



The Universal Credit: **Marginal returns?**

- assessing the impact of the **Universal Credit on Marginal Deduction Rates**

Key Findings:

- Under the Universal Credit the financial benefits of progressing in work, through increased hours or pay, would be cut for many working families – from allowing them to keep 30p for each additional £1 they earn, to around 24p for each additional pound earned.
- Family Action estimates that as many as 1.35 million households could see work progression incentives cut under the Universal Credit, and that more tax paying, working households in receipt of means tested benefits could lose rather than gain work progression incentives under the new system.
- We are also concerned that the Government has not made clear what they will do about Council Tax Benefit and help with childcare costs. Under some of the models proposed in the White Paper, our calculations suggest that Marginal Deduction Rates could effectively exceed 100% for some families, (meaning claimants would lose money if they worked longer hours).

Summary:

- The rate of deductions (through increased Income Tax and National Insurance, and reduced means tested benefit payments) incurred on earning an additional £1 is known as a person's Marginal Deduction Rate. For some low-income working households, MDRs can be extremely high, currently reaching as much as 95.5% - meaning that households receive very little benefit from taking on additional work.
- Family Action agree with the Government that action needs to be taken to increase financial incentives for people in low income working families to progress in work by increasing their working hours or to work for a promotion. We are therefore pleased that for some in-work, benefit claimants, the Universal Credit could substantially reduce Marginal Deduction Rates.

- However, we are concerned that for many people the Universal Credit could reduce work progression incentives. For workers in households currently paying Income Tax and National Insurance, and claiming tax credits, but not receiving housing benefit or council tax benefit, marginal deduction rates are currently 70%. Following the introduction of the Universal Credit they will be 76%.
- Our estimate suggests that as many as 1.35 million households are in this position. It is also estimated that under the Universal Credit, more tax-paying, working households in receipt of means-tested benefits would face increased, rather than reduced, MDRs.
- In addition, we are concerned that insufficient emphasis has been placed on the place of help with childcare costs and of Council Tax Benefit within the new system. Under some of the Government's proposals for dealing with childcare costs, some households could effectively face Marginal Deduction Rates of more than 90%, or even 100%.
- The paper proposes that 1) The taper rate for the Universal Credit is reduced to the 55% originally proposed by the Centre for Social Justice, and 2) that Council Tax Benefit is included in the Universal Credit. Family Action will develop our proposals for dealing with childcare costs within the system in the coming weeks.

1) About Family Action

Family Action has been a leading provider of services to disadvantaged and socially isolated families since 1869. We work with over 45,000 vulnerable families and children a year by providing practical, emotional and financial support through over 100 community-based services across England. Additionally in 2009-2010 we distributed 4,218 grants totalling over £1,104,883 to families and individuals in financial hardship throughout the UK. Family Action won the 2009 Charity Awards Foundation award for effectiveness and jointly with CAB, Gingerbread and our sponsors Barclaycard the 2010 Third Sector Award for best corporate partnership for Horizons, an integrated welfare advice, training and educational grants package for lone parents. Find Family Action on the Web at www.family-action.org.uk.

Family Action works with vulnerable families in the home, providing early intervention services that strengthen families, assisting them to take more responsibility for their lives, parent their children, where appropriate, helping them to move towards employment.

As such we are very supportive of the Government's efforts to introduce a system which will improve the financial incentives to move into and progress in, employment. It is for this reason we think it particularly important for the Government to act now to address issues with the Universal Credit, which may undermine its progressive intentions.

We are very happy to further discuss any aspect of this briefing. To contact us please e-mail sam.royston@family-action.org.uk or telephone 02072 417604.

