

The impact of Universal Credit

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Summary

- 1) This chapter sets out the nature of the impact we expect Universal Credit to have. The Universal Credit design as outlined in this paper will make work pay in two important ways:
 - a. the financial reward for entering work will be improved, particularly for those on lowest earnings. We will reduce by 1.3 million the number of workless households facing Participation Tax Rates of over 70 per cent¹⁹.
 - b. The financial reward for low earners seeking to increase their earnings would be improved through the introduction of a single taper rate of about 65 per cent. We expect the highest marginal deduction rate, including tax and National Insurance contributions, for low-earning workers will be reduced from around 96 per cent to around 76 per cent, thereby improving the work incentives of around 700,000 people.
- 2) There will be substantial increases in the take-up of entitlements that are currently unclaimed. This, together with the higher entitlements, will lift many working age adults and many children out of poverty.
- 3) The new system will make error and fraud easier to prevent and detect. The move to real-time earnings and the removal of end-of-year reconciliation will reduce the scope for overpayments.
- 4) A more work-focused benefit system will have wider benefits for society, in terms of better health outcomes, higher educational achievements, and reduced crime.
- 5) In the long-run we anticipate that there will be savings from the dynamic labour supply effects, with Universal Credit reducing the number of workless households by as much as 300,000, and an annual flow of savings due to the greater administrative simplicity of the new system. Before taking account of these savings, we expect total support provided through the working-age benefit system to increase substantially through the introduction of Universal Credit, in particular for those in work.

¹⁹ Estimated on the basis of work of 10 hours per week, at the National Minimum Wage.

Universal Credit model and the baseline

1. The publication has set out the Government's intended design for Universal Credit. In the coming months, we will finalise policy on those aspects we have said we are still considering and assess the interaction it has with other recently announced reforms. However, we are now in a position to set out the impact we expect Universal Credit to have.
2. This analysis is based on the design set out in the rest of the publication. It includes the costs, distributional impacts and changes to work incentives. Our analysis compares the effect of this new system with the current benefits and Tax Credits system, incorporating the changes set out in the June 2010 Budget.
3. We present our estimates on the basis of the pre-Spending Review position because Universal Credit was the centrepiece of the welfare reforms the Government announced in that Review. Some of the other Spending Review measures will affect the detail of the impact shown here. Future decisions on some elements of the design the Government is still considering, as covered in earlier chapters, may also affect the precise results. We will provide further analysis in the impact assessment we publish with the Welfare Reform Bill.

Overall financial impacts

4. The introduction of Universal Credit will enable the Government to increase and better target the support that is provided through the benefit system in order to ensure that work always pays and the most vulnerable are protected.
5. The increased support comes from greater generosity for in-work households with low earnings and more consistent support as households increase their earnings. In addition, the simplification of the system will lead to significantly improved take-up of benefit entitlements among this group. Alongside this, there will be substantial savings due to reduced fraud and error.
6. The costs²⁰ of Universal Credit will build up over a number of years. The Spending Review set aside £2 billion to fund the implementation of Universal Credit over the Spending Review period.
7. The greater simplicity of the Universal Credit system will lead to a streamlined administration, which we anticipate will lead to savings of more than £0.5 billion a year.

²⁰ Costs and savings are quoted in 2010/11 prices.

