



Reforms to Universal Credit

Executive summary

This joint report by the Trades Union Congress and the Child Poverty Action Group considers reforms to Universal Credit that could have a significant impact on the number of children in poverty and on the incentives for claimants to get paid work or increase their earnings.

We find that the most effective reform for tackling child poverty is an increase in the child element: spending £1 billion in this way would reduce the number of children in relative and absolute poverty. The government's planned increase in the income tax personal allowance, by contrast, would reduce the numbers in absolute poverty by a smaller amount and *increase* the number in relative poverty.

Two reforms stand out as having a significant impact on work incentives. Reducing the "taper" (the rate at which Universal Credit is withdrawn as earnings rise) would significantly cut the marginal tax/deduction rates for lone parents and couple families, giving those with jobs a stronger incentive to increase their earnings. For most families it would also increase "gains to work" – the amount families without paid work would be better off if parents got jobs. We also found that a Second Earner Work Allowance would improve work incentives at comparatively low cost.

Increasing the income tax personal allowance would also improve work incentives – but at about three times the cost of reducing the taper rate.

We also looked at packages of reforms that would cost about the same as the government has already spent on raising the allowance (and about the same as it plans to spend on further increases). These packages combine increases in the child element, reductions in the taper, second earner allowances and other reforms such as higher payments to families with disabled children. These packages cut the number of children in poverty by up to 645,000, reduce marginal rates by up to 8.8 percentage points and increase gains to work for most families by up to 10.9 per cent.

1 Introduction

Universal Credit is widely accepted as the most important social security reform for thirty years. It brings together most of the means-tested benefits and tax credits for people of working age and has dominated policy-making for five years.

It is also the government's answer to any question about poverty in the UK, and especially those which ask how the legally binding targets set out in Child Poverty Act 2010 will be achieved. Yet the poverty-reducing potential of UC has been downgraded over the course of its development. The earliest assessment of UC's poverty impact can be found in the 2010 White Paper when the government estimated that "as many as 350,000 children and 500,000 working age adults could be moved out of poverty".¹ After successive downward revisions to these estimates as the implementation of UC became less generous, the most recent impact assessment simply removed all reference to the new benefit's poverty reduction potential. What we have in mid-2015, then, is a policy that promises much but may deliver little. Indeed, the swingeing cuts to the value of tax credits

that are likely to be made in the near future will be imported into the new benefit, undermining its poverty impact more than ever.

Nonetheless, Universal Credit will be the basis of the benefit system for adults under retirement age for some time to come. The Coalition Government invested a great deal in it (in terms of political capital as well as public funds) and the newly elected Conservative Government is likely to press ahead with full roll-out of the policy. Future governments of a different political persuasion would not reverse this policy casually – they would be averse to wasting the money already invested and the integration of working age benefits was a strategic goal of the Labour governments which preceded the Coalition Government of 2010-15.

Anti-poverty organisations therefore need to think through how Universal Credit can be reformed to make it a more effective instrument for fighting poverty. Many organisations (including CPAG and the TUC) have already identified the new benefit's failings and reforms to address them. With this project, however, we are concerned to help the government to prioritise anti-poverty reforms.

To do this we have taken into account two constraints that Ministers will have to address in deciding priorities. The first and most obvious is spending restraint – no likely government will have very large sums to spend on Universal Credit reform. We do not accept that this is an absolute restriction – CPAG and the TUC both believe that tackling poverty, especially child poverty, deserves a higher share of public spending. And over time there may be more scope for increased investment in UC. But, however much or little there is for reform, Ministers will always be intensely interested in how best to spend every extra pound.

The second constraint is the effect of any reform on work incentives. The last government prioritised 'making work pay', so does the current government, and so will the next. Means-tested benefits, like UC, have a tendency to reduce incentives to increase earnings and ministers will be concerned to make sure that any reforms minimise this tendency (or at least do not make it worse). Improving incentives by cutting entitlements would cause an unacceptable increase in poverty so this report considers reforms to the structure of UC that would enhance the relative attractiveness of paid work.

2 A brief overview of how Universal Credit works

Universal Credit is a single benefit for people of working age (that is, over the age limit for compulsory education and below the state pension age) and it is replacing means-tested benefits and tax credits for people in that age group. A family's UC is calculated by working out their maximum entitlement and then deducting an amount related to their income. The maximum entitlement is made up of:

- A standard allowance (the amount depends on whether you are single or a couple and under or over 25);
- A child element (different rates for first and other children);
- A disabled child element (paid at a lower or higher rate);
- A disability element (either a lower Limited Capability for Work Element or a

higher Limited Capability for Work & Work-Related Activity Element);

- A carer element;
- A childcare element (85 per cent of eligible costs, up to a limit that depends on whether you have one or more children receiving childcare);
- A housing element (similar to Housing Benefit).

The deductions take account of earnings, other income and savings.

- Only earnings above a “work allowance” are taken into account. There are different work allowances for couples and singles, for claimants with and without children, for claimants with and without limited capacity for work and work-related activity and for those not claiming housing support.
- 65 per cent of earnings over the work allowance are deducted from the claimant’s maximum UC – this is known as the ‘taper’.

