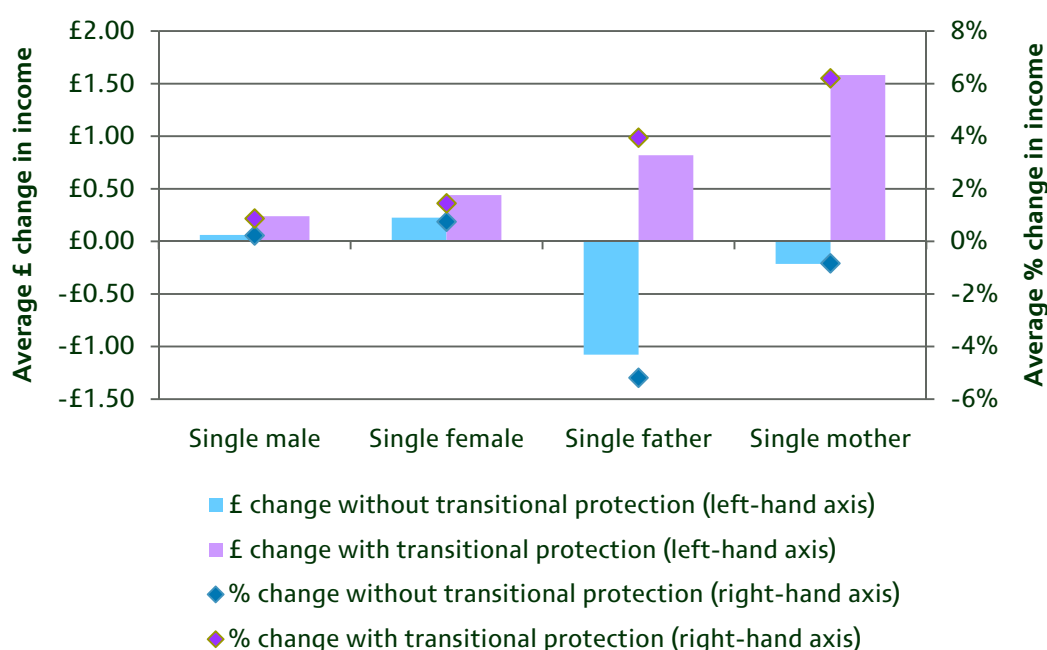
Figure 4.6. Winners and losers among single people by sex, without transitional protection



Notes: As for Figure 4.1.

Source: As for Figure 4.1.

Figure 4.7. Average impact on single people by sex



Notes: As for Figure 4.1.

Source: As for Figure 4.1.

4.5 Summary

Under the (unrealistic) assumptions that there is full take-up of all benefits and tax credits in the current regime and of Universal Credit, and that there are no behavioural responses to Universal Credit, we estimate the following:

- The long-run cost of Universal Credit will be around £1.7 billion (in 2014–15 prices). The short-run cost will depend on how quickly the government transfers existing recipients of benefits and tax credits over to Universal Credit and on the precise details of the transitional protection scheme.
- A total of 2.5 million working-age families will gain, and, in the long run, 1.4 million working-age families will lose, and 2.5 million working-age families will see no change in their disposable income because their entitlements to Universal Credit will match their current entitlements to means-tested benefits and tax credits.
- Overall, Universal Credit will benefit poorer families more than richer ones. The bottom six-tenths of the income distribution will gain on

average, while the richest four-tenths will lose out slightly in the long run.

- On average, couples with children will benefit more from the reform than couples without children, who in turn will benefit more than single adults. Lone parents will, on average, be worse off in the long run. Single-earner couples (with or without children) will benefit substantially from the reform. However, there are winners and losers amongst all four family types.
- Among single adults and lone parents, women will fare better than men.

5. The impact of Universal Credit on work incentives

In this section, we examine the effect of Universal Credit on measures of financial work incentives. We distinguish between the following:

- the incentive to be in paid work at all as opposed to not working, which can be measured by the participation tax rate (PTR, which measures the percentage of earnings lost in tax or withdrawn benefits when an individual moves into work);
- the incentive for an individual who is in work to increase their earnings slightly, which can be measured by the marginal effective tax rate (METR, which measures the percentage of a small change in earnings taken in tax or withdrawn benefits).

We give more detail of these measures in Section 5.1. In Section 5.2, we explain how we calculate work incentives for those observed in work in our data and for non-workers. We then go on to examine how the introduction of Universal Credit will alter these measures of work incentives overall and for particular groups.

5.1 Our measures of work incentives

The incentive to work at all

We measure the incentive to work at all by examining the PTR. This gives the proportion of earnings that are taken away in tax or lower benefit entitlements when an individual starts work, i.e.

$$PTR = 1 - \frac{\text{net income in work} - \text{net income out of work}}{\text{gross earnings}}$$

Therefore, someone whose income after taxes and benefits was £50 if they did not work and £200 if they did work, earning £250, would have a PTR of 40% ($1 - \{£200 - £50\}/£250$).

Note that:

- Net income means income after benefits have been added and taxes deducted.
- Low numbers indicate that the incentive to work is strong and vice versa. A PTR of 0% would indicate that an individual did not have to pay any tax on their earnings and did not lose any benefit entitlement when they started work. A PTR of 100% would indicate that all of an

individual's earnings would be taken from them in tax or lower benefit entitlements if they worked, so they would be no better off in paid work than not working. High PTRs are sometimes referred to as 'the unemployment trap'.

- For individuals in couples, it is possible to calculate the PTR using individual or family income, and this choice will affect our impression of the strength of the financial reward to work. In this paper, we use family income.

The incentive to earn more

The incentive for those in work to increase their earnings can be measured by the METR. This measures how much of a small change in employer cost is lost to tax payments and forgone state benefit and tax credit entitlements, and it tells us about the strength of the incentive for individuals to increase their earnings slightly, whether through working more hours, promotion, qualifying for bonus payments or getting a better-paid job. In this paper, we use the term 'incentive to earn more' for all these possibilities.

As with the incentive to work at all, low numbers mean stronger financial incentives. A METR of zero means that the individual keeps all of any small change in what their employer pays, and a rate of 100% means that the individual keeps none. High METRs amongst workers in low-income families are often referred to as 'the poverty trap'.