Take-up and poverty

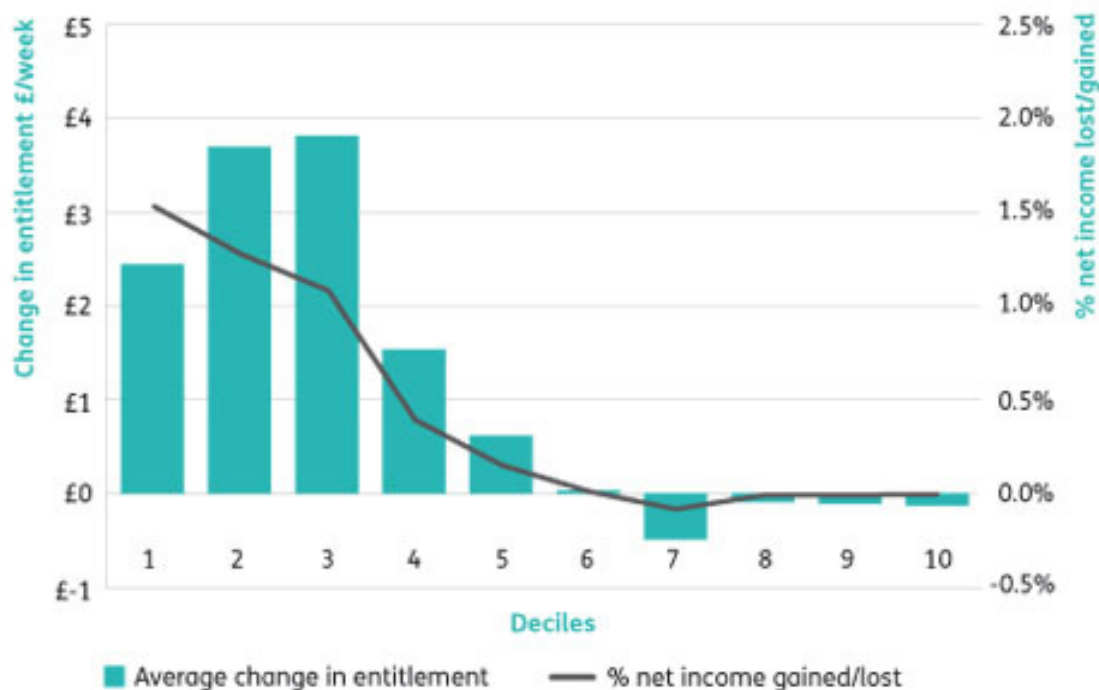
8. By creating a single, integrated benefit, households who claim Universal Credit will now automatically receive everything they are entitled to. The new system ensures that someone either claims everything (because they are eligible) or nothing (because they are ineligible). In effect, there will be ‘automatic passporting’ for people who currently claim some, but not all, of the benefits or Tax Credits to which they are currently entitled. Hence with this much simpler system, households will be more likely to claim their full entitlement.
9. By virtue of the changes to entitlement and improved take up, Universal Credit will have a substantial positive impact on poverty, for both children and adults: Universal Credit could lift as many as 350,000 children and 500,000 working-age adults out of poverty. This is before we consider the positive impact of more people moving into work.

The distributional impact of Universal Credit

10. This radical restructuring of the benefits and Tax Credits system is strongly progressive. It enables the Government to focus support more heavily and more consistently on those at the lower end of the income distribution.
11. Many households will receive more under Universal Credit than under the current system. These higher entitlements arise primarily for three broad groups of working households with low earnings:
 - households not entitled to Working Tax Credit under the current system, for example, because they are working less than 16 hours a week or are childless and aged under 25, who gain entitlement to in-work support under Universal Credit;
 - households receiving Housing Benefit and Council Tax Benefit under the current system who benefit from a significant reduction in the rate at which their benefit is withdrawn as earnings increase; and
 - other households who benefit from the higher earnings disregards and, for most people, lower withdrawal rate the Government is building into Universal Credit.
12. Figure 11 (opposite) shows the average net financial impact we would expect Universal Credit to have by income²¹ decile. In the bottom decile, the average impact of Universal Credit will be to increase net incomes by around 1.5 per cent – a cash value of £2.40 per week. In decile two this figure is around 1 per cent, which equates to more than £3.60 per week. This is before we take the impact of increased take-up into account, so is likely to significantly understate the gains to those on the lowest incomes.

²¹ Equivalised for household size.

Figure 11 Average long-run impact (proportion of weekly income gained/lost and average change in entitlement) by decile from Universal Credit reform



Source: Department for Work and Pensions Policy Simulation Model (based on Family Resources Survey 2008/9), 2014/15.²²

13. No-one will experience a reduction in the benefit they are receiving as a result of the introduction of Universal Credit. At the point of transition onto the new system, those households whose circumstances remain unchanged and who would otherwise experience a reduction in income will receive cash protection.
14. Universal Credit will remove the complexities and inconsistent support available in the current benefits and Tax Credits system and replace it with increased support for low-income families and consistency in support as income rises. This simplification means that, in the long term, some households will be entitled to less under Universal Credit than they would have been had the current benefits and Tax Credits system continued. These distributional losses will also arise gradually over time, as new people come into the system and the circumstances of existing cases change. Figure 11 shows this long-term impact. We expect to see average net incomes reduce in the long term in only deciles 7 to 10, and even there the average reduction will be small – less than 15 pence per week in deciles 8 to 10.²³

²² Modelling captures the effects of changes to entitlement, but does not include the impact of take-up, fraud and error effects, nor the removal of the earnings disregard currently applied to changes of circumstances in Tax Credits.

