

10. The (changing) effects of universal credit

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Summary

- The government is in the process of integrating six means-tested benefits and tax credits for working-age families into a single payment called universal credit (UC). This is the most radical reform to the working-age benefits system for decades.
- Since it was first proposed, the design of UC has been significantly changed. The amounts recipients can earn before their benefits start to be withdrawn have been cut, shaving almost £5 billion per year off its long-run cost. As a result, 2.1 million working households will get less in benefits due to the introduction of UC (average loss of £1,600 a year) and 1.8 million will get more (average gain of £1,500 a year).
- Overall, UC will cut benefit spending by £2.7 billion a year in the long run. Taking working and non-working households together, 3.2 million will see lower benefit entitlements (average loss of £1,800 a year) while 2.2 million will see higher benefit entitlements (average gain of £1,400 a year). Those relatively likely to gain include low-earning households in rented accommodation and one-earner couples with children. Working lone parents, those with assets or unearned income, and two-earner couples are more likely to lose.
- The increase in support for one-earner couples with children strengthens the incentive for couples with children to have one adult in work rather than none, but weakens the incentive for both parents to work rather than just one.
- By increasing entitlements for renters while reducing them for owner-occupiers, and reducing support for those with substantial savings or unearned income, UC will likely focus support more on those with long-term rather than temporary low incomes than the current system, but will impose very high effective tax rates on saving for some claimants.
- Despite cuts to work allowances, UC will still strengthen work incentives overall. Importantly, UC will have the welcome effect of strengthening work incentives for groups who face the weakest incentives now: the number of people who keep less than 30% of what they earn when they move into work (due to the combination of withdrawn benefits and taxes) will fall from 2.1 million to 0.7 million. UC will also reduce the numbers facing very high effective *marginal* tax rates: 800,000 people who would currently keep less than 20 pence, and in many cases less than 10 pence, of an additional pound earned would keep at least 23 pence under UC.
- Expanding job-search conditions to recipients in working families is an unprecedented step. Some recipients may work more, though it could discourage some from claiming. Integration of benefits will likely boost take-up, make the system easier to understand, and ensure easier transitions into and out of work. Making UC a single monthly payment to one person in the household and removing direct payments to landlords may be riskier.

10.1 Introduction

Over the course of this parliament, the government is rolling out the most radical reform to the working-age benefits system for decades. A single means-tested payment, known as universal credit (UC), is being introduced as a replacement for six existing means-tested benefits and tax credits for those of working age: income support, income-based jobseeker's allowance, income-based employment and support allowance, child tax credit, working tax credit and housing benefit.

The 'legacy' system that UC will replace is largely the product of a history of separate decisions to layer new strands of support on top of what came before: for example, the decisions in the 1970s to create a national system of housing benefit and a new form of support for low-income working families. Previous social security reforms, including the Fowler reforms of the late 1980s and the introduction of the current tax credit system in 2003, stopped far short of the ambitious integration of benefits that UC will bring about. The central point of UC, and the reason for many of its potential advantages, is that it replaces the resulting jumble of separate and overlapping means tests with one integrated assessment of families' entitlements. UC should look more like a system that has been designed from scratch as a coherent whole – as indeed it is.

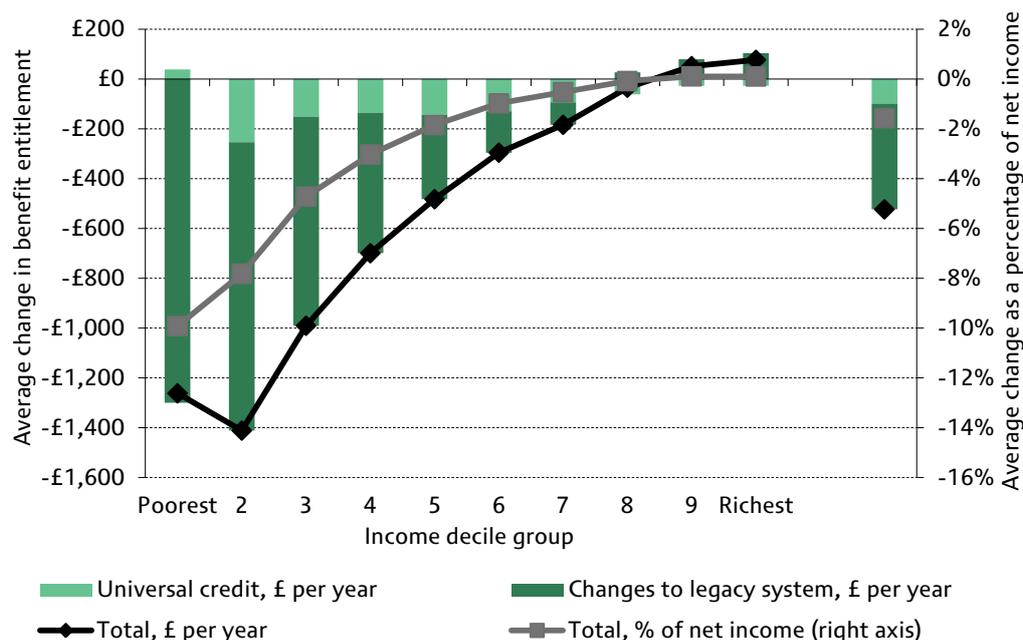
Unsurprisingly with such a radical structural overhaul, its impacts on the incomes and incentives of different households are complicated. They depend on the precise combination of benefit entitlements that a household has under the legacy system – the product of multiple separate benefit entitlement calculations – which in turn depends on a wide array of household characteristics. The impacts also depend, of course, on the structure of UC that the government chooses. That plan has changed significantly since the idea of UC was first set out. In particular, the so-called 'work allowances' – the amounts working families can earn before UC starts to be withdrawn – have been repeatedly reduced relative to the initial UC proposal, significantly cutting the amount of support that UC will give to low-income working families.

The main purpose of this chapter is to set out the impacts on incomes and incentives of introducing UC, given the current (substantially revised) plans for how UC will look. We also review some of the other very important changes that will be associated with the introduction of UC, such as the regime of conditionality, and discuss its potential effects on behaviour, such as labour supply and take-up of benefits.

There are, of course, a number of other important changes to the benefits system being introduced over the course of this parliament, including the introduction of a two-child limit for the child element of child tax credit for new births from April 2017 and a four-year freeze on most working-age benefits. Most of these changes apply to both the legacy benefits system and UC, since many UC parameters correspond to equivalent parameters in the legacy benefits system (so, for example, most elements of UC are also being frozen and the child element of UC is also being restricted to the first two children, and there will be a lower rate of UC for families with children who are new claimants in line with the abolition of the family element of child tax credit for new claimants). Hence those changes are not part of the effect of replacing the legacy system with UC.

Figure 10.1 shows the distributional impact of the changes to the legacy system that are planned between now and 2019–20, and compares it with the distributional impact of then replacing this reformed legacy system with UC – the change that we focus on in the rest of this chapter. We see that both of these sets of changes reduce benefit entitlements

Figure 10.1. Distributional impact of changes to the benefits system to be introduced between 2015–16 and 2019–20



Note: Assumes all reforms are fully in place. Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale.

Source: Authors' calculations using TAXBEN run on the 2013–14 Family Resources Survey.

on average, but that the reduction in benefit entitlements resulting from changes to the legacy benefit system is larger in aggregate and more skewed towards the lowest-income households. Indeed, the richest fifth of households gain on average from other changes to the benefits system as a result of the introduction of the single-tier pension and the tax-free childcare scheme. Replacing the legacy system with UC reduces benefit entitlements in the long run by an estimated £2.7 billion a year. It also results in relatively large losses for lower-income households on average (though not for the very poorest), but the losses are more evenly spread than the losses from reforms to the legacy system. This is because the reduction in work allowances particularly reduces entitlements for those households with higher incomes.

In the remainder of this chapter, we focus solely on the impact of replacing the legacy benefits and tax credits system with UC, ignoring these other changes, which in our modelling we assume are fully in place both in the legacy benefits system and under UC. It is also important to realise that our modelling ignores transitional arrangements that ensure that families transferred from the legacy system to UC will not see an immediate reduction in their benefit payments if their UC entitlement is lower than the amount they receive from the legacy system. Thus, our analysis is concerned with the long-run impact on household incomes of introducing UC as opposed to retaining the (reformed) legacy system.

The rest of this chapter proceeds as follows. We first describe UC and how the plans for its design and roll-out have changed over time (Section 10.2), before examining its effects on households' benefit entitlements (Section 10.3) and individuals' financial work incentives (Section 10.4). We then examine the evidence on the effects it has had in the areas where it has been rolled out so far (Section 10.5). Section 10.6 concludes.

10.2 What is universal credit, and how have the government's plans changed over time?

UC will replace six means-tested benefits and tax credits with a single payment for working-age families. As is clear from this description, the legacy system is somewhat disjointed, with separate out-of-work and work-contingent payments and yet more separate payments to support families who face particular costs (principally housing costs and the costs of children). The benefits that will be replaced by UC are:¹

- **Income support (IS).** Introduced in 1988 as the main income-related out-of-work benefit for those deemed unable to work (those with disabilities, pensioners, lone parents and carers), its scope has diminished over time. The minimum income guarantee and subsequently pension credit replaced IS for pensioners from 1999, income-based employment and support allowance replaced IS on the grounds of disability in 2008, and lone parents whose youngest child is aged 5 or over now have to claim jobseeker's allowance instead. Over the course of 2015–16, there are expected to be an average of 715,000 claimants in Great Britain and total expenditure is expected to be £2.6 billion.
- **Income-based jobseeker's allowance (JSA).** This is the income-related out-of-work benefit for those who are not in paid work and are required to take steps to look for work. Introduced in its current form in 1996, it is expected that the number of claimants will average 598,000 across 2015–16 in Great Britain and the total cost will be £2.0 billion.
- **Income-based employment and support allowance (ESA).** This is the income-related out-of-work benefit for those assessed as having limited capability for work on health grounds. Introduced in 2008, it is expected that there will be an average of 1.7 million claimants across 2015–16 in Great Britain, and total expenditure is expected to be £9.8 billion.
- **Child tax credit (CTC).** This provides support to low-income families with children, both in and out of work. It was introduced in 2003 to replace child additions to other benefits (including those mentioned above). In December 2015, there were 3.8 million families claiming child tax credit, of whom 1.2 million contained no adult in paid work and 2.6 million contained at least one working adult, and total expenditure in 2014–15 was £22.8 billion.
- **Working tax credit (WTC).** This provides support to low-income working families, both with and without children. As well as supporting low-income working families, WTC also strengthens work incentives for those with low incomes who would otherwise see little difference between their earnings in work and the benefits they would be entitled to if they did not work. Similar programmes exist in other developed countries – for example, the earned income tax credit in the US and the French *prime pour l'emploi*. Programmes for providing support to low-income working families with children have existed in the UK since 1971, but they have

¹ Figures for number of claimants and total expenditure are taken from <https://www.gov.uk/government/statistics/benefit-expenditure-and-caseload-tables-2015>, <https://www.gov.uk/government/publications/hmrc-annual-report-and-accounts-2014-to-2015> and https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/485170/cwctc-main-Dec15.pdf.