5.2 Methodology

Our methodology is the same as that used in Adam and Browne (2010).³¹ We use the IFS tax and benefit microsimulation model, TAXBEN, to calculate how much income workers would receive were they not to work. For non-workers, however, an assumption is required about how much they would earn, and how many hours they would work, if they did move into work. Our approach to this is the same as that used in section 2 of Adam and Browne (2010). We use the observed characteristics of non-workers (age, sex, years of education, marriage and cohabitation status,

³¹ See S. Adam and J. Browne, 'Redistribution, work incentives and thirty years of UK tax and benefit reform', IFS Working Paper W10/24, 2010, <http://www.ifs.org.uk/wps/wp1024.pdf>.

number of dependent children, age of youngest child, ethnicity and housing tenure) to predict their earnings conditional on being in each of four different hours bands (1–15, 16–23, 24–29 and 30+) using an ordinary least squares (OLS) regression. We then use the same characteristics to estimate (using a multinomial logit model) the likelihood of each individual being in each of these hours bands were they to work and we weight the participation tax rate associated with each earnings/hours band combination accordingly.

Previous IFS research has emphasised the importance of including employer National Insurance contributions and indirect taxes in our measures of work incentives. However, in what follows we do not account for either of these,³² for two reasons. First, the introduction of Universal Credit does not affect employer NICs or indirect taxes, so excluding these will not alter our view of the change in work incentives caused by the introduction of Universal Credit. Second, this approach makes our results more understandable for the reader – most basic-rate taxpayers think that their METR is 31% at the moment (20% income tax plus 11% employee NICs) rather than 38.8%, which is what it would be if we were also to include employer NICs. However, it does mean that our results will show work incentives to be stronger than they actually are in terms of the value of goods and services individuals are able to purchase with their wages relative to the cost to their employers of employing them in both the pre- and post-Universal Credit systems.

In what follows, we examine work incentives for all those in Great Britain aged between 18 and 59, excluding those in families with a full-time student or someone aged 60 or over or where all members are aged under 18. It is not clear which elements of Universal Credit students will be entitled to, nor how much those under 18 will receive. Northern Ireland is omitted because it is currently not clear whether Universal Credit will operate in Northern Ireland, and given the uncertainty of how Rates

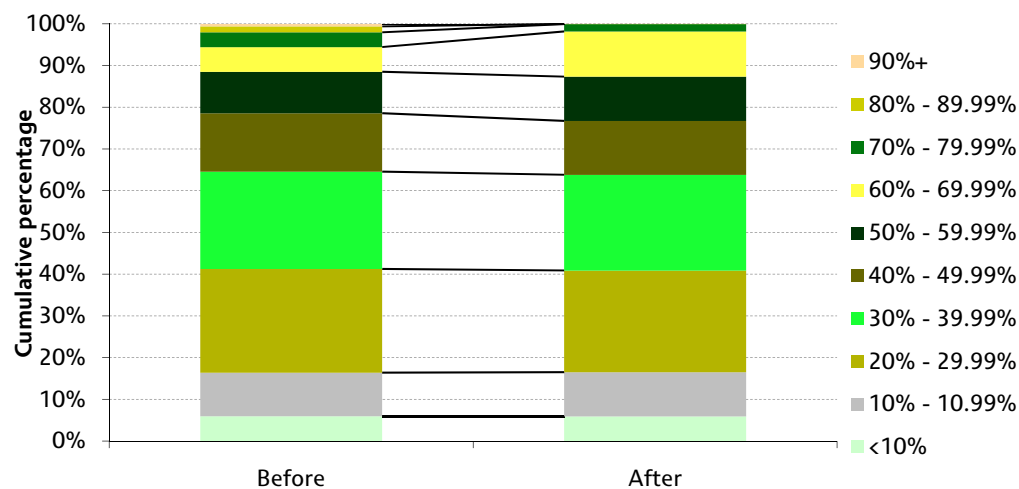
³² i.e. we ignore the fact that paying an employee an additional pound will cost the employer £1.128 because of the existence of employer NICs. Presumably, in the absence of employer NICs, the employer would have been prepared to increase the employee's wages by £1.128 in this case, which would strengthen the incentive for the employee to do this additional work. Also, since employees' willingness to work presumably depends on the quantity of goods and services they can purchase with whatever money they earn, indirect taxes also weaken the incentive to work.

Rebate (the equivalent to Council Tax Benefit) will interact with Universal Credit. Families with adults aged 60 or over are excluded to avoid complications caused by the rise in the female state pension age between now and 2014. Universal Credit will not affect those families with someone aged over the female state pension age, for which the current Pension Credit system will still apply.

5.3 The effect of Universal Credit on the incentive to work at all

Figure 5.1 shows the distribution of PTRs before and after the introduction of Universal Credit amongst workers and non-workers combined.

Figure 5.1. Participation tax rates before and after introduction of Universal Credit



Notes: Excludes employer NICs and indirect taxes and most ‘business taxes’ (notably corporation tax and business rates) and capital taxes (notably inheritance tax, stamp duties and capital gains tax). In-work incomes for non-workers are estimated as described in box 2.1 of Adam and Browne (2010). Excludes those in families with a full-time student or someone aged 60 or over or where all members are aged under 18. Source: Authors’ calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2008–09 Family Resources Survey.

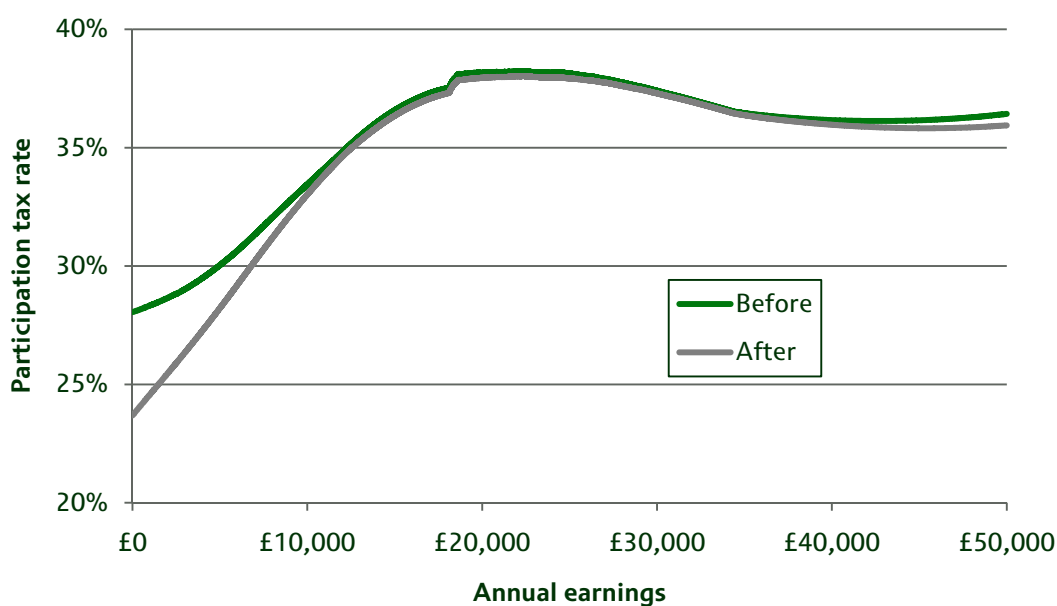
The main effect of the Universal Credit reform is to strengthen the incentives to work for those who have the very weakest incentives to work at the moment. In particular, there are few individuals with a PTR of 70% or higher after Universal Credit is introduced and 1.1 million fewer than under the current system. At present, individuals can lose almost all of their earnings through withdrawn benefits and tax credits when they start earning a small amount. Under Universal Credit, there will be a higher level of disregarded earnings and then the maximum combined tax and benefit withdrawal rate will be 76.2%, meaning that the incentive to earn