Universal Credit has strengths and weaknesses. Both the TUC and CPAG have criticised it for the low value of elements for children, especially for disabled children. On the other hand, compared to tax credits, UC is more generous to families with low earnings. But this is paid for with a higher taper; to illustrate the difference, imagine someone who earns enough to be liable for income tax and National Insurance:

- Under Universal Credit, for every £1 a week increase in earnings they will pay 12p National Insurance Contributions and 20p income tax and their UC will be reduced by 65 per cent of the remaining 68p - 44.2p. Their net income will have risen by 23.8p – their “marginal effective tax rate” (METR) is 76.2 per cent.
- Under the existing tax credit system, for an extra £1, they will pay 12p NI Contributions, 20p income tax and their tax credits will be reduced by 41p,² leaving them 27p better off – their marginal rate is 73 per cent.³

Another criticism of Universal Credit has been the effect on the second earner in families. There is no work allowance for second earners and the higher taper means many couples will decide that a second earner will not increase the family’s earnings enough for it to be worth their while. In most couples the second earner will be a woman, so this effect will tend to reduce women’s employment rates and independent incomes. One of the reforms we look at below is the introduction of a second earner work allowance, designed to reduce this disincentive.

3 How we have evaluated reform options

The TUC and CPAG commissioned Howard Reed of Landman Economics to model the likely cost of various widely canvassed reforms of Universal Credit, their probable poverty-reducing potential and work incentives. Some studies of the effect of policy changes make unreasonable assumptions, such as that everyone is paid at exactly the minimum wage. Landman Economics draws on a tax-benefit model which uses data from the Family Resources Survey to simulate the effects of different policies for the individuals and families who responded to the FRS. For each of the reforms a measure has been provided of the cost effectiveness – how efficient they would be as anti-poverty measures. The research

also analyses a number of packages of measures that allow us to see the consequences of a more strategic approach.

Here we present results for four key reform proposals: cutting the taper, increasing the child element, introducing a second earner work allowance and, for comparison, increasing the income tax personal allowance to £12,500. However, this is a simplification,⁴ so we also note particularly interesting results where pertinent.

4 The impact on child poverty

The baseline for measuring impacts on relative poverty is the number of children in poverty after taking into account all the reforms announced for the 2010-15 Parliament⁵. This gives us the following numbers:

Table 1. Baseline child poverty figures

Households with children in poverty		Children in poverty	
Number (millions)	Proportion of all households with children	Number (millions)	Proportion of all children
1.424	18.3%	2.501	19.2%

Proposals for reducing poverty

We have used this starting point to consider how various reforms to Universal Credit could change the numbers of children in poverty (bearing in mind of course that the financial impacts of reforms go far beyond this, bringing financial benefits to those households already on slightly higher incomes as well as those who are significantly below the poverty line). These proposed changes are set out below and cover increases in the child element, reductions to the taper rate and the introduction of a second earner allowance. The current taper rate is 65 per cent; the changes in child poverty shown in Tables 2 to 5 below are relative to the baseline in Table 1.

Increasing child element

Table 2. How changes in the child element affect the number and proportion of children in poverty

Increase in child element	Change in number (thousands)	Percentage point change in proportion	Cost (£m)
plus 5%	-120	-0.9	957
plus 10%	-210	-1.6	1,916
plus 15%	-271	-2.1	2,881
plus 20%	-355	-2.7	3,856
plus £40/month	-289	-2.2	3,033
plus £80/month	-535	-4.1	6,137

Reducing the taper rate

Table 3. How changes in the taper rate affect the number and proportion of children in poverty

New taper rate	Change in number (thousands)	Percentage point change in proportion	Cost (£m)
55%	-94	-0.7	4,040
60%	-49	-0.4	1,850
64%	-25	-0.2	350

Second earner work allowance

Table 4. How a second earner work allowance affects the number and proportion of children in poverty

	Change in number (thousands)	Percentage point change in proportion	Cost (£m)
at 50% of main earner	-13	-0.1	245
at 75% of main earner	-20	-0.2	365
at 100% of main earner	-23	-0.2	490

Impact of the income tax personal allowance on poverty

For comparison, we looked at the impact of raising the income tax personal allowance to £12,500, a policy that the current government is committed to introducing over the course of this parliament, and often points to as a key intervention designed to improve the living standards of those on lower incomes. An immediate increase in the allowance to £12,500 in the current tax year (2015/16) is estimated to cost around £12.5 billion⁶, and increases already put in place since 2010 are now costing cost government £10.7bn annually (and are set to cost £12.4bn by 2020)⁷. Below we have modelled the costs of future potential increases in the personal allowance on poverty levels and rates.

Table 5. How an increase in the income tax personal allowance to £12,500 affects the number and proportion of children in poverty

Households in poverty		Children in poverty		Cost (£m)
Change in number (thousands)	Change in proportion	Change in number (thousands)	Change in proportion	
+162	+0.6	+115	+0.9	£12,507 ⁸

Overview of policy impacts

Increasing the child element produced substantial improvements, the largest for any of the reforms we considered. For example:

- An £80 a month increase in the child element would reduce the number of children in poverty by 21 per cent; for lone parents' children the reduction would be even larger – 29 per cent.
- Remarkably, the impact on the number of disabled children in poverty would be even larger than increasing in the child disability additions: a 10% increase in the child element reduces the number of disabled children in poverty by 10,900 (a reduction of around 7 per cent), an equivalent increase in the disabled child element by 5,900 (a reduction of around 4 per cent).