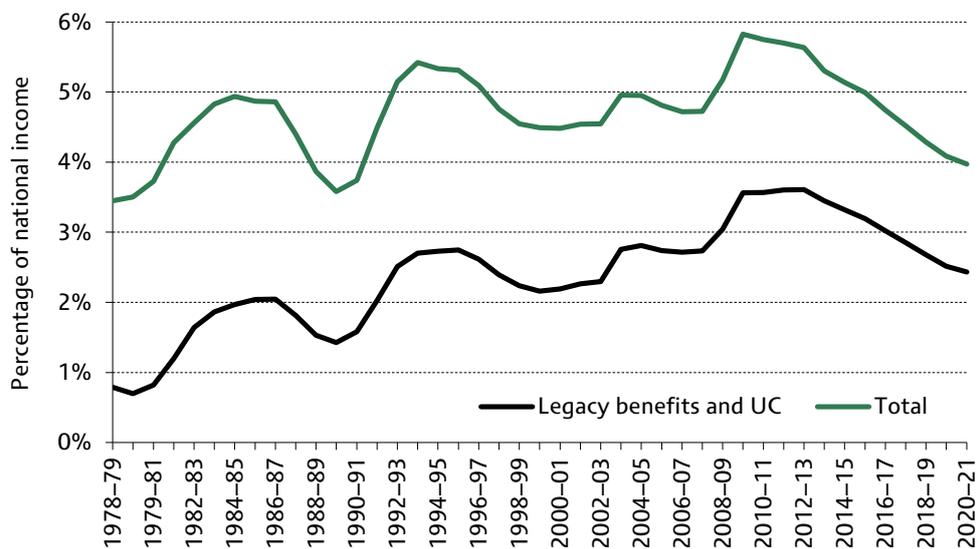
expanded over time to the extent that they are almost unrecognisable from their original incarnations. They were extended to families without children when working tax credit was introduced in 2003. There were 2.3 million families claiming WTC in December 2015 and total expenditure in 2014–15 was £6.2 billion.

- **Housing benefit.** This provides low-income households in rented accommodation with support for their rental costs. A national system of housing benefit has existed since the early 1970s, with the current system introduced in 1988. Over the course of 2015–16, there are expected to be an average of 4.8 million claimants of housing benefit in Great Britain and total expenditure is expected to be £24.4 billion.

Figure 10.2 shows spending on these six ‘legacy’ benefits and then UC as a share of national income from 1978–79 to 2020–21, along with overall spending on benefits for working-age families. Despite the planned cuts in generosity over the course of this parliament, spending on UC and legacy benefits in 2020–21 is still forecast to be higher (as a share of national income) than annual spending on legacy benefits between 1997–98 and 2002–03. By contrast, overall spending on working-age families in 2020–21 is forecast to be at its lowest level in 30 years. Compared with 1990–91, we are forecast to be spending more on means-tested benefits (particularly for low-income working households) and less on the working-age benefits that are not being rolled into UC (for example, contributory incapacity benefits and child benefit).

As one would expect given that all six of the benefits being replaced by UC are means tested, most of those entitled are towards the bottom of the overall income distribution: the poorest fifth of households have more than 40% of all entitlements, and the poorest half have 85% of all entitlements. Households where at least one person is in paid work have 40% of these entitlements despite making up 90% of working-age households.²

Figure 10.2. Benefit spending on working-age families, 1978–79 to 2020–21



Note: Spending figures are for Great Britain; GDP is for the whole UK.

Source: Benefits spending from <https://www.gov.uk/government/collections/benefit-expenditure-tables>. GDP from <https://www.gov.uk/government/statistics/gdp-deflators-at-market-prices-and-money-gdp-december-2015-quarterly-national-accounts>.

² Source: authors’ calculations using TAXBEN run on uprated data from the 2012–13 and 2013–14 Family Resources Survey.

To demonstrate the effect of UC on benefit entitlements at different levels of family income, Figure 10.3 shows the benefit and tax credit entitlements (in current prices) of a lone parent with two children renting in an average-rent area and paid the National Living Wage under the system we currently expect to be in place in 2019–20. We show this first under the legacy benefits and tax credits system (the blocks) and second under UC (the grey line). We can see that the main features of UC are as follows:

- Its basic structure involves a ‘maximum’ level of entitlement, which is received by those with the lowest levels of private incomes and financial assets. Entitlement is reduced below this maximum when income exceeds a certain threshold, known as the work allowance.
- The maximum entitlement is set in a similar manner to the maximum entitlements to the different benefits and tax credits under the legacy system. Thus, in this and most other cases, there is no change in total benefit entitlement for non-working families who have no private income.³ (Though, of course, actual levels relative to today will be lower in real terms as a result of the abolition of the family element of CTC and the four-year freeze on benefit levels announced in the July 2015 Budget, which will affect both the legacy system and UC.)
- This example individual can earn more before benefits start to be withdrawn than they can under the legacy system. Furthermore, when benefits start to be withdrawn, they are withdrawn at a slower rate. Both of these features strengthen the incentive for this individual to work a small number of hours each week.
- Unlike in the legacy system, there is no jump in entitlement at 16 hours of work, the point at which the lone parent becomes entitled to WTC under the legacy system. This means that UC is less generous than the legacy system if this lone parent works more than 16 hours, but more generous than the legacy system if they work less than 16 hours.
- When this example individual is working at least 16 hours per week, UC is withdrawn more slowly as income rises than the combination of tax credits and housing benefit under the legacy system, strengthening the incentive for this lone parent to increase their earnings (whether through additional hours or higher hourly pay).
- The overall effect for this individual is that there is marginally less support when working part time (between 16 and 40 hours per week) than under the legacy system, but more support at higher levels of earnings and for those working only a few hours per week (‘mini jobs’).

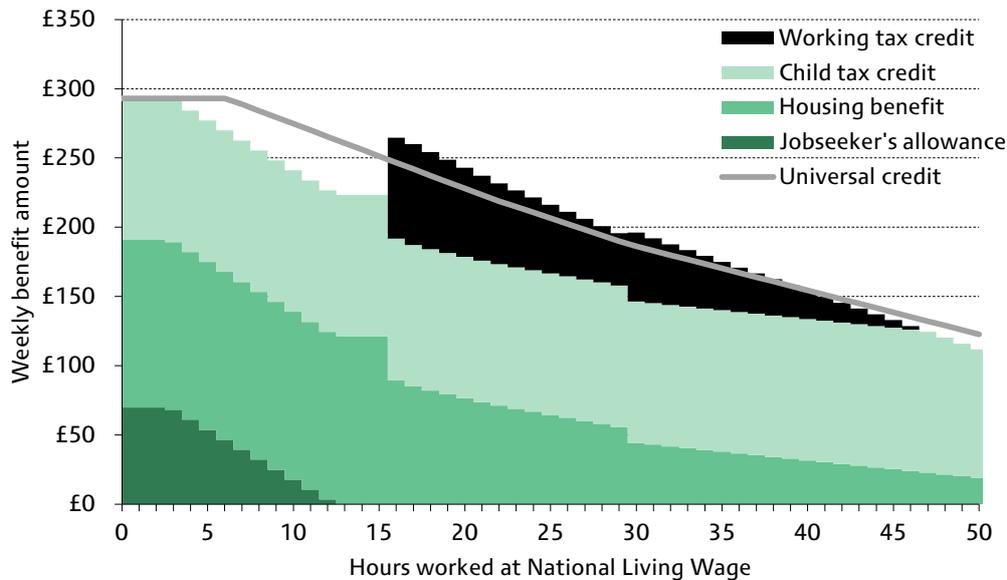
The legacy system provides a clear incentive for lone parents to work at least 16 hours a week, but little incentive to work less than this and a weak incentive to increase their hours worked beyond this level. As a result, few lone parents currently work for less than 16 hours per week and there is a large mass of lone parents working exactly 16 hours each week (see Figure 10.4). Since benefit entitlements do not jump when a lone parent

³ There are, however, some exceptions to this. Couples where one person is aged above the state pension age and the other is not will no longer be entitled to pension credit and will have to claim universal credit instead, meaning that they will no longer receive more support than couples where both people are under state pension age. The additional support given to people with disabilities through the means-tested benefit system is being simplified, which will mean that some groups with the most severe disabilities (those claiming the middle or higher rates of the care component of disability living allowance) will receive less support, and others (those in the ESA support group who are not entitled to disability living allowance) will receive more. Finally, lone parents aged under 25 will receive less support, in a similar manner to the way single people without children aged under 25 receive a lower rate of jobseeker’s allowance under the current system.

works 16 hours a week under UC, it is likely that some of these lone parents will choose to reduce or increase their hours worked in response to the changing incentives they face – the amount of support available to those working fewer than 16 hours a week will increase, and benefit entitlement will decline more slowly as they work more hours above this level.

However, perhaps the most significant change that UC will bring about is that it will integrate several strands of support into a single programme, meaning that families will

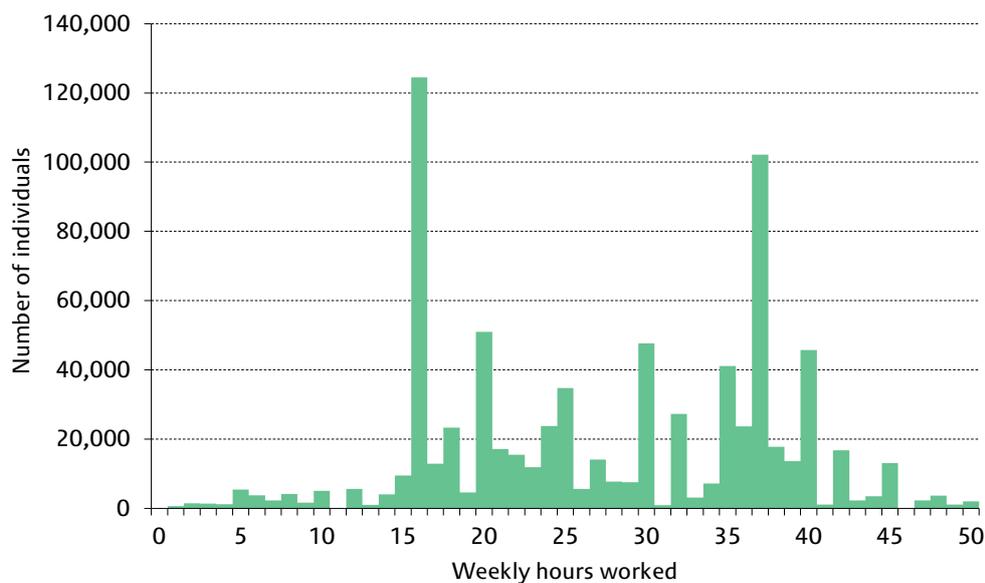
Figure 10.3. Benefit entitlements by hours worked for lone parent with two children under legacy system and UC



Note: Assumes two children aged under 5, no childcare costs, no unearned income, renting at the LHA rate in a median rent area and paid the National Living Wage under the system we currently expect to be in place in 2019–20. Ignores child benefit and council tax support.