only a small amount is significantly strengthened. However, the reform does increase the number of individuals with a PTR of 60% or more by 350,000; these are mostly workers who would receive less Universal Credit than they currently receive in tax credits.

Figure 5.2 shows how PTRs vary by earnings before and after the reform. We can see that the introduction of Universal Credit will reduce PTRs on average, particularly at the lower end of the earnings distribution (less than £10,000 per annum), although it scarcely affects the PTRs of middle earners on average. We might be more surprised that the introduction of Universal Credit will also lower PTRs, on average, for higher earners, who we might expect to be unaffected; the ones who see a fall in their PTRs are people, usually with children, with high levels of savings which mean that, were they not to work, they would be entitled to less Universal Credit than the amount of means-tested benefits and tax credits they would be entitled to in the current system, as Universal Credit will have a more stringent asset test than the current tax credit system. Therefore, their incentive to work strengthens not because their in-work income rises, but because their out-of-work income falls.

Box 5.1 discusses how closely we match the government's estimates of the changes in PTRs caused by the introduction of Universal Credit.

Figure 5.2. PTRs by earnings, before and after introduction of Universal Credit



Notes: As for Figure 5.1. Non-parametric regression (lowess) estimates for PTRs.

Source: As for Figure 5.1.

Box 5.1. Comparing our estimates of the effect of Universal Credit on PTRs with the government's

The White Paper contains analysis showing that the number of non-workers without a working partner facing a PTR of 70% or more if they worked 10 hours at the minimum wage will fall by 1.3 million as a result of the introduction of Universal Credit. As we showed in Section 3, the incentive for these individuals to work for less than 16 hours will be strengthened by the introduction of Universal Credit to a far greater extent than the incentive to work for longer hours (with the precise cut-off depending on how many hours a week currently need to be worked to gain eligibility to Working Tax Credit). Furthermore, it is likely that working for only 10 hours per week at the minimum wage will be insufficient for an individual to escape conditionality under Universal Credit. Therefore, given that it is likely that many of these non-workers would choose to work more than 10 hours per week and/or be able to earn more than the minimum wage were they to work, our analysis in this section estimates what non-workers would earn were they to work and how many hours they would work based on the observed behaviour of workers. It is for this reason that our results show that the introduction of Universal Credit will reduce the number of workers *and* non-workers (both with and without working partners) with PTRs of 70% or higher by only 1.1 million. If we assume, as DWP has in the White Paper, that non-workers would only work for 10 hours per week at the minimum wage, we get a similar result to that in the White Paper – the number of non-workers without a working partner whose PTR is 70% or above falls by 1.2 million.

The pattern of changes in work incentives does vary significantly by family type, as we will now demonstrate. In what follows, we will distinguish between individuals based on whether they have children, whether they have a partner and, if so, whether their partner works.

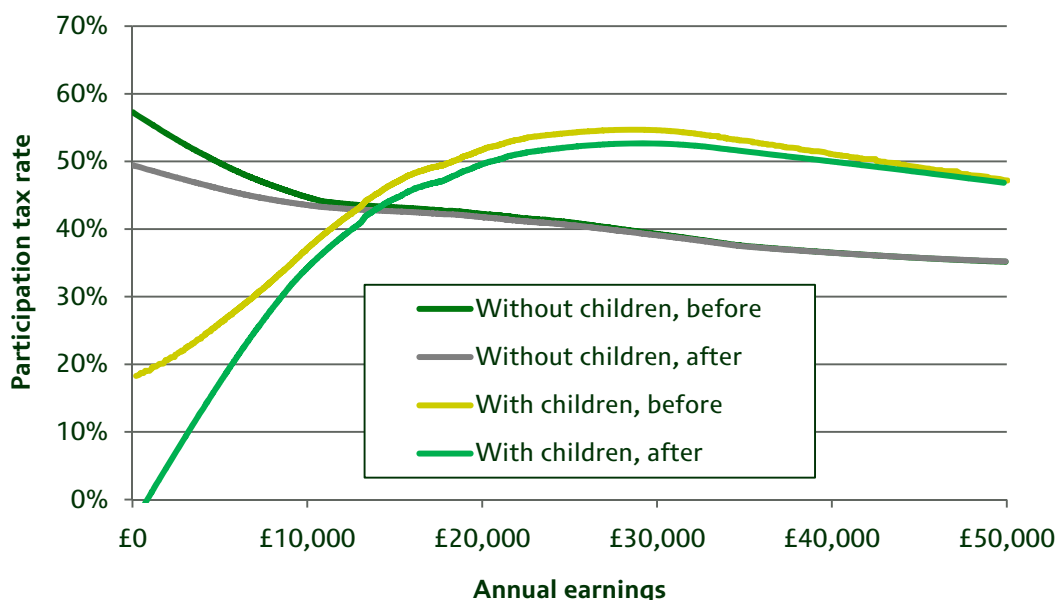
Single adults with and without children

Figure 5.3 shows that for single-adult families (both with and without children), the introduction of Universal Credit will reduce PTRs on average, particularly at the lower end of the earnings distribution. This is because Universal Credit will strengthen the incentive for individuals to earn small amounts by increasing the amount that can be earned before benefits start to be withdrawn, and by reducing the very high withdrawal rates that arise when individuals face the simultaneous withdrawal of several benefits in the current system.