²³ The small average losses in deciles 7-10 come from the removal of the 30 hour premium of Working Tax Credit for higher earners. The losses arise in the long term only and are higher in decile 7 because a greater proportion of people in that decile would have been in receipt of Working Tax Credit.

Earnings Incentives

15. We expect the impacts on earnings incentives to be large. Universal Credit will improve earnings incentives for 700,000 current low earning workers. It increases their financial reward to work more hours or increase their wage rate, and as such it creates a more flexible workforce.
16. The expected Universal Credit withdrawal rate of 65 per cent means that to all intents and purposes, the highest Marginal Deduction Rate²⁴ for low-earning workers would be reduced from around 96 per cent to 65 per cent for those earning below the personal tax threshold and to around 76 per cent for basic rate taxpayers.
17. The following table 1 shows how the earnings incentives of people earning below the personal tax threshold are improved under Universal Credit compared with the current system.

Table 1: Marginal Deduction Rates²⁵ for those in work (working age only), earning below the tax threshold

Marginal Deduction Rate for non-taxpaying earners	Current system millions	Universal Credit millions	Difference millions
Up to 60%	0.3	0.1	-0.3
60%-70%	0.0	0.5	0.5
70%-80%	0.0	0.0	0.0
80%-90%	0.1	0.0	-0.1
Over 90%	0.1	0.0	-0.1

Source: Department for Work and Pensions Policy Simulation Model (based on Family Resources Survey 2008/9), 2014/15 – Figures may not sum due to rounding.²⁶

18. For taxpaying benefit recipients, Marginal Deduction Rates would typically be 76 per cent as a result of an expected withdrawal rate from post-tax earnings of 65 per cent.

²⁴ The Marginal Deduction Rate is the proportion of any extra earnings that is lost as a result of paying more tax and National Insurance and losing benefits. It is a useful measure of the incentive to increase earnings (for example, by working more hours). A higher Marginal Deduction Rate implies there is less incentive to increase earnings.

²⁵ Marginal Deduction Rates for those receiving income-related benefits or Tax Credits in the current system or receiving Universal Credit. Self employed and students are excluded.

²⁶ Modelling is based on entitlement changes only.

Table 2: Marginal Deduction Rates²⁷ for those in work (working age only), earning above the tax threshold

Marginal Deduction Rate for taxpaying benefit recipients	Current system millions	Universal Credit millions	Difference millions
Up to 60%	0.9	0.8	0.0
60%-70%	0.2	0.4	0.2
70%-80%	1.7	2.0	0.3
80%-90%	0.4	0.0	-0.4
Over 90%	0.1	*	-0.1

Source: Department for Work and Pensions Policy Simulation Model (based on Family Resources Survey 2008/9), 2014/15 – Figures may not sum due to rounding.²⁸

* denotes fewer than 50,000 people

19. Establishing a single withdrawal rate, and eliminating the hours rules currently present in Working Tax Credit, has the potential to create a much more flexible labour market. Workers will be able to work the number of hours that most suits their needs and those of their employer, without being constrained by the structure of the benefits system. Employers will find that their workforces become more flexible and open to opportunities for progression.
20. For example, it will now be financially rewarding for a lone parent to work 15 hours per week, or 17 hours per week (both of which would not have been financially rewarded under the existing system which only recognised 16 hours per week); and should more hours be available, the extra earnings will no longer face a Marginal Deduction Rate of 96 per cent. Under the current system a lone parent working 16 hours at the National Minimum Wage would only increase their take home pay by £5 a week if they increased their hours to 25 hours. Under Universal Credit the same lone parent would increase their take home pay by £17.
21. Under the current system parents whose spouses work full time do not face the same financial incentives and constraints as lone parents – and as a result they are able to, and do, work a wide range of different hours – to suit their situation. We believe the same opportunities should be available for all.
22. Hence, Universal Credit will match more closely the structure of today’s labour market,²⁹ where part-time jobs and flexible working are much more common than they once were. Furthermore, this reform will increase the range of viable jobs in the economy.

²⁷ Marginal Deduction Rates for those receiving income-related benefits or Tax Credits in the current system or receiving Universal Credit. Self employed and students are excluded.