Source: Authors' calculations using TAXBEN.

Figure 10.4. Weekly hours worked by lone parents, 2013–14



Source: 2013–14 Family Resources Survey.

not have to change which benefits they claim when they move into or out of paid work, and will only have to deal with one government agency rather than three (HMRC for tax credits, Jobcentre Plus for out-of-work benefits and local authorities for housing benefit). The introduction of UC is also likely to increase benefit take-up rates, as it will no longer be possible for families to only claim part of their benefit entitlement and because they will not have to apply for different benefits should they move into or out of paid work. This is not the end of the story, however. The benefits of greater integration and lower benefit withdrawal rates will be undermined by the decision to leave council tax support as a separate benefit designed and administered by local authorities.⁴ (And, of course, individuals may still need to interact with HMRC to deal with any income tax or National Insurance issues.) This chapter ignores council tax and council tax support, but it is important to bear in mind that the gains from the introduction of UC will not be as large as they could have been had the principle of greater integration been taken to its logical conclusion.

As well as changing families' benefit entitlements, the government has taken the opportunity of the introduction of UC to introduce some other important changes to the way that the benefits system works. The most important of these are the following:

- UC will be paid monthly, as opposed to fortnightly for out-of-work benefits, weekly or every four weeks for tax credits, and fortnightly or every four weeks for housing benefit.
- UC will all be paid to one member of a couple, whereas members of a couple can choose which of them receives each of the legacy benefits.
- Claimants in rented accommodation will, in most cases, be unable to choose to have their support for housing costs through UC paid directly to their landlord, in contrast to the current arrangements for social tenants under housing benefit.
- Job-search conditions will be applied to more benefit claimants than at present when UC is fully in place. Under UC, conditionality will be applied to individuals working fewer hours than the government expects them to and whose total pre-tax family earnings are below a certain threshold. The earnings threshold will be set at the amount that the family would earn if each adult worked for the number of hours they are expected to work at the relevant minimum wage for their age group.^{5,6} This is a significant expansion of conditionality compared with the legacy system, where only those on JSA (and thus by definition working less than 16 hours per week) can be subject to such conditions. Examples of people who would become subject to conditionality would therefore include those working part time and non-working partners of those working full time.
- Individuals who are self-employed will be exempt from these requirements to seek work but will be assumed, for the purposes of the UC means test, to be earning at

⁴ For a discussion of how local authorities can design council tax support schemes to work alongside UC, see S. Adam and J. Browne, *Reforming Council Tax Benefit*, IFS Commentary C123, 2012, <http://www.ifs.org.uk/publications/6183>.

⁵ That is, the National Minimum Wage for those aged under 25 and the National Living Wage for those aged 25 and over.

⁶ So, for example, in a couple where one person was working for 35 hours at the National Living Wage and the other person was not working despite being expected to work 35 hours a week, only the individual who was not working would be subject to conditionality. By contrast, if the person who was in work earned at least 70 times the National Living Wage, neither member of the couple would be subject to conditionality as their total family earnings would be above the threshold.

least the minimum wage that applies to them multiplied by the number of hours they are expected to work each week (even if their income from self-employment is in fact lower than this). In other words, they will not receive more UC than someone employed at the minimum wage even if their earnings from self-employment were below this level. This so-called 'minimum income floor' will not apply during the first year after an individual has set up a business, during which time they will face no conditionality. Partners of self-employed people will still be subject to conditionality if they are not working the number of hours they are expected to work and their total family earnings are below the relevant threshold.

These are all important changes that could have real impacts on labour market behaviour, the allocation of resources within households and the ability of families to manage budgets. Indeed, these changes might have bigger impacts than the changes to benefit entitlements that we can more readily quantify and which we will go on to analyse in detail in the remainder of this chapter.

How has the proposed design of universal credit changed?

We saw in the previous section that the design of UC is relatively simple: each family has a maximum entitlement, based on an integrated assessment of its needs, which is withdrawn at a constant rate once earned income after tax exceeds the family's work allowance (and pound-for-pound against any unearned income the family has). The maximum entitlement is, in most cases, equal to the amount the family would have received under the legacy benefits system if they had no private income (for example, child additions in UC are equal to child elements of CTC, and so on). Therefore changes that have been made to parameters in the legacy benefits system (largely real-terms cuts to its generosity) mostly change maximum entitlements under the UC system automatically and by the same amount.

One area where the UC system has been made more generous relative to the legacy system is in the level of subsidy given to childcare costs: it was announced at the 2014 Budget that UC will cover 85% of childcare costs up to a maximum of £175 a week for one-child families and £300 a week for families with two or more children. This compares with 70% under the current WTC system and under the original plan for UC. This increase in generosity for childcare support will cost an estimated £350 million per year in the long run.⁷

Once net earnings exceed the work allowance, families lose 65p of UC for each additional pound of net earnings. This planned 65% taper rate has remained unchanged since UC was first announced. However, big changes have been made to the work allowances since UC was first proposed: they have now been made less generous on four separate occasions, significantly reducing the planned generosity of UC to working families:

- The 'finalised' (as they were labelled at the time) work allowance levels announced in the 2012 Autumn Statement were significantly lower for many types of families than had been previously proposed.⁸ It was also announced that these work allowances

⁷ Source: paragraph 1.229 of Autumn Statement 2014, Cm 8961, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/382327/44695_Accessible.pdf.

⁸ See Department for Work and Pensions, 'Earnings disregards and tapers', Universal Credit Policy Briefing Note 14, 2011, <http://webarchive.nationalarchives.gov.uk/+/http://www.dwp.gov.uk/docs/ucpbn-14-disregards-tapers.pdf>.

would (like most parameters in the legacy system) increase by 1% a year, rather than with inflation, in 2014–15 and 2015–16.

- The 2013 Autumn Statement announced that, instead of this, the levels of work allowances would be frozen in cash terms for three years, from 2014–15 to 2016–17.
- This freeze was extended for a further year, to 2017–18, in the 2014 Autumn Statement.
- The July 2015 Budget announced further significant reductions in the level of the work allowances, including the abolition of any work allowances for non-disabled families without children. Those planned reductions remain, even though the cuts to tax credit earnings disregards (the work allowance equivalents in the tax credit system) announced at the same Budget were subsequently cancelled at the November 2015 Autumn Statement.

Together, these changes to the level of work allowances mean that spending on UC will be nearly £5 billion a year lower in the long run than it would otherwise have been: a considerable contribution to Mr Osborne’s fiscal consolidation from changes to a benefit

Table 10.1. Changes in planned work allowances for different family types in 2017–18 over time (£ per month)

Family type	2012	2013	2014	2015	% cut since 2012
<i>Not claiming support for housing costs</i>					
Single, no children	£114	£112	£111	£0	100%
Lone parent	£755	£741	£734	£397	47%
Couple without children	£114	£112	£111	£0	100%
Couple with children	£551	£541	£536	£397	28%
Disabled	£667	£653	£647	£397	40%
<i>Claiming support for housing costs</i>					
Single, no children	£114	£112	£111	£0	100%
Lone parent	£272	£266	£263	£192	29%
Couple without children	£114	£112	£111	£0	100%
Couple with children	£228	£224	£222	£192	16%
Disabled	£198	£194	£192	£192	3%
Saving from this change	£1,175m ^a	£385m ^b	£100m ^c	£3,200m ^d	

^a Source: Saving for 2018–19 from table 2.2 of HM Treasury, *Budget 2014*, HC 1104, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/293759/37630_Budget_2014_Web_Accessible.pdf.

^b Source: Saving for 2018–19 from table 2.37 of fiscal supplementary tables from OBR’s December 2013 Economic and Fiscal Outlook, <http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-december-2013/>.

^c Source: Saving for 2019–20 from table 2.2 of HM Treasury, *Budget 2015*, HC 1093, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/416330/47881_Budget_2015_Web_Accessible.pdf.

^d Source: Saving for 2020–21 from Office for Budget Responsibility, ‘Supplementary forecast information release: tax credits costings – November 2015’, http://budgetresponsibility.org.uk/wordpress/docs/Tax-credits-costings_November2015.pdf.

Note: Plans announced in Autumn Statement in each year for 2017–18. Monthly figures in 2015–16 prices, CPI-adjusted.

not yet in place. Table 10.1 details the level of work allowances for 2017–18 as planned at different points in time.

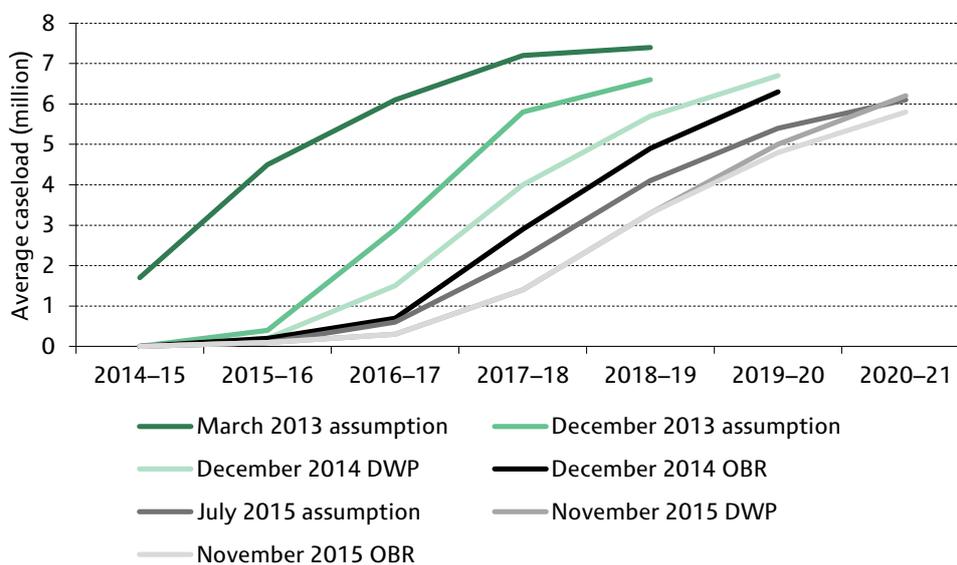
As we shall see in Section 10.3, the combined effect of all this is that UC will now provide less support to working families, on average, than the legacy system that it replaces – a reversal of the original intention.

The roll-out of universal credit

The initial UC proposal was published in a government White Paper in November 2010.⁹ This envisaged that new claims to the legacy benefits (but not tax credits) would cease in October 2013, that new tax credit claims would cease in April 2014 and that all existing benefit and tax credit claimants would be transferred to UC by October 2017. This ambitious plan has not been stuck to, mainly as a result of problems developing the IT systems that will be required to administer the new benefit. Figure 10.5 shows successive vintages of the forecast UC caseload as the roll-out plans have been severely delayed since March 2013.