High-earning lone parents see their PTRs fall as a result of the Universal Credit reform, but high-earning single people without children do not. This is because some lone parents with high levels of savings currently receive CTC when not working (but not any other means-tested benefits), but will not receive any Universal Credit (because of the stricter treatment of assets than in tax credits). However, single adults without children do not

receive any tax credits when not working, and the out-of-work means-tested benefits to which they might be entitled already have a stringent asset test, so there will be no change for them when Universal Credit is introduced.

Figure 5.3. PTRs by earnings for single-adult families with and without children, before and after introduction of Universal Credit



Notes: As for Figure 5.1. Non-parametric regression (lowess) estimates for PTRs.
Source: As for Figure 5.1.

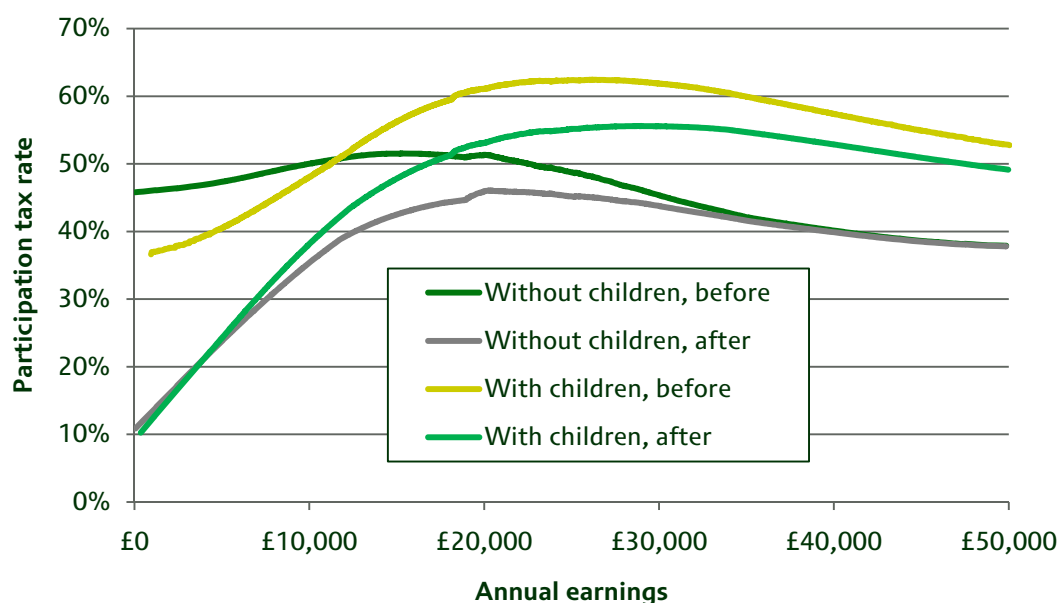
Actual and potential first earners in couples

In Figure 5.4, we show the same analysis for those in couples whose partner does not work; this includes both members of couples where neither partner works and workers in one-earner couples, i.e. potential and actual first earners in couples.

For those in couples whose partner does not work (both with and without children), the introduction of Universal Credit reduces PTRs on average, particularly at the lower end of the earnings distribution. The main reasons are similar to those discussed earlier for single adults: Universal Credit has higher earnings disregards than the current out-of-work benefits, and workers will tend to face a combined tax and benefit withdrawal rate that is lower than can exist under the current system when individuals face the simultaneous withdrawal of several benefits or tax credits. Also, for those with children, PTRs fall even at higher earnings

because some workless couples with children will be entitled to less Universal Credit than their current entitlement to CTC as a result of the stricter treatment of assets. Finally, it is worth noting that Universal Credit reduces the PTRs of those in couples whose partner does not work by more than it does for single people. This is because Universal Credit represents a larger giveaway to single-earner couples than to working single adults, as we discussed in Sections 3 and 4.

Figure 5.4. PTRs by earnings for those in couples whose partner does not work, before and after introduction of Universal Credit



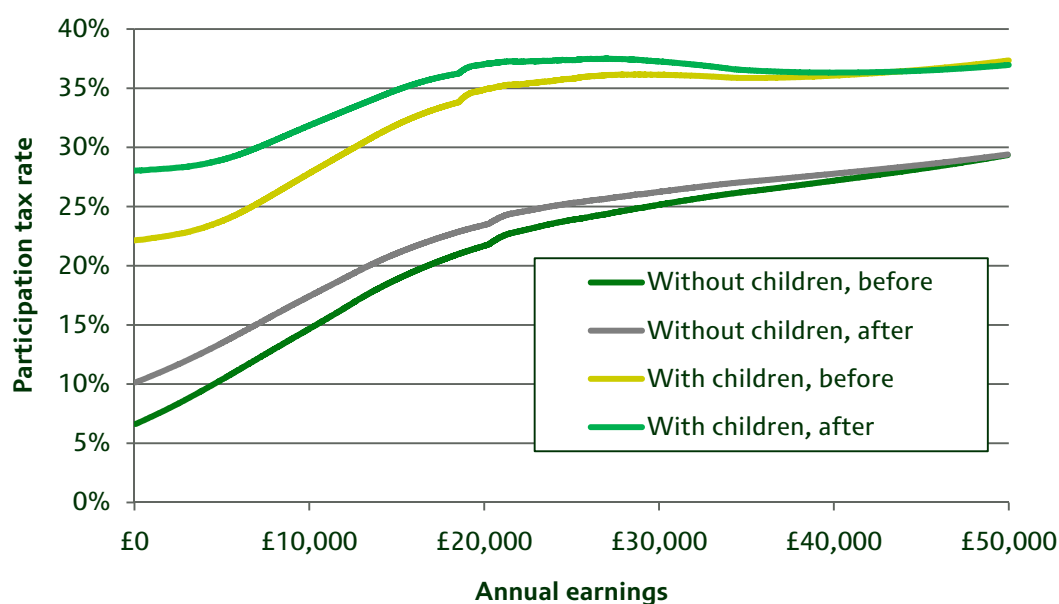
Notes: As for Figure 5.1. Non-parametric regression (lowess) estimates for PTRs.
Source: As for Figure 5.1.

Actual and potential second earners in couples

Figure 5.5 shows the same analysis for those in couples whose partner works. This includes both members of two-earner couples and non-workers in single-earner couples.