- The number of adults taken out of poverty is significant too: up to 130,000 for the most expensive option, including 40,000 disabled adults.
- The reduction in absolute poverty would be even larger. The £80 a month increase would take more than 700,000 children out of absolute poverty, including 48,000 disabled children and 328,000 children in lone parent families.
- The more generous an increase, the more it costs, but even the most expensive of these options would only cost about half as much as the costs of raising the income tax personal allowance over the last Parliament.
- This reform does not take cash away from families without children, so the numbers in absolute poverty would be unaffected.
- Some people would lose out, however: median incomes would rise, meaning that the number of childless families in poverty would go up - by 45,000 if the child element was raised by £80.

Given the fact that changes to the taper rate are proposed mainly to improve work incentives, the impacts on child poverty are larger than we expected. A reduction in the taper to 55 per cent reduces child poverty by almost 100,000.

The second earner work allowance was designed as a work incentive measure, but it was remarkably efficient in dealing with child poverty (see the discussion below of cost effectiveness). The variant set at 75% of the main earner's work allowance is especially notable, reducing the number of children in relative poverty by 20,000 at a cost of £365 million.

Raising the income tax personal allowance would increase the incomes of families that are not poor, often by more than the increases for poor families. It should therefore come as no surprise that this policy increased the proportion and numbers in relative poverty of every group we looked at.

- It increased the number of children in relative poverty by a substantial 115,000. For lone parents, it increased the proportion by 1.6 percentage points, for disabled adults by 0.9 points, for disabled children by 0.7 points, for working single people by 1.3 points, for one earner couples by 0.5 points, for two earner couples by 0.1 points and for self-employed people by 0.2 points.
- For absolute poverty, however, the impact was positive, with the number of children in poverty reduced by 49,000, the number of disabled adults in poverty down 45,000 and the number of two-earner couples in poverty reduced 27,000.
- Raising the personal allowance not only *increased* relative child poverty, it was the most expensive option we considered.

5 Efficiency in reducing child poverty

Table 6 below presents the cost effectiveness of these reforms and child poverty. The first column gives the reform. The second column is the cost of each measure – a negative figure indicates a saving. The third column shows the number of children lifted out of relative poverty per £1bn spent on each reform; a negative

figure is the number of children moved *into* relative poverty per £1bn spent. The final column gives a ranking for value for money.

Table 6. Value for money of reform options

Option	Cost (£m)	Child poverty reduction achieved per £bn invested	Rank
Change taper			
55%	4,035	23,314	12
60%	1,849	26,585	11
64%	352	71,398	7
Increase child element			
plus 5%	957	125,759	1
plus 10%	1,916	109,485	2
plus 15%	2,881	93,935	4
plus 20%	3,856	92,057	5
plus £40/month	3,033	95,412	3
plus £80/month	6,137	87,105	6
Second earner disregard			
at 50% of main earner	245	53,506	9
at 75% of main earner	365	55,997	8
at 100% of main earner	490	47,047	10
Income tax personal allowance			
raise to £12,500	12,507	-9,169	13

Two points stand out from this table. One is that raising the personal tax allowance is an ineffective way to address relative child poverty. (In a longer version of this table⁹ it ranks 37th of the 37 policy options we looked at.) The second is that increasing the child element is the most efficient – the six different levels of enhancement we studied are the six highest ranked variants in the whole study.

6 Effects of reforms on work incentives

In the context of benefit and tax credit policy, work incentives have to be thought of in two ways. For claimants who are already employed we are most interested in incentives to increase hours of work, while for claimants who are not employed we are interested in incentives to enter work. For the first group we look at marginal earned deduction rates – for every extra pound someone earns, how much does their net income increase (after taking income tax, NI Contributions and reduced UC into account)? For the second group we look at gains to work – how much better off is someone in work under the current system and does that go up or down for each reform?

Governments of both main parties have always taken an interest in the “welfare-to-work” agenda and they are also interested in encouraging UC claimants to work a full week where this is a reasonable expectation. As it stands, however, Universal Credit’s role in promoting increased earnings is not entirely clear: on the one hand, as we have seen, the benefit is designed to encourage people to get very short hours jobs. On the other, new rules, known as “in-work conditionality” could lead to people facing the loss of some or all of their UC if they do not act to raise their earnings - which will usually be by working longer hours.

Two of the reform options examined in this paper – reducing the taper and introducing a second earner work allowance – are primarily designed as work incentive measures. We have, however, evaluated all four options as anti-poverty measures; similarly, we will look at the impact of all four on work incentives.

We look at each reform and its impact on marginal rates – how much better off will someone be under each reform if they are already in paid work? Note that the marginal rates analysed in this report include the Universal Credit taper *plus* income tax and employee National Insurance contribution marginal rates where payable. We analyse average marginal rates for currently working UC claimants in three groups:

- Working lone parents.
- Primary earners in couples with children.
- Secondary earners with couples with children.¹⁰

For each reform, we show the change to the average marginal rate for working UC recipients and compare this figure with our baseline – the existing Universal Credit system, shown in Table 7 below:

Table 7. Average Marginal Earned Deduction Rate (MEDR) for working adults in families with children receiving Universal Credit

Group	Average Universal Credit MEDR in group (per cent)
Lone Parents in receipt of UC	60.8
Primary earners, all UC recipients with children	69.3
Secondary earners, all UC recipients with children	68.1

For each reform we also look at the potential gains to work for adults who are not currently working in families claiming Universal Credit. As with the marginal rate analysis we look at three groups separately:

- Non-working lone parents.
- Potential primary earners in couples with children where neither adult is currently employed.
- Potential secondary earners in couples with children where one adult is currently working.