²⁸ Modelling is based on entitlement changes only.

²⁹ In the three months June to August 2010, the increase in employment was 178 thousand. Of this increase 143,000 (80 per cent) were in part-time jobs. Office for National Statistics, Labour Markets Statistics, October 2010.

Employment incentives

23. Universal Credit will increase the financial rewards to enter, and retain work for low earners. It will reduce the highest Participation Tax Rates³⁰ they currently face, and will create a genuinely progressive set of Participation Tax Rates.
24. The number of households facing Participation Tax Rates over 70 per cent in this situation would reduce by around 1.3 million under Universal Credit – increasing dramatically the financial reward from entering work, especially at low earnings. Table 3 shows the Participation Tax Rates for workless households if they were all to enter work at 10 hours per week at National Minimum Wage.

Table 3: Participation Tax Rates for the first earner in a workless household if they were to enter work at 10 hours per week (working age only)

Participation Tax Rate for first earners	Current system millions	Universal Credit millions	Difference millions
Up to 60%	1.2	3.0	1.8
60%-70%	1.5	1.0	-0.5
70%-80%	0.2	0.2	-0.1
80%-90%	0.6	*	-0.6
Over 90%	0.6	*	-0.6

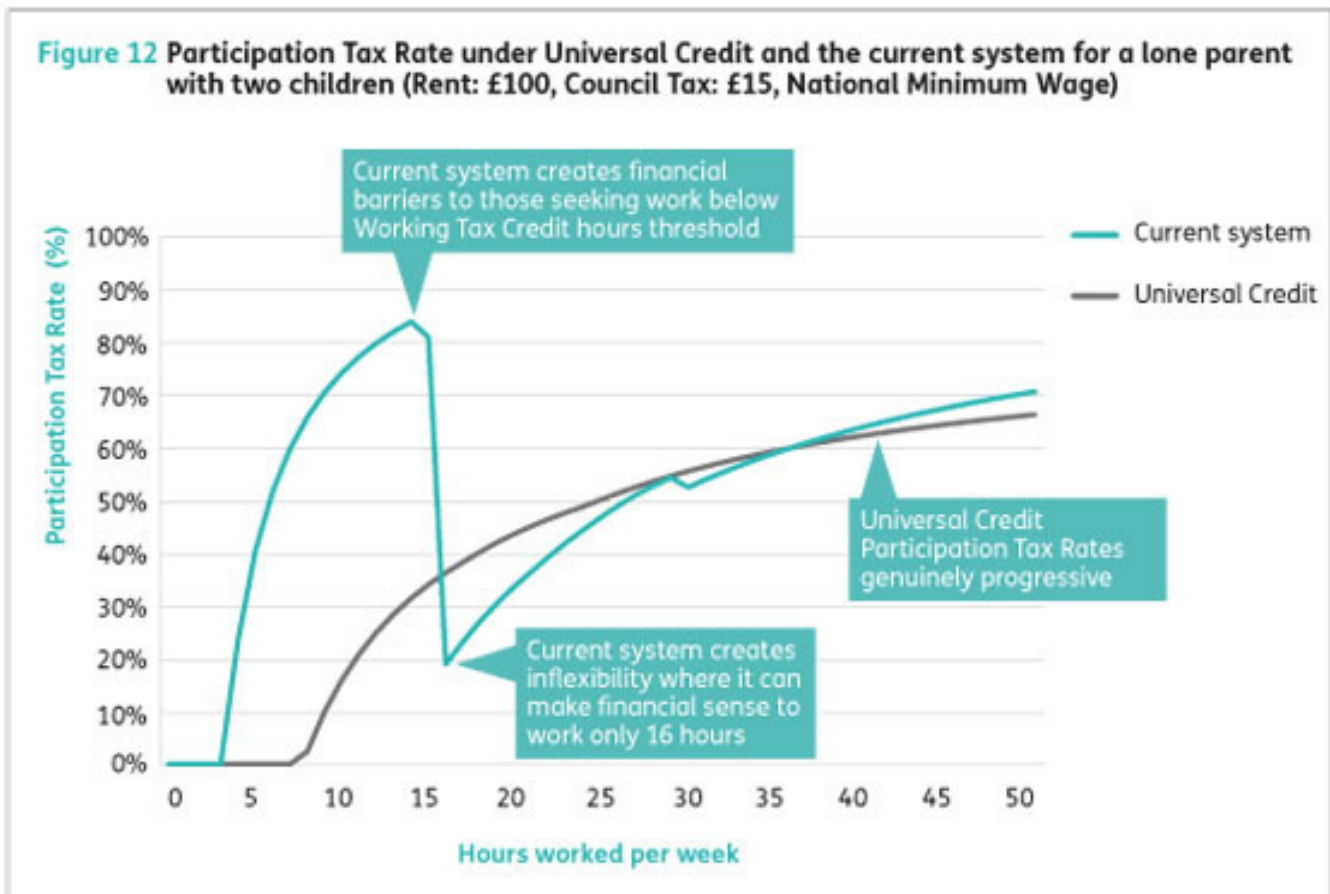
Source: Department for Work and Pensions Policy Simulation Model (based on Family Resources Survey 2008/9), 2014/15³¹ – Figures may not sum due to rounding.