We can see that Universal Credit will weaken the incentives for couples to have two people in work rather than one. This is mostly due to the change from a 41% gross income taper in tax credits to a 65% net income taper in Universal Credit; this means that a (potential) second earner who is entitled to Universal Credit when out of work will initially lose 65p of each pound earned when they move into work, rather than 41p as they do under the current tax credit system (see Box 3.2).

Figure 5.5. PTRs by earnings for those in couples whose partner works, before and after introduction of Universal Credit



Notes: As for Figure 5.1. Non-parametric regression (lowess) estimates for PTRs.
Source: As for Figure 5.1.

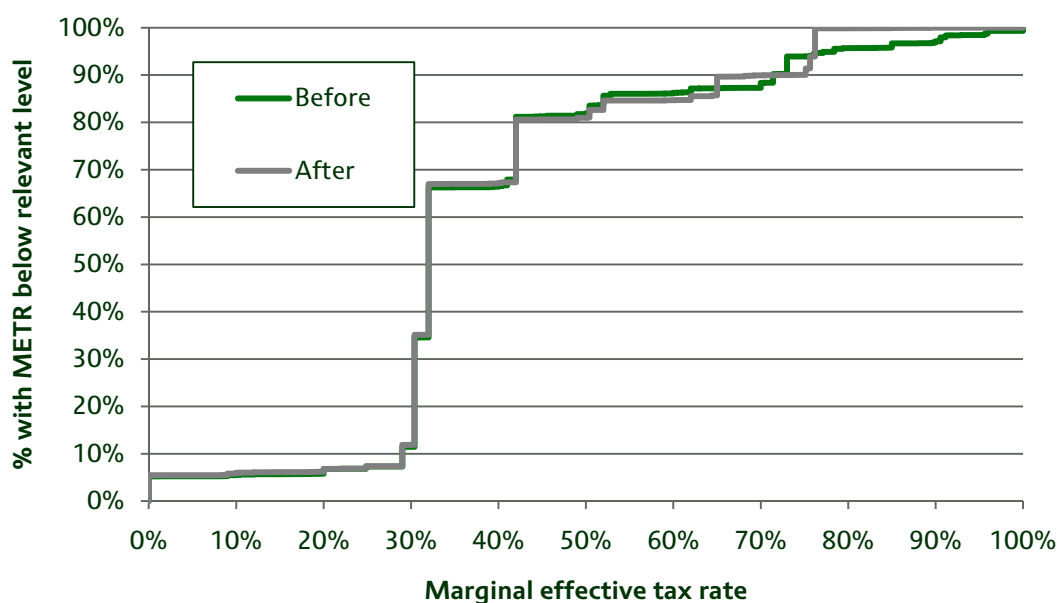
Summary

Universal Credit will strengthen the incentive to work at all, on average, especially at low earnings. It will particularly strengthen work incentives for those who have the weakest incentives to work under the current tax and benefit system – namely single adults, and those in couples whose partner does not work who would only earn a little if they were to work. However, Universal Credit will weaken work incentives for (potential) second earners in couples, who will see Universal Credit withdrawn more quickly if they enter work than currently happens with tax credits.

5.4 The effect of Universal Credit on the incentive to earn more

Figure 5.6 shows the distribution of METRs before and after the introduction of Universal Credit for those who are currently in work. We can see that the introduction of Universal Credit will mean that there are no METRs above 76.2%, but it will increase the number of individuals with METRs higher than 73% and increase the number with METRs of 65% or more. However, the vast majority of workers will not have their METRs affected by the introduction of Universal Credit: they are not entitled to

Figure 5.6. Cumulative distribution of METRs before and after introduction of Universal Credit (workers only)



Notes: Excludes employer NICs and indirect taxes and most ‘business taxes’ (notably corporation tax and business rates) and capital taxes (notably inheritance tax, stamp duties and capital gains tax). Excludes those in families with a full-time student or someone aged 60 or over or where all members are aged under 18.

Source: Authors’ calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2008–09 Family Resources Survey.

means-tested benefits or tax credits under the current system, and will not be entitled to Universal Credit either.

Around 3.5 million workers will see a change in their METR, the most significant groups among these being:

- Around 900,000 workers who will see their METR increase from 73% (or just under if they are contracted out of the State Second Pension or are self-employed) to 76.2% (or just under). These are basic-rate taxpayers who, if they increase their earnings slightly, currently face withdrawal of tax credits, and will face withdrawal of Universal Credit.
- Around 300,000 workers who will see their METR increase from 32% (or just below) to 76.2% (or just below). These are people who are currently not entitled to means-tested benefits or tax credits, but who will become entitled to Universal Credit, and therefore will face the withdrawal of Universal Credit if they increase their earnings slightly.

- Another 350,000 workers – mostly in two-earner couples – who will see their METR increase from 0% or 41% to 65%. These are non-taxpayers who are entitled to Universal Credit, and who face it being withdrawn at a rate of 65p in the pound when they increase their income. At present, such workers see tax credits withdrawn at a rate of 41%, or keep all of a small increase in earnings if they are not entitled to tax credits under the current system.
- Around 600,000 workers facing METRs of between 77% and 96% who will see their METR fall to 76.2% when Universal Credit is introduced. These are workers who currently face a simultaneous withdrawal of several benefits or tax credits if they increase their earnings.
- Around 350,000 individuals who will see their METR fall from 80% or more to 65%. These are non-taxpaying individuals who currently face either the combined withdrawal of Housing Benefit and Council Tax Benefit, or the withdrawal of an out-of-work means-tested benefit, and who would be subject only to the withdrawal of Universal Credit.
- Around 400,000 basic-rate taxpayers who will see their METR fall substantially from over 70% to 32% (or just under). Such people are currently entitled to tax credits, but will not be entitled to Universal Credit, as entitlement tends to reach less far up the earnings distribution than for tax credits.
- Around 200,000 non-taxpayers who will see their METR fall from various values to zero. Such workers will not be entitled to Universal Credit, but are currently entitled to tax credits or means-tested benefits. These individuals tend to be low-earning adults in two-earner couples.

Box 5.2 discusses how closely we match the government's estimates of the changes in METRs caused by the introduction of Universal Credit.

Figure 5.7 shows the change in METRs by earnings. Universal Credit reduces METRs, on average, for those earning less than £26,000, particularly those earning less than £20,000, and very slightly increases METRs, on average, for those earning more than this.