The Department for Work and Pensions (DWP)'s current plan is for claims of income-based JSA for single people without children to cease across Great Britain by March 2016 and for this group to claim UC instead. Other new claims for legacy benefits and tax credits will then end on a rolling geographic basis between November 2016 and June 2017. Existing claimants of IS, income-based JSA and housing benefit will then be transferred onto UC between May 2018 and January 2020, with those claiming income-based ESA or tax credits only being transferred in 2020–21. The OBR assumes, given delays to the roll-out so far, that this migration will in fact take place six months later than DWP is currently assuming. In any case, it is clear that UC will not be delivered to

Figure 10.5. Revisions to the OBR's universal credit roll-out assumptions



Source: Chart 4.8 of OBR, *Economic and Fiscal Outlook*, November 2015, <http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2015/>.

⁹ Department for Work and Pensions, *Universal Credit: Welfare that Works*, Cm 7957, 2010, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/48897/universal-credit-full-document.pdf.

anything like the original timescale: there are currently fewer than 200,000 claimants of UC compared with the 4.5 million there were expected to be at this point under the original plan.

When families are transferred onto UC, they will not suffer a reduction in support at that point even if their entitlements are lower under UC than under the legacy benefits system. This is known as 'transitional protection'. Families in this situation will continue to receive the amount of benefits that they would have been entitled to under the legacy system at the point when their UC claim began, but with no subsequent uprating in line with inflation (hence the protection is only 'in cash terms'). This cash-terms entitlement will remain constant until either:

- UC entitlement exceeds this amount – this could be either the result of nominal increases in UC rates (in other words, inflation will erode the value of transitional protection over time) or from changes in circumstances such as the birth of a child or a reduction in income;¹⁰ or
- certain changes in family circumstances occur – a family member moves out of employment, a couple splits up or a single person forms a partnership.

The existence of transitional protection creates a peculiar set of incentives for those affected. Since a family will lose transitional protection if they do something that would normally increase their benefit entitlement, such as reducing their earnings, moving to a higher-rent property or having another child, a family entitled to transitional protection would face a stronger incentive not to do any of these things. In some ways, this would simply be reducing the perverse incentives that are inherent in means-tested benefit systems, but it could produce some less desirable incentives: for example, a family might be more reluctant to take on some temporary additional work as they would permanently lose their transitional protection when their situation returned to normal. It also means that those currently receiving benefits or tax credits have an incentive to maintain their claim in order to avoid having to make a UC claim as a new claimant in the future, as they would not receive transitional protection in this case. This might mean that some claimants were reluctant to take on additional work that would increase their income to the extent that they were no longer entitled to means-tested support, if they thought it was likely that they would claim UC in the future.

In summary, it is crucial to understand the role of transitional protection, which means that no family will lose benefit entitlement in cash terms at the point of transition onto UC. The sense in which UC represents a reduction in generosity is that, ultimately, families' entitlements under UC will tend to be lower than the entitlement of families with the same characteristics would have been had the legacy system remained in place. That is because the transitional protection will become irrelevant over time, as more and more claimants will have started their claim after the introduction of UC, and the protection enjoyed by the shrinking number of pre-existing claimants expires due to inflation and changes in families' circumstances.

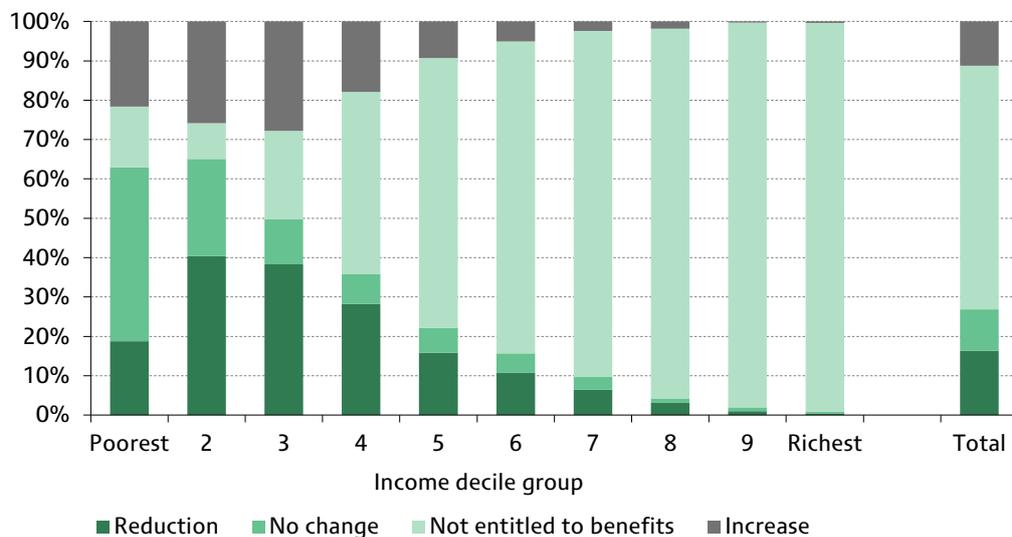
¹⁰ If a family's circumstances change in a way that would reduce their benefit entitlement (e.g. if their earnings increased), they would continue to have the same amount of transitional protection on top of their adjusted benefit entitlement. This is to avoid a situation where families could be worse off as a result of increasing their income by losing transitional protection.

10.3 Who gains and loses from the introduction of universal credit?

Figure 10.6 shows the number of working-age households¹¹ in each decile (or tenth) of the income distribution who see higher or lower benefit entitlements as a result of the introduction of UC. This ignores transitional protection, as discussed above, which will ensure that no claimant loses in cash terms at the point of transition to UC. Hence we are analysing the long-run effect of introducing UC, i.e. comparing the benefit entitlements of families under UC once transitional protection has expired with what their entitlements would have been under the legacy system with all other planned changes in place.

In total there are 19.7 million working-age households (of which 15.6 million contain someone in paid work). We see that the majority of these households (12.2 million, or 62%) are not entitled to means-tested support either before or after the introduction of UC and so are not affected by the reform. These are predominantly the richer half of households. A further 2.1 million households are entitled to means-tested support but see no change in their entitlement under UC. These are predominantly households in the lowest income groups who have no earnings or other private income. However, 3.2 million households see a reduction in their means-tested benefit entitlement from the introduction of UC and 2.2 million see an increase. Both of these groups are most heavily concentrated in the bottom half of the income distribution, though not at the very bottom.

Figure 10.6. Number of working-age households who see increases or reductions in benefit entitlements from the introduction of universal credit, by income decile



Note: Income decile groups are derived by dividing all working-age households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.

Source: Authors' calculations using TAXBEN run on the 2013–14 Family Resources Survey.

¹¹ That is to say, households containing at least one adult aged below the female state pension age.

- The average reduction in entitlements among those who see a reduction in entitlements is £1,800 a year and the average increase in entitlements among those who see their entitlements increase is £1,400 a year.
- 2.1 million working households lose an average of £1,600 a year and 1.8 million working households gain an average of £1,500 a year.
- 1.1 million non-working households lose an average of £2,300 a year and 0.5 million non-working households gain an average of £1,000 a year.

In the remainder of this section, we focus on those households who will be entitled to one or more of the means-tested benefits and tax credits that are being replaced by UC once other planned changes have been introduced, who we estimate will number 7.0 million. Of these households:

- 3.0 million contain no one in paid work and 4.0 million contain at least one worker.
- 3.2 million see a reduction in benefit entitlements (after transitional protection). Of these, 2.1 million are working households and 1.1 million have no one in work. The average reduction in entitlements for those who see their entitlement reduced is around £1,800 per year.
- 2.0 million will see an increase in their entitlements. Of these, 1.5 million are working households and 0.4 million non-working households (the figures do not sum due to rounding).¹² The average increase in benefit entitlements among these 2.0 million households is around £1,450 per year.

Table 10.2 gives more information about the types of household that see their benefit entitlements increase or decrease when the legacy benefits system is replaced by UC (ignoring transitional protection). We see that non-working households see lower benefit entitlements on average as a result of the introduction of UC. Although approximately half of non-working households claiming a benefit that will be replaced by UC do not see their benefit entitlements change (1.5 million out of 3.0 million), some non-working households who have more than £6,000 of savings or substantial amounts of unearned income lose out very significantly as these are treated more harshly in the UC means test than in the means test for tax credits.¹³ This harsher treatment means that UC weakens the incentive to save for some families. We do not look at these incentive effects here, but they will be examined in detail in forthcoming IFS research.

Among working households, those in rented accommodation gain on average and those who are homeowners lose. Of the 1.8 million working owner-occupying households on legacy benefits, 1.3 million lose from the introduction of UC and only 0.3 million gain (with the remaining 0.2 million unaffected). By contrast, of the 2.2 million working renting households on legacy benefits, 0.8 million lose and 1.3 million gain (with the

¹² A further 200,000 households who are currently not entitled to any benefits or tax credits will become entitled to UC, and will thus also gain from its introduction, bringing the total number of households with increased benefit entitlements to 2.2 million as above. These households gain an average of £1,200 a year.

¹³ Specifically, those with savings or other financial assets of more than £16,000 cannot receive means-tested benefits but they can receive tax credits. UC retains the rules from means-tested benefits, meaning that those with high levels of savings who receive tax credits will see this support eliminated. Those claiming tax credits with savings between £6,000 and £16,000 will also see this reduce their UC to a greater extent than it reduces their tax credit entitlement. Finally, certain forms of unearned income, including contributory JSA and ESA and spousal maintenance, will reduce UC entitlement pound-for-pound – this is the same as the way this income is treated in out-of-work benefits, but with a higher withdrawal rate than in housing benefit (65%) or tax credits (41%).

Table 10.2. Average change in benefit entitlements among those entitled to legacy benefits as a result of the introduction of universal credit, by housing tenure and earnings level

Household type	Owner-occupiers		Renters	
	Average change in entitlement	Number of households (thousands)	Average change in entitlement	Number of households (thousands)
Non-working households	-£995	615	-£596	2,407
Lowest-earning third of working households	-£745	515	+£460	825
Middle-earning third of working households	-£1,506	569	+£227	765
Highest-earning third of working households	-£941	680	+£625	656
All working households	-£1,066	1,764	+£429	2,247
All	-£1,048	2,379	-£102	4,654

Note: Only includes households entitled to a means-tested benefit or tax credit that is being replaced by UC. Household earnings adjusted for household size using the McClements equivalence scale. A couple without children would be in the bottom third if their total earnings are less than £6,400 per year and the top third if their total earnings are more than £12,600 per year. For a couple with two children, the equivalent numbers are £9,300 and £18,400 (assuming the children are aged between 5 and 12).