* denotes fewer than 50,000 people

25. The introduction of more generous earnings disregards in Universal Credit, when combined with a single taper rate, creates a genuinely progressive Participation Tax Rate. This means that the combined withdrawal of benefits and taxes from the lowest earners (who tend to have the least secure employment prospects) is always less than from higher earners.
26. The improvement in Participation Tax Rates is illustrated in Figure 12 which shows the Participation Tax Rate for a lone parent with two children. In this example, the higher disregards for lone parents in Universal Credit mean that benefit is not withdrawn until around seven hours of work at the National Minimum Wage, whereas the current system withdraws benefit earlier.

³⁰ The Participation Tax Rate measures the proportion of total earnings lost from withdrawal of benefits and taxation. It is a measure of the financial reward for entering work. A high Participation Tax Rate means the financial incentive to work is low, and a low Participation Tax Rate means that the incentive is higher.

³¹ Modelling is based on entitlement changes only.



27. Such a lone parent in these circumstances would gain more from a move into work under Universal Credit than under the current system. This is true for most hours levels, and especially so for low-hours work. The viable options for entering work have expanded well beyond the current 16-hour option.
28. Hence, under Universal Credit not only is the current labour force more flexible, but there are many more financially rewarding job opportunities for workless households.

Impact of simplification

29. Universal Credit will radically simplify the current system of benefits and Tax Credits. This will improve work incentives in three ways: increased transparency of the financial benefits of work, reduced administrative burden on entering work, and reduced risk associated with an initially unsuccessful attempt at entering work.

30. Under the current system, there is clear evidence that many people are unaware of their full benefit entitlements and potential gains from moving into work. Latest statistics show that the take-up rate of Housing Benefit for people in work is low – between just 38 per cent and 51 per cent. There is also evidence that this means that many are deterred from entering work.³² The simplification of the system under Universal Credit will reinforce the transformation of the financial incentives to participate in work by helping people to see clearly that work pays.
31. Currently, somebody moving from an out-of-work benefit to work of 16 hours or more will typically cease a claim for benefit and start a new claim for Tax Credits with HM Revenue & Customs, as well as informing their Local Authority of a change in circumstances. This can be a daunting process, and people may face some delay in receiving their full entitlement – in some cases, delays in handling the change to Housing Benefit can leave tenants with arrears of rent. Universal Credit will smooth the current transition between benefits and work, and in the process remove much of the burden from taking that step.
32. Many people perceive the process of moving between benefits and work as a risky one. They may perceive a substantial risk of a delay in receiving new entitlements, possibly as a result of their own previous experience or the experience of friends and family. Similarly they may fear that should they later lose their job, it would take some time to re-establish their entitlement to out-of-work benefits.
33. Universal Credit is a single system supporting those in and out of work. Hence, as people's earnings increase or decrease, their Universal Credit amount will adjust smoothly to reflect this – thereby eliminating this risk.

Dynamic effects

34. This scale and scope of the Government's Universal Credit reform is unprecedented in recent times – it is the most significant change to the welfare system since the Beveridge reforms in 1947. However, even those pivotal reforms were ultimately the source of a good deal of today's complexity and the simplification that Universal Credit will bring is without parallel in UK history.
35. This chapter has set out the scale of the static impacts the Government expects Universal Credit to have. However, we believe that these impacts will be even more positive in practice because of the dynamic effects.
36. The introduction of Universal Credit will drive dynamic labour market effects as a result of many factors:
 - a. increased financial rewards to work;
 - b. increased transparency of these rewards;
 - c. reduced administrative complexity associated with a move into work and, related to this, reduced risks of interruptions in benefit payments occurring;

³² Turley C and Thomas A, September 2006, *Housing Benefit and Council Tax Benefit as in-work benefits: Claimants' and advisors' knowledge, attitudes and experiences*, Department for Work and Pensions Report 383.