Again, this pattern varies between different types of individuals. In Figures 5.8–5.10, we show the patterns for single adults, workers in single-earner

couples and two-earner couples, further split by whether they have children or not.

Box 5.2. Comparing our estimates of the effect of Universal Credit on METRs with the government's

On 9 December 2010, the Shadow Secretary of State for Work and Pensions asked the following question in the House of Commons, and received the following response from the Minister for Employment:

Douglas Alexander: 'To ask the Secretary of State for Work and Pensions what estimate he has made of the number of people who will face (a) higher and (b) lower marginal deduction rates following full implementation of the universal credit according to the modelling used as the basis for his White Paper.'

Chris Grayling: 'Following full implementation of universal credit, marginal deduction rates will reduce for around 1.5 million workers in total, with the average (median) reduction in marginal deduction rate being 20 percentage points. Included in this total, universal credit will particularly improve earnings incentives for 700,000 low-earning workers, reducing the highest marginal deduction rates from 95.8% to around 76%.'

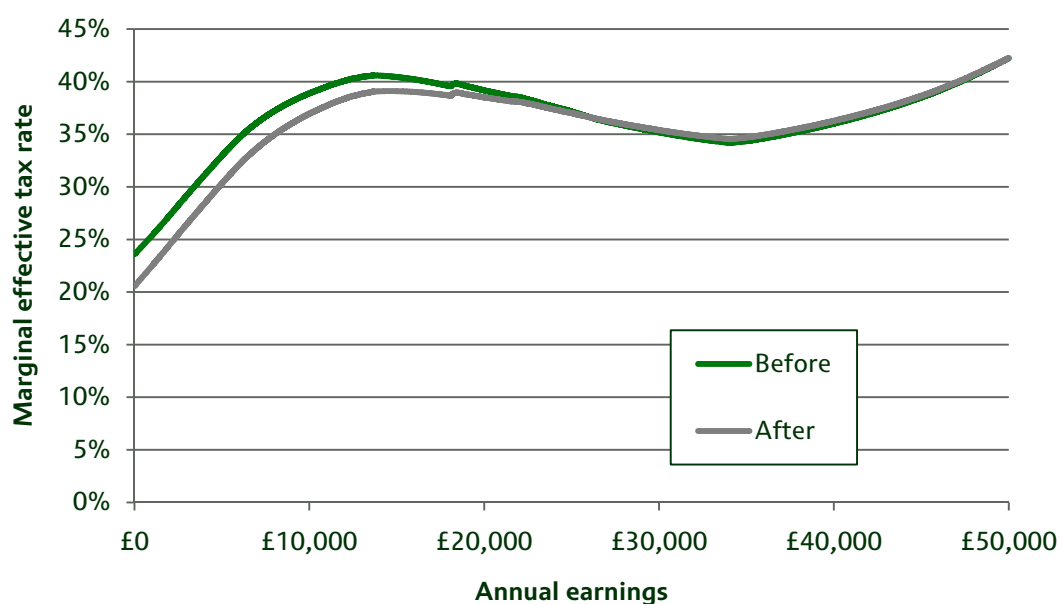
'Some households will see their marginal deduction rates increase under universal credit. For example, households previously receiving tax credits only will see a small increase in their marginal deduction rate from 73% to around 76%. In addition, because universal credit allows low-earning households to keep more of their earnings, some households who previously received no state support will now do so. As a consequence they will experience a higher marginal deduction rate than they otherwise would have done but they will be better off financially.'

'Marginal deduction rates will increase for around 2 million workers in total following full implementation of universal credit. However, the average (median) increase will only be 4 percentage points.'^a

As the discussion in the text shows, our analysis broadly matches the government's conclusions, with slightly more individuals seeing a reduction in their METR (1.7 million) and slightly fewer seeing an increase (1.8 million) in our analysis. We also broadly agree with the government's estimates of the median increase and decrease among those who see their METRs increase and decrease. It is worth noting, however, that although the majority of those who see their METR increase only see it increase slightly, there are a substantial number for whom the increase in the METR is more significant. The mean increase in the METR among those who see their METRs increase is 21 percentage points. The mean decrease in the METR among those who see their METRs decrease is 27 percentage points.

^a Source: *Hansard, House of Commons Written Answers, 9 December 2010, vol. 520, part no. 88, cols 400–401, available at <http://services.parliament.uk/hansard/Commons/bydate/20101209/writtenanswers/part016.html>.*

Figure 5.7. METRs by earnings before and after introduction of Universal Credit (workers only)



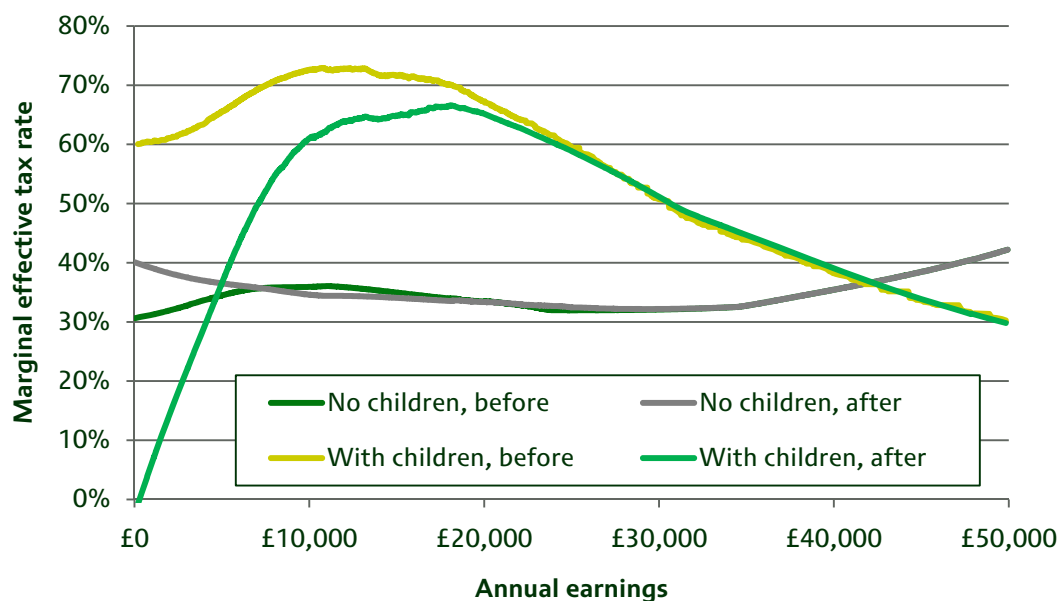
Notes: As for Figure 5.6.