Source: Authors' calculations using TAXBEN run on the 2013–14 Family Resources Survey.

remaining 0.2 million unaffected). The gains for renters arise because the legacy benefits system withdraws housing benefit and tax credits over the same range of income, meaning that the overall level of support for renters can decline very rapidly as their earnings increase. By effectively replacing separate and overlapping housing benefit and tax credit means tests with one means test, UC ensures that total support is withdrawn more gradually from these families as incomes rise. This increases the overall benefit entitlement of many households in rented accommodation – particularly those with higher levels of earnings. By contrast, owner-occupiers tend to see a reduction in their in-work support, mainly because the reductions in the proposed work allowances mean that they receive less in-work support than they receive from tax credits in the legacy system. The biggest losses among owner-occupiers are in the middle third of earners currently entitled to benefits: those with lower earnings are not as affected by reductions in the work allowances as their earnings were below the previous level of the work allowance, whereas those with the highest incomes have low levels of entitlements to means-tested benefits in the first place and so cannot lose very much when their total level of support is reduced under UC.

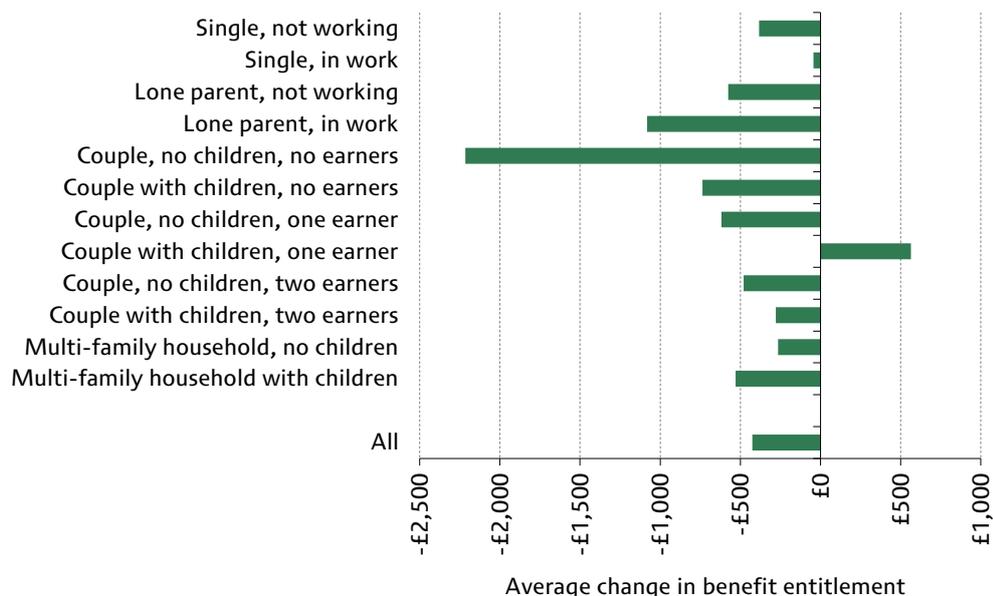
Owning a property or having built up savings is an indication that a family is likely to have had a higher income in the past than a family with a similar level of current income who do not have these things. Hence, the combination of renters doing better than owner-occupiers and assets being treated more harshly in the means test under UC

means that it may well better target benefits on those who are poor over their whole lifetime as opposed to those who have a low income at a particular point in time.

Figure 10.7 shows the average change in entitlements by household type (again, within the group of households who have some means-tested benefit or tax credit entitlement under the legacy system). We can see that the only group to see an increase in their average entitlements is single-earner couples with children, who gain around £500 a year on average. This mainly arises because, under the legacy system, couples with children are entitled to more out-of-work benefits than lone parents, but the maximum entitlement to WTC for those in work is the same as for lone parents. This means that the cut in support upon entering work is particularly large for couples with children. As one integrated payment without this distinction between in-work and out-of-work benefits, it is not possible for the difference between in-work and out-of-work benefits to be as large under UC. Hence couples with children with one adult in work tend to hold onto more benefit entitlements under UC than under the legacy system. By contrast, the reductions in work allowances mean that working lone parents see a big reduction (of around £1,000 a year) in their benefit entitlements on average.

The group that sees the biggest average reduction in its benefit entitlements is non-working couples without children. This is despite the fact that most are unaffected; the average losses result from some very large losses for a small number of these households. These include couples where one individual is aged above the state pension age and the other is not, who are entitled to pension credit under the legacy system (which is more generous than working-age out-of-work benefits) but who will have to claim UC instead following its introduction; and households with someone claiming the middle or higher rate of the care component of disability living allowance, who will no longer receive the severe disability premium under UC.

Figure 10.7. Average change in benefit entitlement among those receiving a legacy benefit by household type



Source: Authors' calculations using TAXBEN run on the 2013–14 Family Resources Survey.

Summary

UC will reduce benefit entitlements on average, but not for everyone. Many non-working families without any private income or assets will see no change in the amount they receive, and some low-income working families – particularly those in rented accommodation and single-earner couples with children – will see their entitlements increase. Owner-occupiers and families with significant amounts of unearned income or financial assets will see the biggest reductions in their benefit entitlements, on average.

However, this analysis gives a far from complete picture of the impact UC will have on household incomes. First, transitional protection means that in the short run, claimants rolled onto UC will gain from its introduction on average, as some families' benefit entitlements increase and the rest are protected from cash cuts in support. Second, many households do not take up all the benefits to which they are entitled under the legacy system and this may change under UC: under the legacy system, it is possible for families to take up one benefit but not another, but the integrated nature of the system means that this will not be possible under UC. It seems likely that this will increase benefit take-up overall (though conceivably changes to conditionality associated with UC could mean that some families – in particular, those in work who would not be subject to any conditionality under the legacy system – choose not to take up UC so that they would not become subject to the new job-search requirements). Third, UC changes the incentives people face to engage in paid work or increase their earnings, and if people respond to these changes in incentives, this will also affect their households' incomes. Effects on work incentives are the focus of the next section.

10.4 The impact of universal credit on work incentives

In this section, we examine the impact of UC on individuals' incentives to do paid work. We first quantify UC's effects on financial work incentives: that is, the relationship between the amount an individual earns before taxes and benefits and their net income after taxes and benefits. We also discuss how the non-financial aspects of UC affect work incentives.

In our analysis of financial work incentives, we distinguish between two concepts: the incentive for individuals to be in paid work at all (as opposed to not working) and the incentive for those in paid work to increase their earnings slightly. We measure the incentive for individuals to be in paid work at all using the participation tax rate (PTR), the proportion of earnings that an individual loses in either higher taxes or withdrawn benefits when they enter paid work. The incentive for those in work to increase their earnings is measured by the effective marginal tax rate (EMTR), which measures the proportion of a small change in earnings that is lost in either higher taxes or withdrawn benefits. Thus, in both cases, higher numbers mean weaker work incentives.

Impact on the incentive to be in work at all

Table 10.3 shows the impact of UC on the distribution of PTRs among those aged between 19 and the state pension age. We can see that the most striking effect of the introduction of UC is to reduce the number of people with very high PTRs (i.e. very weak work incentives) but increase the number of people with slightly lower PTRs: the number of

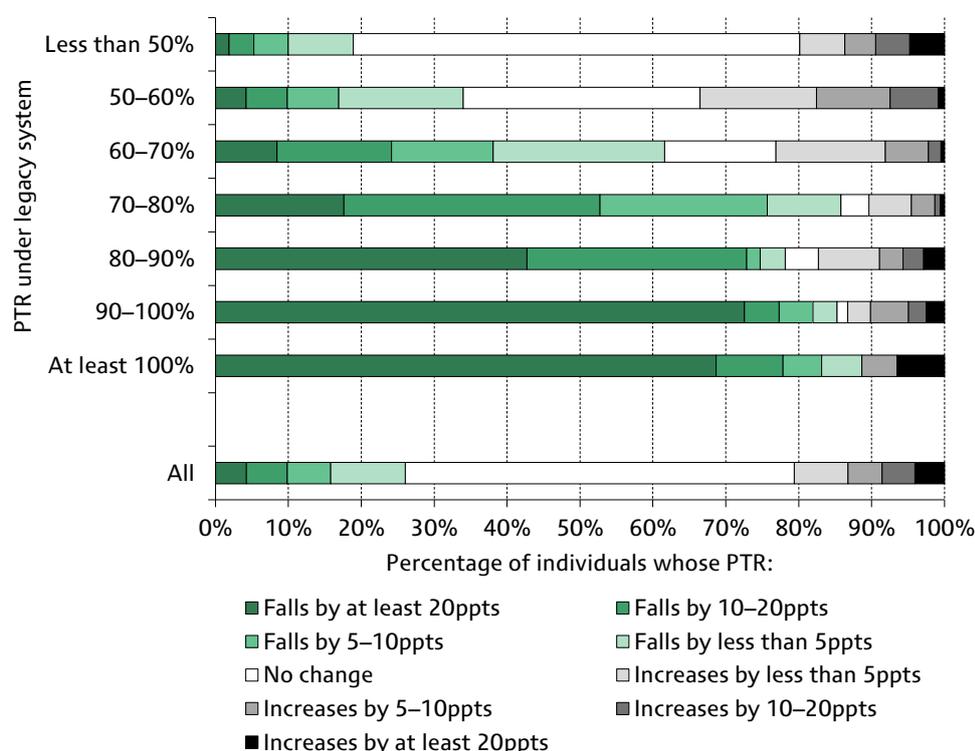
people with a PTR of at least 70% falls by about two-thirds, from 2.1 million to 0.7 million, and the number of people with PTRs of between 50% and 70% increases by around 1.9 million. This is the result of UC rationalising the means-tested benefit system, which removes the very weak incentives that can result in the legacy system when

Table 10.3. Numbers of working-age people with PTRs of different levels under universal credit and legacy benefits system (millions)

PTR	Legacy system	Universal credit
Less than 50%	30.2	29.7
50%–60%	2.7	3.3
60%–70%	2.0	3.3
70%–80%	1.3	0.4
80%–90%	0.5	0.2
90%–100%	0.2	0.1
At least 100%	0.1	0.1
Average PTR	31.8%	31.4%

Note: Sample is all aged between 19 and the state pension age. Potential earnings for non-workers calculated as described in S. Adam and D. Phillips, An Ex-Ante Analysis of the Effects of the UK Government’s Welfare Reforms on Labour Supply in Wales, IFS Report R75, 2013, <http://www.ifs.org.uk/publications/6586>. Ignores council tax and associated rebates, indirect taxes and employer National Insurance contributions. Source: Authors’ calculations using TAXBEN run on the 2013–14 Family Resources Survey.