We have assumed that people get jobs of either 20 hours a week or 40 hours, which allows us to look at whether each reform gives a greater incentive than the current system for both part-time and full-time work. Hourly wages for people moving into work are slightly below the median for people already in work – this is calculated using a procedure developed for a recent report by Howard Reed for the Social Mobility and Child Poverty Commission, described in full detail in the Appendix to this report. The gains to work are then compared with the gain under the existing system.

The gains to work figures are given as percentage increases in household income when a non-working person moves into work, and we can show how these are

worked out by looking at the baseline – the existing UC system. Table 8 below shows average weekly household incomes when not working, and gains to work at 20 or 40 hours of work per week, for individuals in each of the three groups analysed.

Table 8. Gains to work for non-working adults in families with children receiving Universal Credit

Group	Average weekly incomes (£)			Gain to work (£/week)		Gain to work (%)	
	Not working	20 hours	40 hours	20 hours	40 hours	20 hours	40 hours
Non-working lone parents	394.15	417.91	458.34	23.74	64.17	6.0	16.3
Potential primary earners	394.18	497.88	548.99	103.70	154.82	26.3	39.3
Potential secondary earners	488.48	564.95	655.28	76.47	166.79	15.7	34.1

We present the gains to work in percentage terms (the two most right-hand columns of Table 8 above) for each of the reform options, to make it easier to assess whether they increase or reduce these gains.

Effects of reducing the taper

The following tables look at the impacts on marginal rates and percentage cash gains to work of reducing the taper from its current rate (65%).

Table 9. Impacts of reductions in the Universal Credit taper on marginal rates (%)

Taper	Lone parents			Primary earners in couples			Secondary earners in couples			Cost (£m)
	Current system	Reform	Diff.	Current system	Reform	Diff.	Current system	Reform	Diff.	
55%	60.8	54.8	-6.0	69.3	62.9	-6.4	68.1	60.4	-7.7	4,035
60%	60.8	57.8	-3.0	69.3	66.1	-3.2	68.1	64.3	-3.8	1,849
64%	60.8	60.1	-0.7	69.3	68.7	-0.6	68.1	67.5	-0.6	352

Table 10. Impacts of reductions in the taper on gains to work for currently non-working adults (%)

		Lone parents					
		20 hours a week			40 hours a week		
Taper	Current system	Reform	Difference	Current system	Reform	Difference	
55%	6.0	7.4	1.4	16.3	20.4	3.9	
60%	6.0	6.7	0.7	16.3	18.3	2.0	
64%	6.0	6.2	0.2	16.3	16.7	0.4	
Potential primary earners in couples							
		20 hours a week			40 hours a week		
Taper	Current system	Reform	Difference	Current system	Reform	Difference	
55%	26.3	28.9	2.5	39.3	45.0	5.7	
60%	26.3	27.6	1.3	39.3	42.1	2.8	
64%	26.3	26.6	0.3	39.3	39.8	0.5	
Potential secondary earners in couples							
		20 hours a week			40 hours a week		
Taper	Current system	Reform	Difference	Current system	Reform	Difference	
55%	15.7	15.8	0.1	34.1	32.9	-1.2	
60%	15.7	15.5	-0.2	34.1	33.3	-0.8	
64%	15.7	15.6	-0.1	34.1	34.0	-0.1	

If we take, for example, a change of two percentage points or more in marginal rates or gains to work as significant, the larger changes to the taper have significant effects on marginal rates, but less so on gains to work, where it takes a five point cut (for lone parents) and a 10 point cut (for potential primary earners in couples) in the taper to have an effect on percentage gains to work. This is not particularly surprising – a change in the percentage of earnings deducted from claimants’ in-work benefits will necessarily have more impact on their marginal rates than on their overall incomes. But the fact that the impact on gains to work is still noticeable underlines the fact that changes to the taper rate have a great deal of potential.

For secondary earners in working couples claiming UC the effects on marginal rates are similar to primary earners, but for potential second earners in couples where only one adult is in work, the effects on gains to work go in the opposite direction to primary earners; a lower taper rate reduces gains to work in percentage terms. This is because lowering the taper increases net incomes for the primary earner in these couples (who is already in work), meaning that further increases in net income as a result of the second earner (who has a lower hourly wage than the primary earner in most cases) are worth less as a percentage of net income than when only one earner is in work. This shows that reforms which increase the incentive for primary earners in couples to enter work (or remain in work) can weaken work incentives for secondary earners, and vice-versa.

Effects of *increasing* the UC taper

The background to the discussion about Universal Credit is the tight fiscal environment. The TUC and CPAG are well aware that, in these circumstances there may be pressure to increase the taper, in order to achieve the savings mandated for the social security budget. It might be tempting to think that a small increase cannot do much damage, and some of the money saved could be used for compensating reforms.