Source: As for Figure 5.6.

Single adults with and without children

Universal Credit has a very different impact on the METRs of single workers without children and of lone parents, as shown in Figure 5.8. For single adults without children, Universal Credit increases the METRs of those with very low earnings. This is because there is a small disregard in the current system of out-of-work benefits but no earnings are disregarded for single adults without children under the Universal Credit system: each additional pound of after-tax earnings reduces Universal Credit entitlement by 65 pence. For lone parents, however, Universal Credit has a higher disregard than the current system of out-of-work benefits, and a lower withdrawal rate for those who face withdrawal of multiple benefits under the current system. This reduces the average METR at all earnings levels below £20,000.

Figure 5.8. METRs by earnings for single-adult families with and without children, before and after introduction of Universal Credit (workers only)



Notes: As for Figure 5.6.

Source: As for Figure 5.6.

Single-earner couples

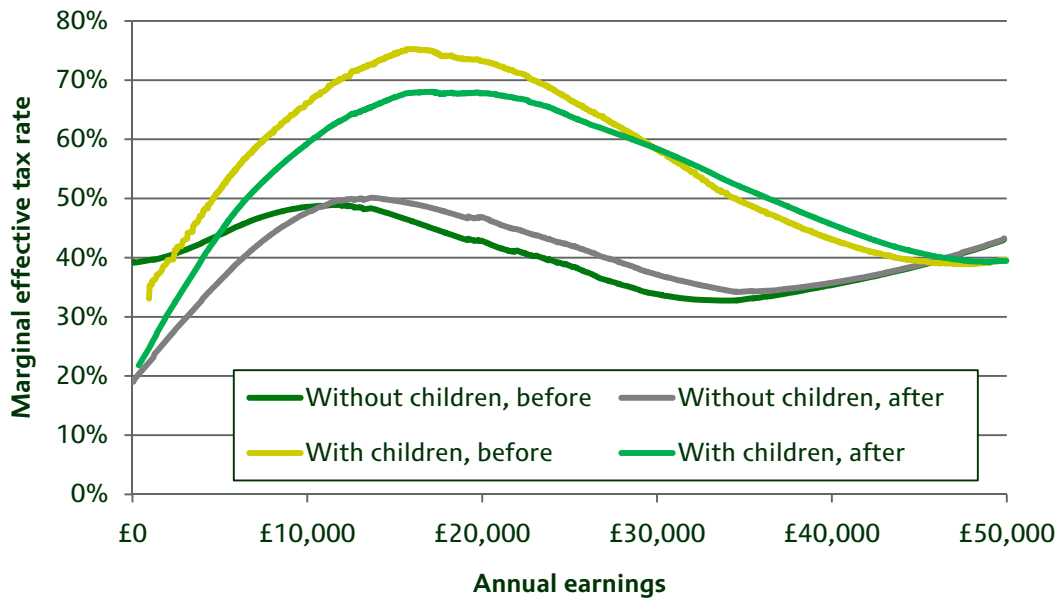
Figure 5.9 shows the same analysis for single-earner couples with and without children.

For both those with and without children, the introduction of Universal Credit will reduce METRs for those on low earnings, but increase METRs at higher levels of earnings. This is, again, because Universal Credit has a more generous disregard than the current out-of-work benefits, and the combined withdrawal rate of multiple benefits being withdrawn at the same time is higher than the withdrawal rate for Universal Credit.

However, because Universal Credit is more generous for single-earner couples than the current system, the withdrawal of Universal Credit continues further up the income distribution than the withdrawal of means-tested benefits and tax credits does under the current system. This will increase the METRs of those individuals who become entitled to Universal Credit who are not entitled to means-tested benefits and tax credits under the current system, as they will face withdrawal of Universal Credit as well as paying income tax and National Insurance if they increase their earnings slightly. Also, the METR for basic-rate taxpayers facing

withdrawal of Universal Credit will be higher than the METR for basic-rate taxpayers facing withdrawal of tax credits under the current system, at 76.2% rather than 73%. Both these factors explain why METRs will rise, on average, for those with children and earnings between £30,000 and £45,000.

Figure 5.9. METRs by earnings for single-earner couples with and without children, before and after introduction of Universal Credit



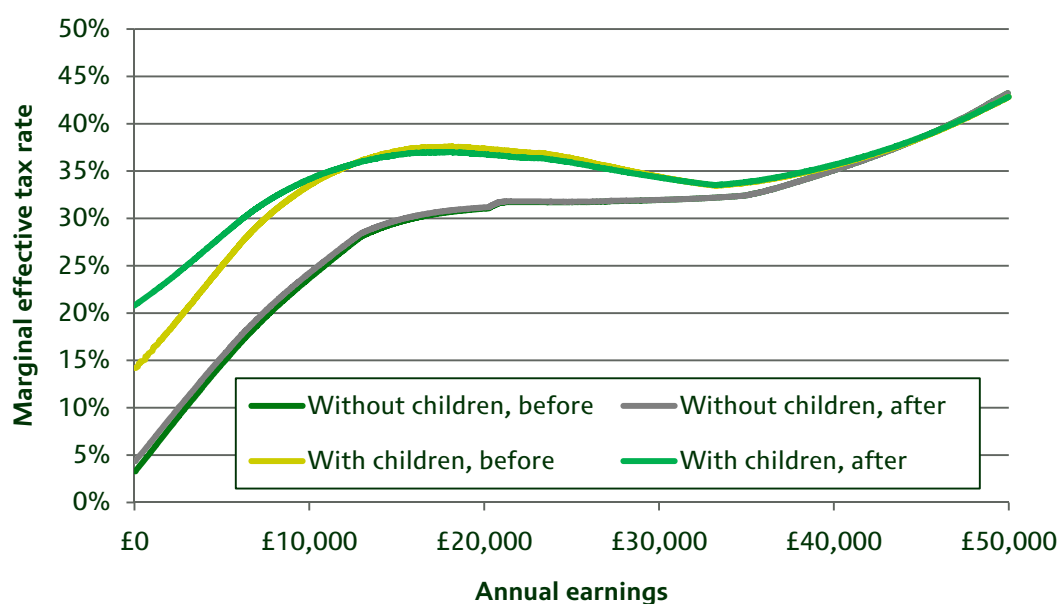
Notes: As for Figure 5.6.
Source: As for Figure 5.6.