Figure 10.8. Changes in PTRs resulting from the introduction of UC, by PTR under legacy system



Note: Sample is all aged between 19 and the state pension age. Potential earnings for non-workers calculated as described in S. Adam and D. Phillips, An Ex-Ante Analysis of the Effects of the UK Government’s Welfare Reforms on Labour Supply in Wales, IFS Report R75, 2013, <http://www.ifs.org.uk/publications/6586>. Ignores council tax and associated rebates, indirect taxes and employer National Insurance contributions. Source: Authors’ calculations using TAXBEN run on the 2013–14 Family Resources Survey.

individuals face the simultaneous withdrawal of multiple benefits when they enter work. This is a welcome change: the distortion imposed by a tax increases more than proportionally to the effective tax rate, so it is preferable – all else equal – to have two people with a 60% PTR rather than one with a PTR of 50% and the other with a PTR of 70%. This advantage of UC is masked when looking at average work incentives: the average (mean) PTR falls by only 0.4 percentage points (ppts) and the median (or middle) PTR by less than 0.1 ppts.

Figure 10.8 shows the number of working-age people who see changes in their PTR of different magnitudes as a result of the introduction of UC, by the initial PTR they face. We see that more than half will see no change in their PTR from the introduction of UC: these are individuals who have no entitlement to means-tested benefits when they are not working (most likely because their partner's income is sufficient to keep them off benefits), or who have no in-work benefit entitlement and an out-of-work benefit entitlement unchanged by the introduction of UC. These individuals tend to have relatively low PTRs.

But many people do see their PTRs changed by UC – 9.6 million see a reduction in their PTR and 7.6 million an increase – and within this there are a significant number who see large changes: 29% of working-age adults (10.8 million people) see their PTR change by at least 5ppts, 18% (6.8 million) by at least 10ppts and 8% (3.1 million) by at least 20ppts. Big changes in PTRs can arise either from big changes in the amount of support received when working or from big changes in the amount that would be received when not working (or some combination of the two). In the case of those with a partner in paid work, this means that their PTR will also depend on the amount of in-work support their partner would receive if they themselves stopped working.

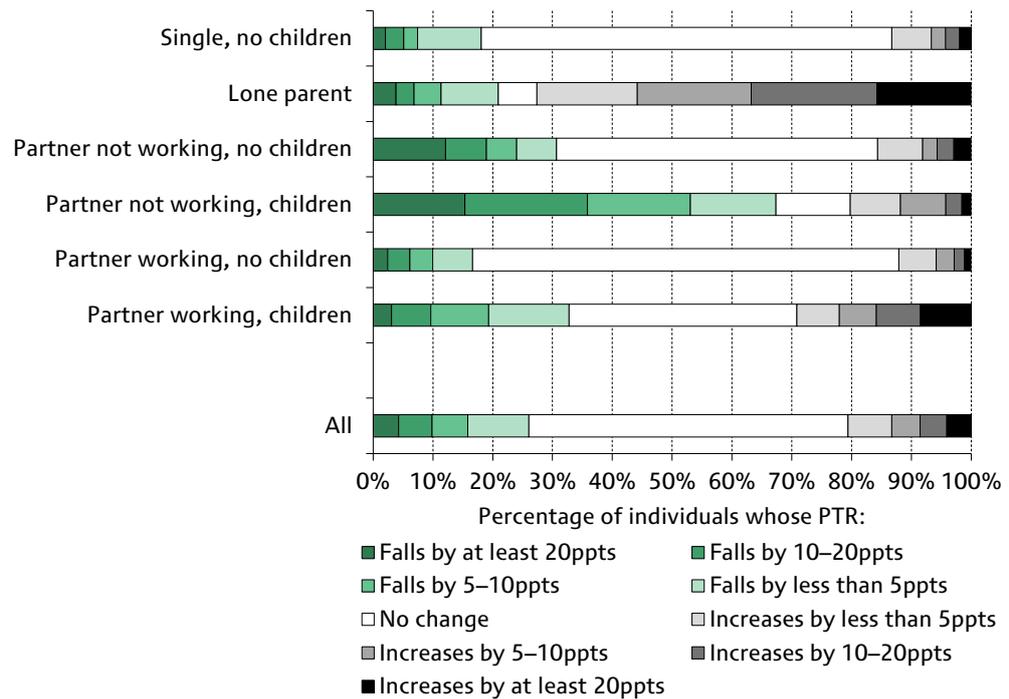
Perhaps unsurprisingly given the results in Table 10.3, those who have the highest PTRs (i.e. weakest incentives to work) under the legacy system are the most likely to see big reductions in their PTRs under UC, whereas those with more moderate PTRs under the legacy system (though not those with the strongest incentives) are the most likely to see increases in their PTRs.

Figure 10.9 shows how the PTRs of different groups of individuals change as a result of the introduction of UC. We can see that the biggest effect UC has is to strengthen the incentive for couples with children to have one person in paid work: two-thirds of those in couples with children whose partner is not in paid work see their PTR fall, and their average PTR falls by 9.5ppts. This is unsurprising given Figure 10.7, where we saw that single-earner couples with children gained on average from the introduction of UC.

Lone parents, by contrast, are the group most likely to see an increase in their PTR: 73% of lone parents see their incentive to be in work weakened as a result of the introduction of UC, and on average their PTR increases by 8.0ppts. The reason for this is again apparent from Figure 10.7, as their in-work support on average falls by more than their out-of-work benefits. Note that this is a much larger increase in the average PTR for lone parents than was the case before the reduction in work allowances announced in the July 2015 Budget.¹⁴

¹⁴ See table 6.3 of S. Adam and J. Browne, 'Do the UK government's welfare reforms make work pay?', IFS Working Paper W13/26, 2013, <http://www.ifs.org.uk/publications/6853>.

Figure 10.9. Changes in PTRs resulting from the introduction of UC, by person type



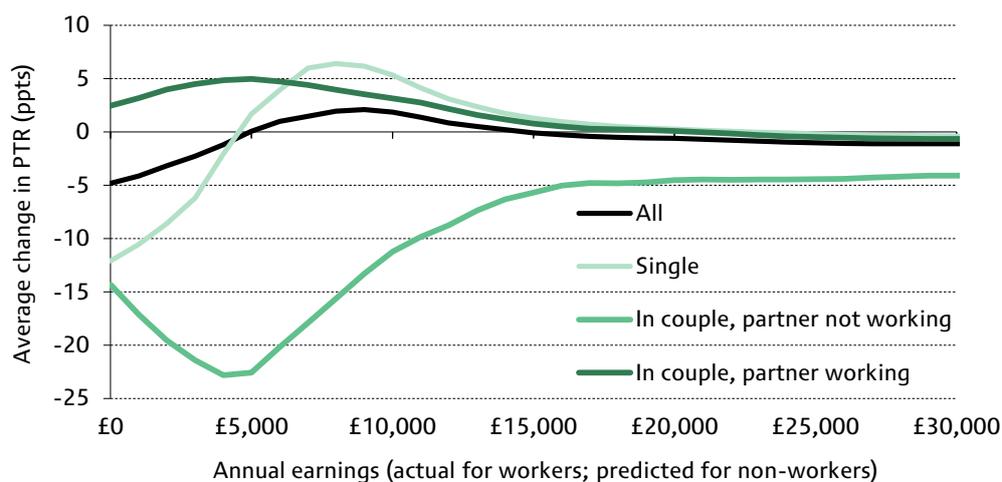
Note: Sample is all aged between 19 and the state pension age. Potential earnings for non-workers calculated as described in S. Adam and D. Phillips, *An Ex-Ante Analysis of the Effects of the UK Government’s Welfare Reforms on Labour Supply in Wales*, IFS Report R75, 2013, <http://www.ifs.org.uk/publications/6586>. Ignores council tax and associated rebates, indirect taxes and employer National Insurance contributions.

Source: Authors’ calculations using TAXBEN run on the 2013–14 Family Resources Survey.

Another group that is more likely to face higher PTRs is those with children and a partner in paid work: 29% of this group see an increase in their PTR, and the average PTR for the group increases by 2.1ppts. Again, the reason for this can be found in Figure 10.7: single-earner couples with children receive an increased level of support from UC in a way that two-earner couples do not, thus making having only one member of the couple working more attractive relative to both members being in paid work. A way of avoiding this weakening of work incentives for the group would be to introduce an individual-level work allowance in UC: that is to say, allowing each member of a couple to earn a certain amount before UC started to be withdrawn rather than starting UC withdrawal once *family* earnings exceed the work allowance.¹⁵ The overall impacts of such a policy would depend on its precise design: simply giving each individual in a couple a work allowance at the same level as the current family-level work allowances would strengthen incentives for those with a working partner without weakening incentives for any other group, but would increase overall benefit spending. An alternative of reducing the levels of work allowances for couples, but using the revenue raised to give a work allowance to each member of a couple, would strengthen incentives for those with a working partner but weaken them for those whose partner was not in paid work, since they could earn less before their UC started to be withdrawn.

¹⁵ The Resolution Foundation’s review of UC recommended a similar change – see D. Finch, *Making the Most of UC: Final Report of the Resolution Foundation Review of Universal Credit*, 2015, <http://www.resolutionfoundation.org/wp-content/uploads/2015/06/UC-FINAL-REPORT1.pdf>.

Figure 10.10. Changes in PTRs resulting from the introduction of UC, by earnings and person type



Note: Sample is all aged between 19 and the state pension age. Potential earnings for non-workers calculated as described in S. Adam and D. Phillips, An Ex-Ante Analysis of the Effects of the UK Government’s Welfare Reforms on Labour Supply in Wales, IFS Report R75, 2013, <http://www.ifs.org.uk/publications/6586>. Ignores council tax and associated rebates, indirect taxes and employer National Insurance contributions.

Source: Authors’ calculations using TAXBEN run on the 2013–14 Family Resources Survey.

People without children are far less likely to see their PTRs affected by the introduction of UC: they are far less likely to receive in-work support either before or after the introduction of UC, and their out-of-work benefit entitlements are often unaffected.