Table 11. Impacts of increases in the taper on marginal rates (%)

Taper	Lone parents			Primary earners in couples			Secondary earners in couples			Cost (£m)
	Current system	Reform	Diff.	Current system	Reform	Diff.	Current system	Reform	Diff.	
66%	60.8	61.2	0.4	69.3	69.1	-0.2	68.1	68.0	-0.1	-343
70%	60.8	62.8	2.0	69.3	68.6	-0.7	68.1	64.0	-4.1	-1,590

Table 12. Impacts of increases in the taper on gains to work for currently non-working adults (%)

Taper	Lone parents					
	20 hours a week			40 hours a week		
	Current system	Reform	Difference	Current system	Reform	Difference
66%	6.0	5.9	-0.1	16.3	15.9	-0.4
70%	6.0	5.3	-0.7	16.3	14.3	-2.0
Taper	Potential primary earners in couples					
	20 hours a week			40 hours a week		
	Current system	Reform	Difference	Current system	Reform	Difference
66%	26.3	26.0	-0.3	39.3	38.7	-0.6
70%	26.3	25.0	-1.3	39.3	36.6	-2.7
Taper	Potential secondary earners in couples					
	20 hours a week			40 hours a week		
	Current system	Reform	Difference	Current system	Reform	Difference
66%	15.7	15.7	0.0%	34.1	34.3	0.2
70%	15.7	16.0	0.3%	34.1	35.2	1.1

We therefore modelled the effects of a one percentage point and five percentage point increase in the taper.

It is certainly true that these changes could raise significant sums: £343 and £1,590 million respectively. But increasing the taper also increases the number of children in poverty. It is worth noting an asymmetry in the scale of impact of these measures - a five point rise in the taper rate increases the proportion of children in poverty by 90,000, whereas a ten point cut decreases child poverty by 90,000. Increasing the marginal rate improves work incentives on average for the subsample of families who are claiming Universal Credit in the baseline scenario, because some of these families are floated off of Universal Credit and therefore have a marginal rate equivalent to their tax rate without any impact from UC deductions. However, increasing the taper also reduces gains to work for lone

parents and potential primary earners (although gains for work for potential secondary earners as a percentage of household income when the secondary earner is not in work are improved). If one of our aims is to promote full-time work, the fact that a five point increase in the taper rate would reduce the gains from moving into full-time work by 2.7 per cent for potential primary earners in couples, and 2 per cent for non-working lone parents, should be a further reason for being cautious about raising money this way.

Increasing the child element

Table 13. Impacts of increased child element on marginal rates (%)

Increase	Lone parents			Primary earners in couples			Secondary earners in couples			Cost (£m)
	Current system	Reform	Diff.	Current system	Reform	Diff.	Current system	Reform	Diff.	
+5%	60.8	60.6	-0.2	69.3	69.3	-0.0	68.1	68.2	0.1	957
+10%	60.8	60.4	-0.4	69.3	69.2	-0.1	68.1	68.2	0.1	1,916
+15%	60.8	60.2	-0.6	69.3	69.1	-0.2	68.1	68.1	0.0	2,881
+20%	60.8	60.2	-0.6	69.3	69.1	-0.2	68.1	68.1	0.0	3,856
+£40/month	60.8	60.2	-0.6	69.3	69.1	-0.2	68.1	68.1	0.0	3,033
+£80/month	60.8	59.9	-0.9	69.3	68.9	-0.4	68.1	68.1	0.0	6,137

Increasing the child element has very little impact on marginal rates, so this measure is unlikely to stop many in-work claimants increasing their hours. The impacts on gains to work for lone parents and primary earners in couples are slightly positive. There are negative impacts on gains to work for secondary earners arising because the increase in the child element leads to higher net household incomes for households with one earner in work, even before the second earner moves into work. This means that gains for work for second earners, while similar in cash terms, are smaller in percentage terms when the child element increases.

However, the work incentive problem in Universal Credit is more the high marginal rates than the gains to work, which are already significant. (This is not particularly due to the introduction of UC - the benefit system is structured to ensure that people are almost always better-off in work).

Table 14. Impacts of increased child element on gains to work for currently non-working adults (%)

							Lone parents
20 hours a week				40 hours a week			
Increase	Current system	Reform	Difference	Current system	Reform	Difference	
+5%	6.0	6.1	0.1	16.3	16.3	0.0	
+10%	6.0	6.2	0.2	16.3	16.3	0.0	
+15%	6.0	6.3	0.3	16.3	16.4	0.1	
+20%	6.0	6.5	0.5	16.3	16.6	0.3	
+£40/month	6.0	6.4	0.4	16.3	16.5	0.2	
+£80/month	6.0	7.2	1.2	16.3	17.2	0.9	
							Potential primary earners in couples
20 hours a week				40 hours a week			
Increase	Current system	Reform	Difference	Current system	Reform	Difference	
+5%	26.3	26.3	0.0	39.3	39.1	-0.2	
+10%	26.3	26.3	0.0	39.3	39.0	-0.3	
+15%	26.3	26.4	0.1	39.3	39.0	-0.3	
+20%	26.3	26.5	0.2	39.3	39.0	-0.3	
+£40/month	26.3	26.5	0.2	39.3	39.1	-0.2	
+£80/month	26.3	27.2	0.9	39.3	39.5	0.2	
							Potential secondary earners in couples
20 hours a week				40 hours a week			
Increase	Current system	Reform	Difference	Current system	Reform	Difference	
+5%	15.7	15.2	-0.5	34.1	33.3	-0.8	
+10%	15.7	14.8	-0.9	34.1	32.4	-1.7	
+15%	15.7	14.4	-1.3	34.1	31.6	-2.5	
+20%	15.7	14.0	-1.7	34.1	30.9	-3.2	
+£40/month	15.7	14.4	-1.3	34.1	31.5	-2.6	
+£80/month	15.7	13.3	-2.2	34.1	29.2	-4.9	

Second earner work allowances

For the second earner allowance options we only show the impact on incentives facing secondary earners in families with children.