1) The Problem

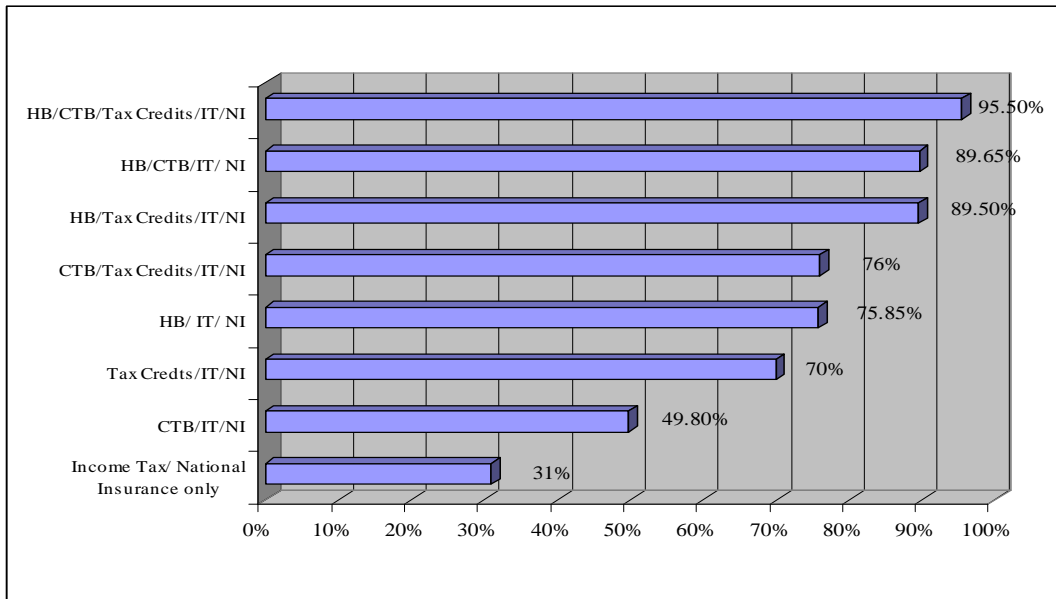
The Government has often talked about the limited incentives that working benefit claimants currently have to earn more money by working longer hours, or by increasing their rate of pay. As the first chapter of the White Paper highlights:

“Once in receipt of Working Tax Credit, greater effort also often receives little or no financial reward as Tax Credits, Housing Benefit and Council Tax Benefit are withdrawn at the same time as liability for Income Tax and National Insurance contributions increase.

“The combined effect of benefit withdrawal rates and additional tax as earnings increase is called the Marginal Deduction Rate and has the same practical effect as a tax rate. Currently, when combined with tax and National Insurance payments, the withdrawal of Tax Credits, Housing Benefit and Council Tax Benefit can lead to Marginal Deduction Rates which are nearly 96 per cent, much higher than the highest rate of Income Tax.”¹

Family Action agrees that work progression incentives (what the white paper calls “earnings incentives”), can currently be very poor. The chart below illustrates current Marginal Deduction Rates (MDRs) for a variety of different combinations of benefits which tax paying working households might be entitled to.

Chart 1: current Marginal Deduction Rates for working households paying income tax and national insurance with a range of combinations of benefit and tax credit receipts (HB= Housing Benefit, CTB= Council Tax Benefit, IT= Income Tax, NI= National insurance, Tax Credits=Tax Credits at more than the Family element)



¹ DWP (2010) “*Universal Credit: Welfare that works*”, page 8

The Universal Credit proposes to introduce a single benefit taper rate of 65% of net income. For households with a worker paying Income Tax and National insurance, this creates an overall Marginal Deduction Rate of 76%² meaning that for each additional pound they earn they keep 24p.

For many working households receiving a combination of Housing Benefit, Council Tax Benefit and Tax Credits, and paying Income Tax and National Insurance, the Universal Credit has the potential to substantially reduce their MDR from around 90% or more, to 76%. As the paper puts it:

“the highest Marginal Deduction Rate for low-earning workers would be reduced from around 96 per cent to 65 per cent for those earning below the personal tax threshold and to around 76 per cent for basic rate taxpayers.”³

Family Action is pleased that the Universal Credit should achieve this for some households with the highest Marginal Deduction Rates⁴. The Treasury estimate that around 270,000 households face marginal deduction rates in excess of 80%. The Universal Credit could substantially reduce MDRs for many of these households.

However, as can also be seen in chart 1 at present, people in receipt of tax credits (above the family element) and paying income tax and national insurance (a large proportion of low to middle income working households), currently pay a Marginal Deduction Rate of 70% (meaning that for each additional £1 they earn, they keep 30p).⁵ Since Marginal Deduction Rates for tax paying Universal Credit recipients would be 76%, then assuming they have their tax credit allowance replaced with some assistance through the Universal Credit, these households would face higher Marginal Deduction Rates under the Universal Credit than under the current system.