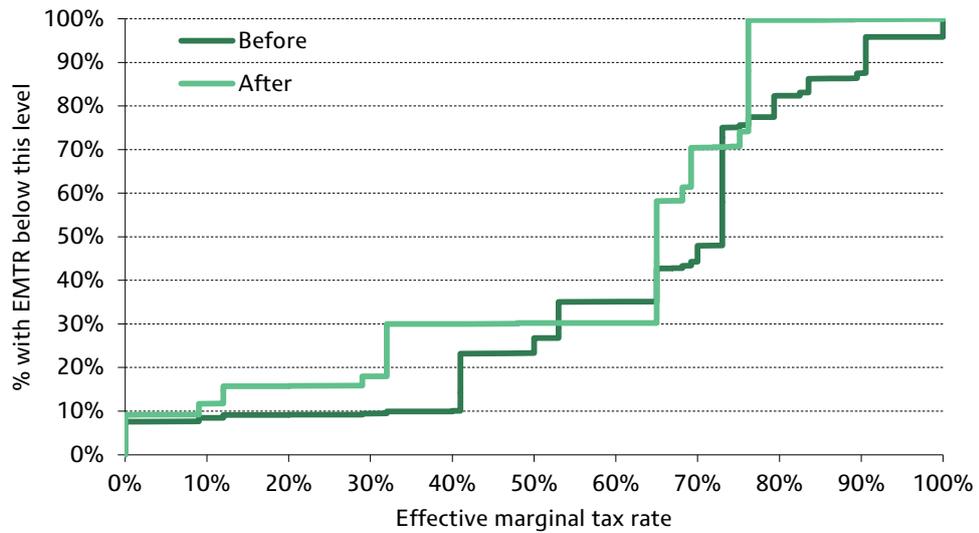
These patterns are also apparent when we look at the impact by earnings level in Figure 10.10. At very low levels of earnings, both single people and those in couples without a working partner see big reductions in their PTRs, driven mainly by the fact that, under UC, benefits are withdrawn much more slowly when an individual works only a few hours each week. However, at slightly higher earnings levels, UC increases average PTRs for single people as it provides less in-work support for this group than the legacy benefits system. For those in couples with a working partner, however, UC increases average PTRs at earnings levels below £20,000 a year. As discussed previously, this arises because the additional support for single-earner couples with children is not replicated for two-earner couples with children, meaning that couples gain less from the second member of the couple moving into work. (As we would expect, changes to means-tested benefits become less important at higher earnings levels.)

Impact on the incentive for those in work to earn more

We can also examine the impact of UC on the incentive for those already in work to increase their earnings slightly. We measure this by the effective marginal tax rate, which is the proportion of a small (1p per week) increase in earnings that is lost in higher taxes or lower benefit entitlements. As in Section 10.3, we focus only on those workers who are entitled to one of the means-tested benefits and tax credits that are being replaced by UC: 4.5 million out of 27.2 million workers.¹⁶

¹⁶ We estimate that a further 350,000 workers not entitled to a means-tested benefit or tax credit under the legacy system will become entitled to UC when it is introduced, and these workers see their EMTRs increase by an average of 55.7ppts as a result since they now face withdrawal of UC if they increase their earnings slightly.

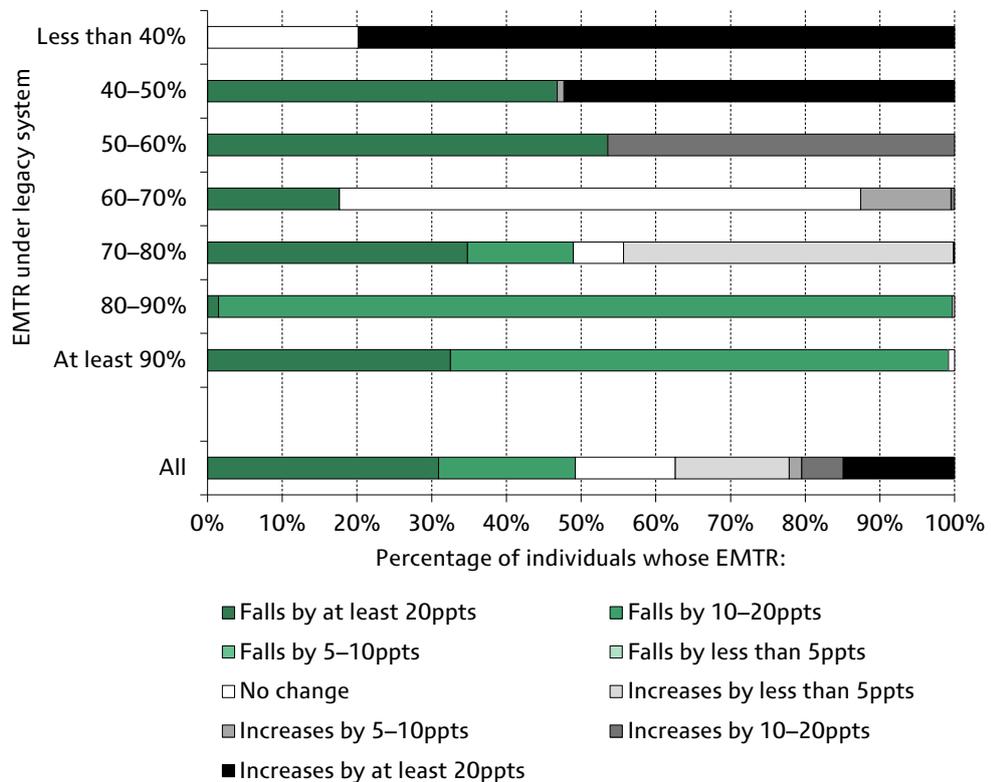
Figure 10.11. The distribution of EMTRs among workers entitled to legacy benefits, before and after the introduction of UC



Note: Sample is all workers aged between 19 and the state pension age. Ignores council tax and associated rebates, indirect taxes and employer National Insurance contributions.

Source: Authors' calculations using TAXBEN run on the 2013–14 Family Resources Survey.

Figure 10.12. Changes in EMTRs resulting from the introduction of UC, for workers entitled to legacy benefits, by EMTR under legacy system



Note: Sample is all aged between 19 and the state pension age. Ignores council tax and associated rebates, indirect taxes and employer National Insurance contributions.

Source: Authors' calculations using TAXBEN run on the 2013–14 Family Resources Survey.

On average, the introduction of UC strengthens the financial incentive for these workers receiving means-tested benefits to earn a little more: their average EMTR reduces by 7.7ppts from 62.2% to 54.5%. But this disguises substantial variation within the group. Figure 10.11 shows the impact of UC on the distribution of EMTRs among these workers and Figure 10.12 shows how EMTRs change depending on the EMTR workers face under the legacy system. We see that the highest EMTR faced by workers following the introduction of UC is 76.2%,¹⁷ and reading across we see that this rate is faced by just over a quarter of these workers or 1.2 million individuals. Under the legacy system, by contrast, around 1 million individuals face EMTRs that are higher than this, all of whom see a reduction in their EMTR to 76.2% or lower. These individuals are all income taxpayers who also pay the main rate of employee National Insurance contributions and face withdrawal of UC if they slightly increase their earnings. For some of these individuals, this represents an increase in their EMTR: for those entitled to tax credits but not housing benefit, the EMTR increases from 73% to 76.2%: nearly 700,000 people see this small increase in their EMTR. But for others, in particular those facing withdrawal of both housing benefit and tax credits if they increase their income slightly, this represents a reduction in their EMTR from around 90%.¹⁸ The removal of these very high EMTRs (under the legacy system, around 800,000 workers face an EMTR of at least 80% and 600,000 face an EMTR of at least 90%) is one of the main achievements of the integration of the benefits system by introducing UC.

Among current workers on legacy benefits, 1.3 million would face an EMTR of 65% under UC. These are people who would face the withdrawal of UC at a rate of 65% if they increased their earnings, but would be subject to no additional direct tax or benefit withdrawal. For around 600,000 of these individuals, this represents an increase in their EMTR as they face no benefit withdrawal at all under the legacy system¹⁹ or they face only withdrawal of tax credits at a rate of 41%. For around 350,000 others, it represents no change in their EMTR, as they face withdrawal of housing benefit under the legacy system at a rate of 65% and would face withdrawal of UC at the same rate. For the remaining 350,000, it represents a reduction in their EMTR, as under the legacy system they face withdrawal of both tax credits and housing benefit at a combined rate of close to 80% or they face withdrawal of an out-of-work benefit at a rate of 100%.

We also see that around 550,000 of those previously entitled to a means-tested benefit or tax credit face an EMTR of 32% following the introduction of UC – the EMTR faced by a basic-rate taxpayer who also pays employee NICs at the standard rate. These individuals are not entitled to UC, and so no longer face withdrawal of means-tested support if they increase their earnings; thus, these individuals lose out from the introduction of UC but see their incentive to increase their earnings strengthen. Consistent with the analysis in Section 10.3, members of this group are more likely to be owner-occupiers than renters.

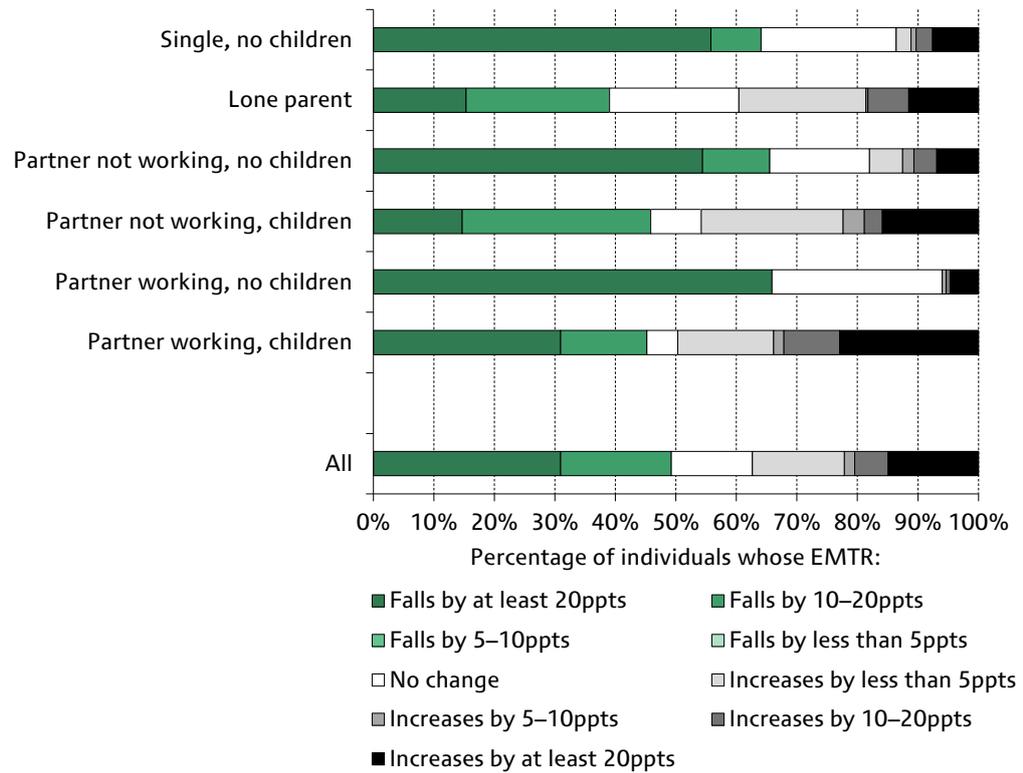
Figure 10.13 shows how these changes vary for different types of workers claiming one of the legacy benefits or tax credits. We see that those without children are particularly likely to see reductions in their EMTR, as they are the most likely to see their entitlement to means-tested support eliminated once UC is introduced, meaning that they will no

¹⁷ Though remember that this analysis excludes employer NICs, council tax support and indirect taxes, all of which will increase the EMTRs that workers face.

¹⁸ Note that this means that owner-occupiers, who do not receive housing benefit, are more likely to see an increase rather than a decrease in their EMTR than renters.