Table 15. Impacts of second earner allowances on secondary earners' marginal rates (%)

	Tapers	Current system	Reform	Difference	Cost (£m)
at 50% of main earner		68.1	68.0	- 0.1	245
at 75% of main earner		68.1	68.0	- 0.1	365
at 100% of main earner		68.1	67.7	- 0.4	490

Table 16. Impacts of second earner allowances on potential secondary earners' gains to work (%)

	Tapers	20 hours a week			40 hours a week		
		Current system	Reform	Difference	Current system	Reform	Difference
at 50% of main earner		15.7	16.5	+ 0.7	34.1	34.7	+ 0.6
at 75% of main earner		15.7	16.9	+ 1.1	34.1	35.0	+ 0.9
at 100% of main earner		15.7	17.4	+ 1.5	34.1	35.3	+1.2

This reform had only a limited impact on marginal rates for secondary earners who were UC claimants in the baseline scenario, but does increase gains to work (by up to 1.5 percentage points). This is one of the most efficient reforms for increased gains to work, and is one of only three reforms we modelled that cost less than £1 billion for each percentage point increase in gains to work. (The other two are higher work allowances for disabled people and lone parents.)

Income tax personal allowance raised to £12,500

Table 17. Impacts of £12,500 allowance on marginal rates (%)

	Lone parents			Primary earners in couples			Secondary earners in couples			Cost (£m)
	Current system	Reform	Diff.	Current system	Reform	Diff.	Current system	Reform	Diff.	
	60.8	59.3	-1.5	69.3	66.7	-2.6	68.1	63.4	-4.7	12,507

Table 18. Impacts of £12,500 allowance on gains to work for currently non-working adults (%)

Group	Current system	20 hours a week			40 hours a week		
		Reform	Difference	Current system	Reform	Difference	
Lone parents	6.0	6.1	0.1	16.3	17.0	0.7	
Primary earners	26.3	26.5	0.2	39.3	40.1	0.8	
Secondary earners	15.7	16.3	0.6	34.1	36.0	1.9	

The impact of a higher personal allowance on work incentives is positive. An immediate increase to £12,500 reduces marginal rates by between 1.5 and 4.7 per cent for each group of working UC claimants, and increases gains to work by between 0.7 and 1.9 points for each group of non-working UC claimants. On all these counts except for gains to work for secondary earners, however, the tax allowance increase would be out-performed by a 10 percentage point cut in the taper rate – at a third of the cost.

Looking at these reforms, including those specifically designed to improve work incentives; we are struck by how difficult it is to achieve substantial improvements. The major problem in Universal Credit is the high marginal deduction rate and it is likely that it acts as a disincentive to increased earnings. Against marginal rates usually in excess of 60%, most of the reforms we have looked at cut it by two percentage points or less. A ten point reduction in the taper rate reduces marginal rates by 6.4 points for primary earners and 7.7 points for secondary earners and this is a high point.

Looking at gains to work, our data underline the fact that the UK does not have a large “better off out of work” problem – all the groups we look at here are already better off in work, often substantially so.

This suggests that further progress on gains to work may depend on action on the other side of the wage/benefit balance – raising the minimum wage, increasing the number of employers committed to the living wage and increasing the scope of collective bargaining for low-paid workers.

7 Packages of reforms

Each of the individual reforms has strengths and weaknesses in terms of value for money, poverty reduction and work incentives. Second earners allowances do well from a poverty reduction point of view and in terms of gains to work, but do not perform so well on marginal rates. Small reductions in the taper rate are efficient at reducing child poverty and reduce marginal rates, but are less impressive when it comes to gains to work. The second earner disregard is an above average performer on poverty and gains to work, but not on marginal rates.

We therefore looked at packages of reforms that would cost roughly the same as immediately introducing the £12,500 personal allowance – this option fails on all the criteria we have used in this exercise and is massively expensive. It does have the advantage though of suggesting an amount of Treasury money that could potentially be in play - the current government plans eventually to raise the allowance by this much, so it can hardly be labelled unaffordable.

In our discussion of the various policies, we have seen that increases in the child element have the biggest impacts on child poverty and reductions in the taper have the biggest impact on work incentives. In these packages we combine these elements with increases in the disability or disabled child elements, plus bonuses for working above a certain number of hours or second earner disregards.

The reform options are as follows:

Option 1: Reduce taper to 60%, increase child element by £80/month, increase disability element by £80/month, hours bonus at 16 hours (£80/month). This package is designed to combine substantial increases in child support with additional support for people moving into work at greater than 16 hours per week (or for part-time workers increasing their hours to more than 16 per week).

Option 2: Reduce taper to 60%, increase child element by £40/month, increase disability element by £40/month, raise work allowance by 30%, second earner disregard at 100% of main earner, hours bonus at 16 hours (£40/month). This

package is designed to provide moderately large increases in child support at the same time as providing substantial additional incentives to work, particularly for second earners and people moving into full-time work.

Option 3: Keep the taper as it is, increase child element by £80 a month, raise disability element by £80 a month, increase work allowances by 30%, introduce a second earner work allowance at 50% of the main earner rate and an hours bonus of £40 a month. This package explores alternative ways of improving work incentives without changing the UC taper, and also provides substantial increases in child support.

Option 4: Our final package is much more focused on improving work incentives, and includes a 10 percentage point cut in the taper (to 55%), a 10 per cent increase in the work allowances, an £80 a month increase in the hours bonuses, a £40 a month increase in the per child amount and a £40 increase in the disabled child amount.