2) Estimated numbers affected

A large number of working households pay Income Tax and National Insurance, and receive tax credits but do not receive other means-tested benefits. As highlighted above, for these households, the Universal Credit changes are going to reduce their incentive to progress in work. Based on figures produced in the June budget⁶, it can be estimated that as many as

² To be precise, were the Universal Credit to be introduced now, maximum Marginal Deduction Rates would be 75.85%, following the 1% rise in National Insurance contributions, the rate would be 76.2%.

³ DWP (2010) “*Universal Credit: Welfare that works*”, page 15

⁴ As discussed in detail below, we would need to see the Government’s plans for help with council tax and childcare costs before we can confirm which households would benefit

⁵ This will increase to 73% after the 1p increase in National Insurance Contributions, and 2% rise in Tax Credit tapers from April 2011.

⁶ HM Treasury (June 2010) “Budget 2010” p68-69

Table A3 on page 69 of the June budget shows that in 2010/11 330,000 households face MTRs of over 70%. In 2011/12 this would increase to 1,680,000 under changes introduced by the previous Government. The notes highlight that the increase of 1,350,000 households is the result of the 1% increase in National Insurance Contributions. It is reasonable to assume these households, currently facing MTRs of 70%, are paying Income

1,350,000 households currently face Marginal Deduction Rates of 70% caused by a combination of paying tax and receiving Tax Credits. Were they to receive Universal Credit instead of Tax Credits, these households would have their MDRs increased to 76%.

The June budget figures indicate that, excluding households currently facing a Marginal Deduction Rate of 70%, around 330,000 working households currently face a Marginal Deduction Rate between 70 and 100% (and around 270,000 have an MDR of over 80%). Given this, it is reasonable to estimate that considerably more tax paying, working households in receipt of means tested benefits would face reduced, rather than increased work progression incentives under the Universal Credit.

It is notable that in the reforms proposed in the Centre for Social Justice (CSJ) paper "Dynamic Benefits" a taper rate of 55% was proposed for the Universal Credit. The model the CSJ used suggests that this taper rate is very efficient since:

*"It reduces disincentives to work, while avoiding increasing the MTRs at higher earning levels in a counterproductive way."*⁷

Were the Government to implement this taper rate, households in receipt of the Universal Credit and paying income tax and national insurance would face an overall taper of 69.4% - almost exactly the same as current taper rates for households paying income tax and national insurance, and receiving tax credits.

It may be argued that it is more important for the Universal Credit to reduce extremely high Marginal Deduction Rates (those in excess of 80%) than it is to prevent high Marginal Deduction Rates (those of 70%) from rising. As currently envisaged the Universal Credit could improve work incentives for many of these households. However, in order to do so, key problems of how Council Tax Benefit and help with childcare costs are integrated into the system would need to be addressed.

3) Childcare costs and Council Tax Benefit

The Government has promised that under the Universal Credit, Marginal Deduction Rates will not exceed 76.2%. As Iain Duncan Smith put it:

*"The highest marginal deduction rates for in-work households will fall from 95.8% to an absolute limit of 76.2%-that is with the conjunction of tax and the withdrawal-and there will be a single taper rate of about 65% before tax."*⁸

Tax and National insurance, receiving Tax Credits at more than the family element, but no other means tested benefits.

Treasury figures are for working heads of families in receipt of income-related benefits or tax credits where at least one person works at least 16 hours per week, and the head of the family is not receiving pensioner or disability premia.

⁷ The Centre for Social Justice (2009) "Dynamic Benefits: Towards welfare that works" p229

⁸ <http://www.theyworkforyou.com/debates/?id=2010-11-11b.438.0&s=douglas+alexander#g440.0>

However, in calculating this figure, the Government do not appear to have considered the impact of integrating childcare costs, and of Council Tax benefit into the system. The potential impact of integrating these into the Universal Credit system, could have a substantial impact on Marginal Deduction Rates.

3.1. Council Tax Benefit

Council Tax Benefit has explicitly been left out of the Universal Credit. Although changes are going to happen, it is unclear exactly what the Government plan to do about council tax benefit, although the Universal Credit White Paper (p23) simply states:

“Universal Credit will replace most of the benefits and Tax Credits that currently provide means-tested support apart from Council Tax Benefit.... We are planning to give Local Authorities a greater say in the help that people on low incomes get with their Council Tax bills in ways that will protect the most vulnerable and complement Universal Credit.”