- d. reinforcement of the conditionality regime; and
 - e. in the long-run, the reinforcement of pro-work social norms.
37. Given the fundamental nature of these reforms, no model or analytical technique exists that could enable us to quantify these effects with absolute precision. However, the scale of the Universal Credit measures is such that we can be very confident that they will have a significantly greater impact than any previous reforms, examples of which are provided in table 4, below.

Table 4: Employment gains from recent labour market reforms

Recent labour market reforms	Employment impact
Tax Credits, New Deal for Lone Parents and childcare strategy	80,000 Lone parents ³³
New Deal for Young People	30,000 ³⁴
Working Families Tax Credits	25,000-59,000 ³⁵

38. Based on available evidence, a plausible estimate is that the Universal Credit reform will reduce the number of workless households by around 300,000.³⁶ We believe that there is no reason why this increase should not be brought about within two to three years of implementation.
39. The majority of the reduction in workless households will be brought about by an increase in the number of currently workless people who will choose to engage in part-time work. The design of Universal Credit is specifically targeted to achieve this and the improvement in the incentives for currently workless people to move into part-time work is substantial. The improved financial incentives to move into work will be reinforced by the Work Programme and the completion of the transfer of Incapacity Benefit recipients to the Employment and Support Allowance.
40. We also believe that Universal Credit will create new opportunities for people to combine part-time work with benefit receipt and that this will significantly reduce the incentives for people to behave fraudulently and to “work and claim”.
41. In addition to the increase in part-time working among currently workless people, we also expect that more people will be prepared to move into more substantial jobs as a result of the greater clarity of work incentives, the simpler administrative procedures, and the reduced risk of experiencing an interruption in benefit payments when moving into work.

33 Gregg P and Harkness S, June 2003, *Welfare reform and lone parents employment in the UK*. CMPO working paper. series no. 03/072.

34 Riley and Young, December 2000, *New Deal for Young People: Implications for Employment and the Public Finances*, Employment Service Research Report 062.

35 Blundell R, Brewer M and Shephard A, 2005, *Evaluating the labour market impact of Working Families Tax Credit using difference-in-differences* HM Revenue & Customs Working Paper 4.

36 Based on internal analysis using the Department for Work and Pensions’ Policy Simulation Model. It combines a set of plausible assumptions about the impact of improved incentives to work in a Universal Credit world with evidence of the impact of previous initiatives to improve incentives to work. Further evidence is set out in the Impact Assessment that accompanies this White Paper.

42. Looking further ahead, the reduction in workless households should act to reduce worklessness further as a culture of work becomes the norm amongst a greater number of households and communities.
43. Although the number of workless households will reduce, it is possible that, in some families, second earners may choose to reduce or rebalance their hours or to leave work. In these cases, the improved ability of the main earner to support his or her family will increase the options available for families to strike their preferred work/life balance.

Fraud and error

44. The greater simplicity of the Universal Credit scheme will generate savings by reducing the scope for fraud, error and overpayments. For example, one category of fraud and error in the Tax Credit system is the incorrect reporting of hours worked. Because hours worked play little or no role in the Universal Credit assessment this should largely disappear under the new system.
45. Taken together with the impact of the planned use of real-time earnings on overpayments of Tax Credits, we anticipate that these measures will reduce losses from fraud, error and overpayments by more than £1 billion per year in the long term.
46. In the longer term we also expect the greater simplicity of the Universal Credit system to reduce administrative costs by more than £0.5 billion a year.

Equality impacts

47. Some of the design and operational issues have the potential to affect the protected groups under the public sector equality duty. We will be carrying out a full Equality Impact Assessment which we will publish in January 2011 as part of a broader set of Impact Assessments for the Welfare Reform Bill. In the meantime we are publishing, an outline of the Equality Impact Assessment explaining the evidence which is available on potential equality impacts, and how we will monitor and evaluate these equality impacts in the Welfare Reform Bill.