¹⁹ These are people below the threshold for the withdrawal of any of the legacy benefits or tax credits but above the UC work allowance (which is zero for non-disabled childless claimants).

Figure 10.13. Changes in EMTRs resulting from the introduction of UC, for workers entitled to legacy benefits, by person type



Note: Sample is all aged between 19 and the state pension age. Ignores council tax and associated rebates, indirect taxes and employer National Insurance contributions.

Source: Authors' calculations using TAXBEN run on the 2013–14 Family Resources Survey.

longer face withdrawal of means-tested benefits if they increase their earnings. Those who are most likely to see an increase in their EMTR are people in couples with children whose partner is in paid work. Many of those in this group who see big increases in their EMTRs do not earn enough to pay income tax and are entitled to tax credits but not housing benefit under the legacy system; these individuals see their EMTRs increase from 41% to 65%. Lone parents and those in couples with children are more likely to see more modest reductions in their EMTRs. This occurs for those individuals who face withdrawal of both housing benefit and tax credits if they increase their earnings under the legacy system, and a lower overall withdrawal rate under UC as these two overlapping means tests are combined into a single one.

Discussion of incentives for individuals to increase their earnings raises the question of whether those working families who see reductions in their benefit entitlement might make up the loss of income by increasing their earnings. In fact, many of those who do see a reduction in their benefit entitlements as a result of the introduction of UC also see a fall in their EMTR, meaning that their financial incentive to earn more is strengthened even if one ignores the desire to make up the lost income. Of the 3.0 million workers in the 2.1 million households who see their benefit entitlement reduced, 1.3 million see a reduction in their EMTR as a result of UC's introduction, 0.7 million see no change and 1.0 million see an increase in their EMTR. This arises because many of those who see a reduction in their overall benefit entitlement see that entitlement removed entirely, meaning that they no longer face withdrawal of means-tested benefits if they increase

their earnings. Overall, 1.1 million of the 2.1 million working households who see their benefit entitlements reduced as a result of the introduction of UC contain an adult whose EMTR is reduced.

Changes to non-financial aspects of work incentives

The changes to the amounts of benefits people are entitled to at different levels of hours and earnings are not the only way UC will change work incentives. As previously discussed, UC also involves a significant change in the job-search conditions for those in receipt of means-tested benefits. Under the legacy system, those in receipt of JSA are subject to work-search conditions if they are working less than 16 hours per week. Working 16 or more hours makes one ineligible for JSA, and potentially eligible for WTC, for which there are no conditions requiring one to look for more hours or higher pay. Under UC, an hours limit for work-search requirements is to be replaced by an earnings threshold that is significantly tougher. The rules stipulate that non-disabled single people will in most cases be expected to look for higher-paid employment (whether through more hours or a higher wage) if they earn less than 35 times the relevant minimum wage for their age group per week, whilst non-disabled couples will in some cases be required to earn double that between them. This significantly increases the number of individuals who will be subject to conditionality, particularly among those in couples. Indeed, the 2015 Spending Review stated that the introduction of UC will mean that conditionality is extended to an additional 1.3 million people by 2020,²⁰ approximately doubling the number of people claiming JSA or ESA who are subject to conditionality at the moment.²¹

In many cases, those brought into the conditionality regime – such as people with children and a working partner – are those who will face weaker financial work incentives as a result of the introduction of UC. Hence the financial and non-financial changes may have offsetting effects on people's choice over how much to work. It remains to be seen which will be more important drivers of people's behaviour – it is possible that conditionality will be more significant than the changes to financial incentives already discussed, but the effects are highly uncertain. It is not clear exactly how much will be required of those already in work but earning less than the relevant threshold, and there is little evidence from previous reforms on the effects we would expect from in-work conditionality.

The integrated nature of UC could also have impacts on people's behaviour. One consequence of the plethora of programmes that currently exist is that people often do not know what they are entitled to, let alone what they would be entitled to if their circumstances were different. Many out-of-work families are unaware that they could continue to claim housing benefit if they moved into low-paid work.²² People might therefore be discouraged from working by a perception of lost entitlements that exceeds the reality. Similar problems arise because some potential claimants do not realise that

²⁰ Paragraph 1.129 of HM Treasury, *Spending Review and Autumn Statement 2015*, Cm 9162, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479749/52229_Blue_Book_PU1865_Web_Accessible.pdf.

²¹ In May 2015, there were just under 1.2 million people either claiming JSA or in the work-related activity group of ESA (source: DWP tabulation tool, <http://tabulation-tool.dwp.gov.uk/100pc/tabtool.html>). Lone parents with young children claiming IS also face some very limited conditionality.

²² See C. Turley and A. Thomas, *Housing Benefit and Council Tax Benefit as In-Work Benefits: Claimants' and Advisors' Knowledge, Attitudes and Experiences*, DWP Research Report 383, 2006, <http://webarchive.nationalarchives.gov.uk/20130314010347/http://research.dwp.gov.uk/asd/asd5/rports2005-2006/rrep383.pdf>.

WTC can be claimed by those without children. Under UC, by contrast, it is likely to be clearer that the same benefit will be available to a large number of working-age people in different circumstances. This also means that people could be more secure in the knowledge that their entitlement would continue even if their circumstances changed, unlike in the legacy system where problems sometimes arise when people have to apply for support from a different programme when they move into work: delays between stopping receiving one benefit and starting to receive another can cause hardship to families and discourage people from moving into work.

These impacts could work in either direction, however. However complicated the legacy system is, working tax credit arguably provides a clear signal that, if you work the requisite hours, support is available. UC might lack that kind of salient and easily-understood focal point: whatever the true effect on net incomes, higher disregards and a moderate withdrawal rate might be more obscure and may be seen as limiting the losses from going into work rather than providing an explicit reward to doing so. Furthermore, if it is the case that people overestimate (rather than underestimate) the return to work, a simpler, more transparent system might actually weaken perceived work incentives as people become aware of how much support they can lose when entering work.

Summary

UC will have little effect on average measures of financial work incentives, but will significantly strengthen or weaken work incentives for a minority of individuals. It has the welcome effect of strengthening incentives for those who face the very weakest incentives in the legacy benefits system. On average, it will strengthen the incentive for couples to have one person in work rather than none, but weaken the incentive for lone parents to work. Non-financial aspects of UC – in particular, the conditionality requirements and increased transparency – could also be important. But to understand how people's behaviour is likely to change, we need to take account of how responsive they are to the changing incentives they face. In the next section, we examine the evidence to date on the impact UC has actually had on people's behaviour.

10.5 What impact has universal credit had so far?

As discussed in the previous section, one would expect the changes in financial work incentives and conditionality that result from the introduction of UC to affect some people's choices over whether to work and how much to work.²³ However, given the limited extent to which UC has currently been rolled out, we have little evidence of its effects in practice.

The DWP has produced detailed peer-reviewed analysis of the early labour market effects of UC, by comparing the employment outcomes of new benefit claimants in areas where UC has been rolled out to those of similar claimants in other areas.²⁴ Note that, because

²³ For example, in its initial impact assessment of universal credit, the government stated that it expected the changes to financial work incentives to increase employment by between 100,000 and 300,000. Note however, that that figure was based on a system of universal credit with much higher work allowances. Source: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220177/universal-credit-wr2011-ia.pdf.

²⁴ Department for Work and Pensions, *Estimating the Early Labour Market Impacts of Universal Credit: Updated Analysis*, 2015,

these are new claimants, there is no transitional protection so claimants can lose as well as gain entitlement relative to the legacy system right from the outset. The DWP analysis looks solely at the very specific group of claimants who were first eligible for UC: non-disabled single adults without children who are not claiming support for housing costs. The analysis found a relatively large impact of UC in increasing the probability of people in this group being in work at some point within the first nine months after making a claim (8ppts), but much smaller impacts on the probability of actually being in work after nine months (3ppts) and on total earnings over that nine-month period (2%, and not statistically significantly different from zero). This may reflect the fact that UC makes it more worthwhile for these individuals to accept (and report) a small number of hours of short-term temporary work, but (as we saw in Section 10.4) little difference to their incentive to engage in the type of work that we might expect single people without children to be most likely to seek, i.e. full-time work.

The evidence on the early effect of UC for this group seems robust. But non-disabled single adults without children who are ineligible for support for housing costs make up a small share of those who will eventually be affected by UC – around 10% – and are far from a random sample of the wider population eligible for UC. We estimate that this group actually sees no change in its average PTR as a result of UC whereas, as shown in Section 10.4, some groups will see their financial work incentives strengthened by UC (for example, those in couples with children whose partner is not in paid work) and some will see those incentives weakened (for example, lone parents). In addition, the same change in incentives can have different behavioural effects on different people. For example, those with a disability may be less responsive to financial work incentives. Overall, then, we cannot draw firm conclusions about the labour market impact of UC when fully rolled out on the basis of these initial estimates.

10.6 Conclusion

Universal credit will look significantly different when it is finally fully introduced compared with the original plans. In particular, reductions in the planned levels of work allowances – the amount claimants can earn before benefit entitlements start to be reduced – mean that it reduces rather than increases the total level of support for working households. The way in which the planned levels of work allowances have been repeatedly trimmed back does not give the impression that this has been the result of a carefully-thought-through plan for the shape of the future benefits system. Rather, it appears as though cutting work allowances has been seen as a convenient way of reducing planned social security spending by making changes to a benefit that has not yet been introduced.

Despite the overall reduction in in-work support, there are groups that will benefit directly from UC's introduction. Those in rented accommodation and single-earner couples with children will see their benefit entitlements increase under UC on average. This will strengthen the financial incentive for couples with children to have one person in work rather than none. On the other hand, this does weaken the incentive for both members of a couple with children to work rather than just one, as two-earner couples with children see a reduction in their benefit entitlements on average under UC.

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/481827/universal-credit-estimating-early-labour-market-impacts-dec-2015.pdf. All figures in this paragraph are from this publication.

While the winners and losers from UC, and its impacts on financial work incentives, have been affected significantly by the changes made to it since it was first mooted, the main potential benefits of the structural changes that UC will bring remain intact. It will be a welcome simplification of the benefits system, and will still strengthen work incentives for those who face the weakest incentives under the legacy system. On the other hand, it also remains the case that these benefits are being undermined to some extent by the decision to leave support for council tax as a separate system designed by local authorities. This complicates the overall system and potentially reintroduces some of the very high benefit withdrawal rates that UC would otherwise have abolished entirely.

If UC is to significantly increase the amounts of paid work that people do, it seems likely that this would be more the result of non-financial changes – such as increasing the conditionality requirements on benefit claimants and the increased level of integration and simplicity that UC will bring to the system – rather than because people face stronger financial incentives to do paid work. Indeed, early evidence has shown that UC has led to increased labour market participation among a group for whom it does not strengthen financial work incentives on average. The success of UC as a whole may also depend on how smoothly other non-financial changes work, such as the fact that payments will be made monthly and only to one member of a couple and that there will be no direct payments to landlords.