Were the Government to provide some form of means tested help with Council Tax, the withdrawal of Council Tax Benefit (or whatever it is replaced with) for higher earning households could act as a further work progression disincentive.

The withdrawal rate on Council Tax Benefit is currently 20%, meaning that for each £1 of eligible income above the personal applicable amount for a CTB recipient, the claimant loses 20p of Council Tax Benefit.

Were a withdrawal rate of 20% to be maintained for income net of tax and Universal Credit, a tax paying, Universal Credit recipient who also received Council Tax Benefit would have a Marginal Deduction Rate of not 76% but 81%.⁹

3.2. Childcare costs

Parents in can currently receive support for childcare costs through the childcare element of Working Tax Credit. They can currently receive additional support of up to 80% of help with childcare costs, (the Universal Credit White paper notes that from 2011 this reduces to 70%).

In addition (although this is not noted in the White Paper - and is very broadly unrecognised) childcare costs are currently disregarded for the purposes of calculating entitlement to Housing Benefit and Council Tax Benefit (so families with high childcare costs may receive more HB/CTB). As a result of this, some households can currently receive help with up to 97% of their childcare costs.

⁹ MTR for individual paying Income Tax and National Insurance, and receiving Universal Credit is 76.2%, leaving a claimant 24p in each extra pound they earn. 20% of 24p is 4.8p, so after council tax paid at 20% net of tax and UC, the claimant keeps 19p in each additional pound they earn.

The Government have not yet determined how help with childcare costs will be integrated into the Universal Credit. The white paper sets out three possible options:

- An additional amount for childcare on top of the basic Universal Credit award, at similar rates to those currently offered.
- Recognising childcare through an additional earnings disregard rather than an additional payment.
- Providing support for childcare through a voucher or discount scheme, rather than as part of the Universal Credit award.

The following sections address each of these options in turn.

In England, childcare costs are an average of £88 for 25 hours per week¹⁰ (in some areas this could be considerably higher). Using this assumption gives an hourly average cost of around £3.50. For a parent earning £6 per hour, this makes childcare cost around 58% of earnings.

Based upon this, in the following calculations it is assumed that for each extra £1 earned, childcare costs an additional 58p for one child.

3.2.1. An additional amount for childcare on top of the basic Universal Credit award, at similar rates to those currently offered.

The following calculation highlights the impact on effective Marginal Deduction Rates (including childcare costs as a deduction) if the Universal Credit were introduced with an element simply covering 70% of childcare costs:

On earning an additional pound, and paying an additional 58p in childcare costs:

- *The claimant pays additional tax and national insurance of 32p.*
- *To take account of their additional childcare costs, the claimant gains 40.6p in maximum Universal Credit entitlement (70% of 58p).*
- *However, the claimant faces a means tested deduction of 44.2p from their Universal Credit entitlement.*
- *In addition, they pay an additional 58p out in childcare costs.*
- *The claimant **keeps 6.4p.***

Under this situation, the claimant's effective Marginal Deduction Rate (including childcare costs) is **93.6%**.

¹⁰ <http://www.daycaretrust.org.uk/pages/childcare-costs-surveys.html>

The above calculation assumes childcare costs for one child of 58p for each additional £1 earned. Assuming 80p childcare costs to cover 2 children, the effective MDR is substantially higher:

- *The claimant pays additional tax and national insurance of 32p.*
- *To take account of their additional childcare costs, the claimant gains 56p in maximum Universal Credit entitlement (70% of 80p).*
- *However, the claimant faces a means tested deduction of 44.2p from their Universal Credit entitlement.*
- *In addition, they pay an additional 80p out in childcare costs.*
- *The claimant **loses 0.2p.***

In this case, the claimant's effective MDR (including childcare costs) reaches 100%.

3.2.2. Recognising childcare through an additional earnings disregard rather than an additional payment.

An alternative is to increase the earnings disregard within the Universal Credit by an amount equivalent to the claimant's childcare costs.

The following calculation indicates the impact on Marginal Deduction Rates, were childcare costs to be disregarded for the purposes of the Universal Credit:

On earning an additional pound, and paying an additional 58p in childcare costs:

- *The claimant pays additional tax and national insurance of 32p.*
- *The claimant faces a means tested deduction of 6.5p from their Universal Credit entitlement (taking into account the disregarded childcare costs).*
- *In addition, they pay an additional 58p out in childcare costs.*
- *The claimant **keeps 3.5p.***

Under this situation, the claimant's effective Marginal Deduction Rate (Including childcare costs) is **96.5%**.