Table 20 below shows the impacts of each reform package on child poverty, as well as the cost of each package (costs range from £12.8 billion for Option 3 to just over £14 billion for Option 2). Options 1 and 3 (which feature larger increases in per-child payments than Options 2 and 4) achieve the largest reductions in child poverty; although in all cases the packages produce a sizeable reduction in child poverty (between 450,000 and just over 650,000) in addition to wider impacts on family incomes.

Table 20. Reform options: changes in the number and proportion of children in poverty

Reform package	Change in number	Percentage point change in proportion	Cost (£m)
Option 1	-631,849	-4.9	13,431
Option 2	-491,327	-3.8	14,062
Option 3	-654,322	-5.0	12,817
Option 4	-459,970	-3.5	13,671

Table 21 shows the impact of each reform option on marginal rates for working UC claimants. Option 2 produces the biggest reduction in marginal rates for lone parents, due mainly to the increase in earnings disregards (work allowances) which are particularly useful for working lone parents. Option 4 produces the largest reduction in marginal rates for primary and (especially) secondary earners, largely due to the reduction in the taper to 55 per cent. This has a bigger impact on second earner work incentives than the introduction of a second earner disregard in Option 2 (although Option 2 still performs well for primary and second earners in couples). Option 3 performs reasonably well for lone parents but not so well for couples (mainly because the taper stays at 65 per cent).

Table 21. Impacts of reform options on marginal rates (%)

Reform Package	Lone parents			Primary earners in couples			Secondary earners in couples		
	Current system	Reform	Diff.	Current system	Reform	Diff.	Current system	Reform	Diff.
Option 1	60.8	56.4	-4.2	69.3	65.5	-3.8	68.1	64.0	-4.1
Option 2	60.8	52.0	-8.8	69.3	64.2	-5.1	68.1	63.2	-4.9
Option 3	60.8	54.5	-6.3	69.3	67.3	-2.0	68.1	67.2	-0.9
Option 4	60.8	52.4	-8.4	69.3	62.0	-7.3	68.1	59.7	-8.4

Table 22 shows the impact of each reform option on gains to work for adults who are currently not in work, in families claiming UC. For lone parents and potential primary earners in couples, Options 2 and 4 produce the largest gains to work in percentage terms at 20 and 40 hours per week, due to the combinations of increased work allowances, a lower taper on earned incomes, and (for Option 2) the 16 hours bonus. For potential second earners in couples with children, gains to work *fall* as a percentage of household income when the second earner is not working, mainly because of the substantial increases in per-child support and the increases in the generosity of UC for primary earners (e.g. taper reductions, increased primary earner work allowances etc.) which mean that net earnings for second earners are worth less as a percentage of total household income, **even though average net earnings for second earners in cash terms are similar or even slightly higher than the baseline case.**

Table 22. Impacts of reform packages on gains to work for currently non-working adults (%)

							Lone parents
20 hours a week				40 hours a week			
Reform Package	Current system	Reform	Difference	Current system	Reform	Difference	
Option 1	6.0	12.6	6.6	16.3	23.8	7.5	
Option 2	6.0	13.5	7.5	16.3	26.8	10.5	
Option 3	6.0	11.8	5.8	16.3	23.6	7.3	
Option 4	6.0	12.9	6.9	16.3	26.2	9.9	

							Primary earners in couples
20 hours a week				40 hours a week			
Reform Package	Current system	Reform	Difference	Current system	Reform	Difference	
Option 1	26.3	33.2	6.9	39.3	46.9	7.6	
Option 2	26.3	35.0	8.7	39.3	49.4	10.1	
Option 3	26.3	32.7	6.4	39.3	45.2	5.9	
Option 4	26.3	34.4	8.1	39.3	50.2	10.9	

							Secondary earners in couples
20 hours a week				40 hours a week			
Reform Package	Current system	Reform	Difference	Current system	Reform	Difference	
Option 1	15.7	12.9	-2.8	34.1	26.7	-7.4	
Option 2	15.7	15.1	-0.6	34.1	28.5	-5.6	
Option 3	15.7	13.4	-2.3	34.1	26.8	-7.3	
Option 4	15.7	14.2	-1.5	34.1	28.3	-5.8	

9 Recommendations

The clearest lesson from this study is that Universal Credit has a great deal of poverty reduction potential which is currently under-utilised. The packages of reforms we have investigated show that it is possible to reduce child poverty whilst maintaining or even improving work incentives, but that this requires extra spending.

One oft-suggested way to find funds for poverty-reducing reforms to UC is to look within the current budget envelope. Increasing the taper has been floated as a possible option in some quarters, with the suggestion made that the savings could be ploughed back into more directly poverty-reducing changes to the new benefit. But our modelling shows that increasing the taper also impacts on child poverty rates directly, as well as dampening work incentives which is likely to have a dynamic impact on working poverty in the longer run.

This report also shows that raising the income tax personal allowance is a terrible way to address child poverty and that there are more efficient ways to increase work incentives for people on lower and middle incomes. Investing in reforms to UC which reduce poverty and increase work incentives would, in our view, be a

much better use of resources than the planned increase in the income tax personal allowance.

We do not intend to promote a blueprint for UC reform. But our modelling does allow us to indicate the direction in which an administration which is truly committed to poverty reduction could reform:

- The most efficient policy for reducing child poverty directly is to increase the value of the child element. The government is legally obliged under the terms of the Child Poverty Act 2010 to reduce child poverty to negligible rates by 2020. Increasing the value of the children's element would take them closer to this ambition.
- The most effective and efficient way of increasing incentives to enter work would be to introduce a second earner disregard. This is relatively low cost and would benefit large numbers of households in poverty;
- The most efficient way to increase work incentives is to reduce the taper rate, thereby allowing those who increase their hours to keep more of their pay and truly be able to work their way out of poverty.

