

Press Release

Universal Credit: much to welcome, but impact on incentives mixed

The Universal Credit will dramatically change the welfare system for working-age adults. If successful, it will make the welfare system more effective and coherent. But it will create winners and losers in the process: couples with children will gain from it and, when transitional protection expires, lone parents will lose. This is one of the key findings of a preliminary analysis funded by the ESRC and published today by the IFS.

The Universal Credit will have mixed impacts on work incentives with, on average, stronger incentives to work for single adults and main earners in couples, but weaker incentives for both adults in a couple to work, rather than just one. It will also lead, on average, to stronger incentives for low earners to earn more, but slightly weaker incentives for middle earners to earn more.

Mike Brewer, Deputy Director of the Institute for Fiscal Studies and an author of the report, said: "The Universal Credit has the potential to simplify the current complicated overlap between benefits and tax credits, making life easier for claimants and saving money currently wasted on administration and lost to fraud and error. But our analysis illustrates the constraints all governments face when contemplating radical welfare reform. Work incentives will be strengthened for some, but weakened for others, and the reform will lead to both winners and losers in the long-run. One clear group of losers will be families with children having savings of over £16,000: they can currently receive tax credits but will not be eligible for any Universal Credit. This may well focus spending on those who need it most, but also gives families an extremely strong incentive to keep financial assets below this level."

What is the Universal Credit and how will it work?

The Government plans to replace most means-tested benefits and tax credits for working-age adults with a single benefit, known as Universal Credit. This would be the largest reform to the welfare system since at least the 1988 Fowler reforms, and should simplify the welfare system and, on average, strengthen incentives to work. Full details are due in the Welfare Reform Bill later this month, and this preliminary analysis is based on the limited amount of information given by the Government in its November 2010 White Paper, "Universal Credit: welfare that works".

Basic entitlements to Universal Credit will be set so most families receiving out-of-work means-tested benefits will receive the same payments as they would under the current regime. Earnings (measured after tax, and having deducted a disregard) will reduce Universal Credit awards at a rate of 65%. This is a much lower rate than under the current set of out-of-work means-tested benefits, and will therefore strengthen the incentive to earn small amounts. It also means that Universal Credit will extend further up the earnings distribution than existing benefits, meaning that the working tax credit will no longer be needed to help ensure a positive financial gain to work. However, the withdrawal rate applying to earned income will be higher than currently applies under tax credits for those in work.

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Unearned income will reduce Universal Credit payments pound-for-pound, a rate which is identical to that in the current set of means-tested benefits, but higher than currently applies under tax credits. Capital rules in Universal Credit mean that families with more than £16,000 of financial capital will not be entitled to any Universal Credit at all. This is no change from the current means-tested benefits, but a dramatic change from tax credits, where a similar amount of savings would merely reduce tax credits awards by, at most, £1.42 a week.

Who will win and lose and how much will it cost?

The report analyses the likely winners and losers from Universal Credit, and its impact on work incentives. Using assumptions very similar to those underpinning the Government's analysis in its White Paper – which assumed full take-up of benefits, and ignored any behavioural impact of Universal Credit – the analysis suggests that:

- the long-run cost of Universal Credit will be around £1.7 billion (in 2014–15 prices);
- 2.5 million families will gain, and, in the long-run, 1.4 million families will lose and 2.5 million families will see no change in benefit and tax credit entitlement;
- Universal Credit will benefit poorer families more than richer ones, on average. The bottom six-tenths of the income distribution will gain on average, while the richest four-tenths will lose out slightly in the long-run;
- On average, couples with children will gain more than couples without children, who will in turn gain more than single adults without children. Lone parents will, on average, lose in the long-run. But there will be winners and, in the long-run, losers amongst all family types.

If, as should happen, Universal Credit increases take-up, then the number of families gaining and the cost to Government might be higher. And if Universal Credit encourages more people to work, this might reduce the cost to Government. The Government intends that no current recipient of benefits or tax credits will lose out at the point of transition to Universal Credit, and this transitional protection will increase the cost to Government, and reduce the number of families losing, in the short-run. (The report also presents results with this transitional protection.)

How will it affect work incentives?

The report also examines how Universal Credit will change financial work incentives.

One measure of the extent to which taxes and benefits weaken the incentive to work at all is the participation tax rate (the fraction of earnings lost to income tax, national insurance and withdrawn benefits or tax credits when someone moves into work). The report finds that Universal Credit will reduce the number of individuals who face a participation tax rate of 70% or more by 1.1 million, but will increase the number of individuals who face a participation tax rate of 60% or more by 350,000.

The Universal Credit will strengthen the incentive to work at all, on average, particularly for those who have the weakest incentives to work under the current tax and benefit system, namely very low-earning single people and primary earners in couples. However, Universal Credit will weaken incentives to work for (potential) second earners in couples, who see Universal Credit

withdrawn more quickly if they entered work than currently happens with tax credits.

A measure of the extent to which taxes and benefits weaken the incentive for those already working to earn more is the marginal effective tax rate (the fraction of a small rise in earnings lost to income tax, national insurance and withdrawn benefits or tax credits), and the report finds that the Universal Credit will:

- reduce the METR of 1.7 million workers, and increase the METR of 1.8 million;
- lower, on average, METRs for those on low earnings, and raise them slightly for those on middle earnings.
- reduce the highest METRs – for example for those currently on an out-of-work means-tested benefit– but increase METRs for basic-rate-tax-paying workers currently facing a tax credit withdrawal, and for low earners with a working partner.

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Notes to Editors:

1. For embargoed copies of the report, “Universal Credit: a preliminary analysis” by Mike Brewer, James Browne and Wenchao Jin, or for other queries, contact Bonnie Brimstone at IFS: 020 7291 4800, bonnie_b@ifs.org.uk.
2. IFS will hold a briefing from 10am – 11:15am on Wednesday 12 January 2011 (<http://www.ifs.org.uk/events/643>). Please let Bonnie Brimstone know if you wish to attend: 020 7291 4818 / bonnie_b@ifs.org.uk.
3. This research was funded by the ESRC Centre for the Microeconomic Analysis of Public Policy at the IFS.
4. The Government’s November 2010 White Paper, “Universal Credit: welfare that works” is at <http://www.dwp.gov.uk/docs/universal-credit-full-document.pdf>. The benefits due to be replaced by Universal Credit are income support, income-related jobseekers allowance and employment and support allowance, working tax credit, child tax credit and housing benefit.