Two-earner couples

Figure 5.10 repeats the analysis for two-earner couples.

The introduction of Universal Credit does not materially affect the METRs of those in two-earner couples without children. This is because few of these families are entitled to means-tested benefits and tax credits under the current system and few will be entitled to Universal Credit either. However, Universal Credit does increase the METRs of low earners in two-earner couples with children. This is because they will face a METR of 65% under Universal Credit compared with 41% under the current tax credit system if they are non-taxpayers, or of 76.2% rather than 73% if they are basic-rate taxpayers. The slight fall in average METRs for earnings between £15,000 and £25,000 for second earners in couples with children

Figure 5.10. METRs by earnings for two-earner couples with and without children, before and after introduction of Universal Credit



Notes: As for Figure 5.6.

Source: As for Figure 5.6.

reflects that, for some families, Universal Credit entitlement will be exhausted at lower earnings than tax credit entitlement currently is.

Summary

The vast majority of workers do not have their METRs affected by the introduction of Universal Credit since they are not entitled to means-tested benefits or tax credits under the current system, and will not be entitled to Universal Credit. A total of 1.7 million workers will see a fall in their METR, and 1.8 million will see a rise. On average, Universal Credit will lower METRs for those on low earnings and raise them very slightly for those on middle earnings.

Universal Credit will ensure that the maximum METR is 76.2%, and so those currently facing a higher METR than that, as a result of facing the withdrawal of several benefits or tax credits simultaneously or as a result of facing a 100% withdrawal of an out-of-work means-tested benefit, will see their METR reduced. These tend to be low earners who do not have a partner or whose partner does not work. However, low earners who do have a working partner will tend to see their METR increase: this is because Universal Credit will have a higher withdrawal rate than tax

credits do in the current system, whether combined with income tax and National Insurance or not. This also means that some higher earners who do not have a working partner will see their METR increase slightly.

5.5 Summary

Because it has a lower withdrawal rate and higher earnings disregards than the current out-of-work means-tested benefits, Universal Credit will strengthen the incentive to work at all, on average, particularly at low earnings.

It will strengthen work incentives the most for those who have the weakest incentives to work under the current tax and benefit system – namely single adults, and those in couples whose partner does not work who would only earn a little if they were to work.

Universal Credit will weaken work incentives for (potential) second earners in couples, who will see Universal Credit withdrawn more quickly if they enter work than currently happens with tax credits.

Both of these features are very much in line with the Labour government's 1999 reform when Working Families' Tax Credit was introduced, which also strengthened the incentive for couples to have one partner in work rather than none, but weakened the incentive for both members of a couple to work.³³

A total of 1.7 million workers will see a fall in their marginal effective tax rate, and 1.8 million will see an increase. On average, Universal Credit will lower METRs for those on low earnings and raise them very slightly for those on middle earnings.

Universal Credit will ensure that the maximum METR faced by workers is 76.2%, so those currently facing a higher METR than that, as a result of facing the withdrawal of several benefits or tax credits simultaneously or as a result of facing a 100% withdrawal of an out-of-work means-tested benefit, will see their METR reduced; these tend to be low earners who do not have a partner or whose partner does not work.

³³ For more on this, see M. Brewer and J. Browne, 'The effect of the Working Families' Tax Credit on labour market participation', IFS Briefing Note 69, 2006, <http://www.ifs.org.uk/bns/bn69.pdf>.

Low earners who do have a working partner will tend to see their METR increase, because Universal Credit will have a higher withdrawal rate than tax credits do. This also means that some higher earners who do not have a working partner will see their METR increase slightly.

6. Conclusion

The government plans to replace most means-tested benefits and tax credits for working-age adults (Income Support, income-related Jobseeker's Allowance and Employment and Support Allowance, Working Tax Credit, Child Tax Credit and Housing Benefit) with a single benefit, known as Universal Credit. This would be the largest reform to the welfare system since at least the Fowler reforms in 1988.

The government hopes Universal Credit will simplify the benefit system and strengthen financial incentives to work. IFS researchers have long argued for a simpler, more integrated benefit and tax credit system to make life easier for claimants, make the gains to work more transparent, and reduce money wasted on administration and lost to fraud and error. This Briefing Note has presented a preliminary assessment of Universal Credit, and has concentrated on the way it will affect household incomes and measures of financial work incentives. The analysis is based on the information given in the November 2010 White Paper, *Universal Credit: Welfare that Works*, and so it should not be seen as definitive, both because full details of how Universal Credit will work have not yet been made available and because Universal Credit is likely to have complicated impacts on take-up and labour supply behaviour which we have not attempted to capture. However, our analysis is intended to be comparable to that provided in chapter 7 of the White Paper.

Our empirical analysis in Sections 4 and 5 illustrates well the constraints all governments face when contemplating radical welfare reform. Universal Credit will strengthen financial work incentives for some, as intended, but weaken them for others. In general, incentives to work will be strengthened for the main earner in a family who works part-time or has low earnings, and will be weakened for those with higher earnings and for second earners in couples. Marginal effective tax rates will tend to fall for those on lower earnings, and rise for those on higher earnings, although this pattern also depends on how many earners there are in the family. The reform will also lead to both winners and, in the long run, losers. Because of the way the parameters of Universal Credit have been set, couples, and particularly those with children, look set to gain by more, on average, than single-adult families, particularly lone parents, who will lose on average according to our analysis. But, in general, the impact on incomes is progressive, with the bottom income deciles gaining the most

as a fraction of income. In the long run, under our rather unrealistic assumptions, we estimate Universal Credit will lead to entitlements to benefits of £1.7 billion a year greater than the current system (in 2014–15 prices).

Many details of Universal Credit remain unclear, though, and we have therefore had to make several simplifying assumptions when undertaking our empirical analysis. Three of the most important outstanding design issues are whether to include Carer's Allowance within Universal Credit, how to replace the childcare element of Working Tax Credit, and what to do about Council Tax Benefit given the government's desire to give local authorities control over its generosity. It is likely that whatever decision is reached in each of these areas will either increase the cost to the taxpayer or involve a loss of income for some families (or both). But it is also not yet clear what the government wants to do about in-kind passported benefits, the Social Fund, various time-limited in-work benefits, Support for Mortgage Interest, disability additions, rates of Universal Credit for students, rates of Universal Credit for those under 25, and the housing element of Universal Credit for those in social housing. We hope that more of these issues will become clear with the publication of the Welfare Reform Bill, expected in late January 2011.