10 Appendix: estimating wages for people not in work in the FRS data

For people already in work in the actual 2010-11 FRS data, their actual weekly wage information is used, uprated to 2014 levels using data from the ONS's Average Weekly Earnings index.

For people who are not in work in the 2010-11 FRS, it is necessary to make an assumption on their level of hourly earnings if they were to move into work in order to estimate gains to work at 20 and 40 hours of work per week. This is achieved by using a set of quantile regressions on hourly wages using the 2014 Labour Force Survey data. Hourly wage equations are estimated separately for each of the following groups:

- men without children
- women without children
- lone parents
- men with children
- women with children

The regressions include the following variables:

- age (16-24, 25-34, 35-44, 45-54, 55-64, 65-74)
- highest educational qualification (degree, other higher education, A-level or equivalent, GCSE or equivalent, other, no qualification)
- regional variables (London, South East or East of England, rest of the UK)
- part-time work dummy (less than 30 hours per week)
- youngest child aged under 5 (where relevant)

The quantile regressions are estimated at the following percentiles: 20th, 25th, 30th, 35th, 40th, 45th, 50th, 55th, 60th and 65th. For each person entering work, a random draw is then taken from the distribution of ten quantile wage points. This allows some dispersion of earnings for people entering work rather than just giving all entrants the median wage (or some other percentile point). The distribution of quantile points chosen leads to average earnings for work entrants being slightly below median wages for the in-work population, which reflects the well-known finding that people currently not in work are likely to have somewhat lower earnings than people in work due to lower experience or other unobservable characteristics¹¹ (Blundell, Reed and Stoker, 2003).

The randomly selected hourly wage from the LFS equations is constrained to be no lower than the October 2014 minimum wage rate for individuals based on age (e.g. £6.50 for employees aged 21 or over).

11 Endnotes

1 DWP, *Universal credit: Welfare that works*, November 2010 Cm 7957

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/48897/universal_credit_full_document.pdf

2 The tax credit taper was 39 per cent until 2011, when the government increased it to its current level.

3 Where a family also receives Housing Benefit the current system involves higher marginal effective tax rates than Universal Credit.

4 The research looked at changes to the taper rate, increases in the child element, increases in the disability elements, increasing the work allowance, introducing a second earner work allowance and changing the minimum income floor for self-employed people. For each of these reforms it considers their effect on the number of households in relative and absolute poverty, the proportion taken out of poverty, how much the reform would cost, the number of children lifted out of poverty per £1bn spent and the effect on work incentives. The study also calculated for us the effect on lone parent families, families with no children, couples with children, working and non-working single people, one-earner couples, two-earner couples, self-employed households, disabled adults and disabled children.

5 This is calculated by using the 2010-11 Family Resources Survey and running all the tax and social security reforms announced during the 2010-15 Parliament through the Landman Economics tax-benefit model to measure their impact on child poverty compared to the 2010-11 baseline. The figures presented here use a Before Housing Costs (BHC) measure of income; After Housing Costs (AHC) is also available on request. For more details on the methodology used to model child poverty, see Appendix D of H Reed and J Portes (2014), *Understanding the parental employment scenarios necessary to meet the 2020 Child Poverty Targets*, Social Mobility and Child Poverty Commission Research Report.

6 Note that increasing the personal allowance to £12,500 by April 2020 – which is more likely to be the course of action followed by the newly elected Conservative Government – would cost much less (The IFS's 2014 Green Budget estimates a cost of around £5 billion – see http://www.ifs.org.uk/budgets/gb2014/gb2014_ch7.pdf). This is because price inflation between 2015 and 2020 means that £12,500 in 2020 is a much lower level for the personal allowance in real terms than £12,500 in 2015. It has not been practicable to measure the cost of similarly phasing the other reforms considered here, so we have compared immediate implementation in each case. If the reforms we consider were phased in as the government plans to phase in the higher personal allowance the cost would be similarly reduced.

7 Analysis undertaken by the House of Commons library has shown that the costs of increasing the personal allowance over the period to 2014/15 are now £10.7bn annually (<http://researchbriefings.files.parliament.uk/documents/SN06569/SN06569.pdf>) and that over the current parliament increasing the personal allowance to £11,000 is set to cost a further £1.68bn annually.

8 The Institute for Fiscal Studies costed this policy at £12 to £12.5 billion in their 2014 Green Budget (<http://www.ifs.org.uk/publications/7072>) and at £7.2 billion in October 2014 (see <http://www.bbc.co.uk/news/uk-politics-29433919> for instance). The difference depends on the date of implementation. Assuming implementation by 2020 produces the lower figure, assuming immediate implementation the higher. The alternative proposals in this report could also be brought in gradually to reduce their cost.

9 Available on request.

10 For two-adult families where both are out of work the secondary earner is the person with lower predicted wages of the two and the gains to work for the secondary earner assume that the primary earner has already moved into work. We have figures for single earners and all UC claimants, available on request.

11 See for instance R. Blundell, H. Reed and T. Stoker (2003), "Interpreting Aggregate Wage Growth: The Role of Labor Market Participation", *American Economic Review*, Vol 93 No 4, pp 1114-1131.