Again, the above calculation assumes childcare costs for one child of 58p for each additional £1 earned. Assuming 80p childcare costs to cover 2 children, the effective MDR is substantially higher:

- *The claimant pays additional tax and national insurance of 32p.*
- *The claimant gets an increase of 7.8p in their Universal Credit entitlement (taking into account the disregarded childcare costs).*
- *However, they pay an additional 80p out in childcare costs.*
- *The claimant **loses 4.2p.***

Again, in this case, the claimant's effective MDR (including childcare costs) exceeds 100%. This time reaching **104.2%**.

3.2.3. Providing support for childcare through a voucher or discount scheme, rather than as part of the Universal Credit award.

The potential impact of this is difficult to measure. However, assuming the Government is not proposing to introduce Universal childcare vouchers (paid regardless of income,) some form of means testing will need to be applied. In addition, such vouchers may not cover the full cost of childcare. In either case, the introduction of vouchers would also increase Marginal Deduction Rates for households with childcare costs.

3.2.4. How do these options compare with the current system?

Before dismissing these options it is worth comparing them to current levels of assistance.

The following calculation highlights the impact on effective Marginal Deduction Rates (including childcare costs as a deduction) at current rates, with a childcare element of WTC which covers 80% of childcare costs for a family paying Income Tax and National Insurance, and receiving Tax Credits but not other means tested benefits:

On earning an additional pound, and paying an additional 58p in childcare costs:

- *The claimant pays additional tax and national insurance of 31p.*
- *To take account of their additional childcare costs, the claimant gains 46.4p in maximum Working Tax Credit entitlement (80% of 58p).*
- *However, the claimant faces a means tested deduction of 39p from their Tax Credit entitlement.*
- *In addition, they pay an additional 58p out in childcare costs.*
- *The claimant **keeps 18.4p.***

Under this situation, the claimant's effective Marginal Deduction Rate (including childcare costs) is **81.6%**.

The above calculation assumes childcare costs for one child of 58p for each additional £1 earned. Assuming 80p childcare costs to cover 2 children, the effective MDR is substantially higher:

- *The claimant pays additional tax and national insurance of 31p.*
- *To take account of their additional childcare costs, the claimant gains 64p in maximum Working Tax Credit entitlement (80% of 80p).*
- *However, the claimant faces a means tested deduction of 39p from their Tax Credit entitlement.*
- *In addition, they pay an additional 80p out in childcare costs.*
- *The claimant **keeps 14p.***

In this case, the claimant's effective MDR (including childcare costs) is **86%**.

These calculations assume households do not receive Housing Benefit or Council Tax Benefit. For households in receipt of these benefits, and paying childcare costs, MDRs can be considerably higher, but even with childcare costs of 80p for each additional pound earned, MDRs do not exceed 100% - reaching a maximum of 97.9%.

As can be seen from the calculations above, none of the Government's proposals so far are entirely satisfactory. These childcare assumptions (which are based on average hourly childcare costs), indicate that the Universal Credit system could create Marginal Deduction Rates in excess of 90%. For families with two or more children in childcare (and so higher hourly childcare costs), Marginal Deduction Rates including childcare could end up in excess of 100%. This compares unfavourably to Marginal Deduction Rates (including childcare costs) for families with childcare costs under the current system.

4) Policy recommendations

Family Action believe that the following adjustments to the Universal Credit need to be introduced to ensure that it does not reduce incentives to progress in work.

- Reduction of the overall Universal Credit taper rate to 55%. This would help to ensure an overall taper rate of less than 70%, meaning that households paying Income Tax and National Insurance, and receiving Tax Credits at more than the Family Element rate, did not lose out.
- The Government should include Council Tax Benefit in the Universal Credit. This would ensure that a separate income taper would not be introduced which undermined the principle of a single withdrawal rate.
- The Government need to be clear about what they plan to do about childcare costs. Some of the alternatives which they present could risk leaving many households with less incentive to progress in work than they do at the present. Family Action will set out its own proposals for dealing with childcare costs in later policy briefs.